

SCANSOURCE INC  
Form 10-Q  
May 09, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the**  
**Quarterly Period Ended March 31, 2008**

Commission File Number: 000-26926

***ScanSource, Inc.***

(Exact name of registrant as specified in its charter)

**SOUTH CAROLINA**  
(State or other jurisdiction of  
incorporation or organization)

**57-0965380**  
(I.R.S. Employer  
Identification No.)

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6 Logue Court

Greenville, South Carolina, 29615

(Address of principal executive offices)

(864) 288-2432

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)  Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                                | Outstanding at May 7, 2008 |
|--------------------------------------|----------------------------|
| Common Stock, no par value per share | 26,274,932 shares          |

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**SCANSOURCE, INC.**

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*Cautionary Statement*

Certain of the statements contained in this Form 10-Q, as well as in the Company's other filings with the Securities and Exchange Commission (SEC), that are not historical facts are forward-looking statements subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. The Company cautions readers of this report that a number of important factors could cause the Company's activities and/or actual results in fiscal 2008 and beyond to differ materially from those expressed in any such forward-looking statements. These factors include:

- fluctuations in interest rates
- the impact of changes in income tax legislation
- exposure to natural disasters

and other factors described herein and in other reports and documents filed by the Company with the SEC, including Item 1A, Risk Factors, of the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2007.

Additional discussion of these and other factors affecting our business and prospects is contained in our periodic filings with the SEC, copies of which can be obtained at the Investor Relations section of our website at [www.scansourceinc.com](http://www.scansourceinc.com). We provide our annual and quarterly reports free of charge on [www.scansourceinc.com](http://www.scansourceinc.com), as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC. We provide a link to all SEC filings where our periodic reports and current reports on Form 8-K and any amendments to previously filed reports may be accessed, free of charge.

**Table of Contents****PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements****SCANSOURCE, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)****(In thousands, except for share information)**

|   | <b>March 31,<br/>2008</b> | <b>June 30,<br/>2007 *</b> |
|---|---------------------------|----------------------------|
| <b>Assets</b>   |                           |                            |
| Current assets:   |                           |                            |
| Cash and cash equivalents   | \$ 5,973                  | \$ 1,864                   |
| Trade and notes receivable:   |                           |                            |
| Trade, less allowance of \$15,461 at March 31, 2008 and \$13,342 at June 30, 2007   | 337,662                   | 349,961                    |
| Other receivables   | 10,371                    | 6,755                      |
| Inventories   | 296,883                   | 272,012                    |
| Prepaid expenses and other assets   | 4,886                     | 10,444                     |
| Deferred income taxes   | 12,519                    | 12,102                     |
| Total current assets  | 668,294                   | 653,138                    |
| Property and equipment, net   | 22,633                    | 26,781                     |
| Goodwill  | 29,909                    | 29,361                     |
| Other assets, including identifiable intangible assets  | 30,820                    | 29,168                     |
| Total assets  | \$ 751,656                | \$ 738,448                 |
| <b>Liabilities and Shareholders Equity</b>  |                           |                            |
| Current liabilities:  |                           |                            |
| Current portion of long-term debt   | \$                        | \$ 200                     |
| Short-term borrowings   | 1,266                     | 3,490                      |
| Trade accounts payable  | 222,151                   | 256,883                    |
| Accrued expenses and other liabilities  | 37,226                    | 35,254                     |
| Income taxes payable  | 5,549                     | 4,356                      |
| Total current liabilities   | 266,192                   | 300,183                    |
| Long-term debt  | 28,888                    | 17,216                     |
| Borrowings under revolving credit facility  | 69,499                    | 90,314                     |
| Other long-term liabilities   | 8,102                     | 5,475                      |
| Total liabilities   | 372,681                   | 413,188                    |
| Minority interest   |                           | 516                        |
| Commitments and contingencies   |                           |                            |
| Shareholders equity:  |                           |                            |
| Preferred stock, no par value; 3,000,000 shares authorized, none issued   |                           |                            |
| Common stock, no par value; 45,000,000 shares authorized, 26,271,532 and 25,855,724 shares issued and outstanding at March 31, 2008 and June 30, 2007, respectively | 94,273                    | 83,653                     |

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|  |            |            |
|--|------------|------------|
| Retained earnings                          | 275,667    | 234,502    |
| Accumulated other comprehensive income     | 9,035      | 6,589      |
| Total shareholders' equity                 | 378,975    | 324,744    |
| Total liabilities and shareholders' equity | \$ 751,656 | \$ 738,448 |

\* Derived from audited consolidated financial statements  
*See Notes to Consolidated Financial Statements*

**Table of Contents****SCANSOURCE, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED INCOME STATEMENTS (UNAUDITED)****(In thousands, except per share data)**

|   | Quarter ended<br>March 31, |            | Nine months ended<br>March 31, |              |
|---|----------------------------|------------|--------------------------------|--------------|
|   | 2008                       | 2007       | 2008                           | 2007         |
| Net sales   | \$ 514,420                 | \$ 492,678 | \$ 1,621,455                   | \$ 1,462,642 |
| Cost of goods sold  | 462,701                    | 441,641    | 1,452,435                      | 1,306,990    |
| Gross profit  | 51,719                     | 51,037     | 169,020                        | 155,652      |
| Operating expenses:   |                            |            |                                |              |
| Selling, general and administrative expenses                                  | 32,723                     | 33,795     | 99,238                         | 101,014      |
| Operating income  | 18,996                     | 17,242     | 69,782                         | 54,638       |
| Other expense (income):   |                            |            |                                |              |
| Interest expense  | 1,097                      | 1,939      | 4,496                          | 5,464        |
| Interest income   | (401)                      | (246)      | (1,108)                        | (529)        |
| Other, net  | 286                        | 141        | (118)                          | (420)        |
| Other expense, net  | 982                        | 1,834      | 3,270                          | 4,515        |
| Income before income taxes and minority interest                              | 18,014                     | 15,408     | 66,512                         | 50,123       |
| Provision for income taxes  | 6,986                      | 5,326      | 25,347                         | 18,743       |
| Income before minority interest   | 11,028                     | 10,082     | 41,165                         | 31,380       |
| Minority interest in income of consolidated subsidiaries, net of income taxes |                            | 11         |                                | 57           |
| Net income  | \$ 11,028                  | \$ 10,071  | \$ 41,165                      | \$ 31,323    |
| Per share data:   |                            |            |                                |              |
| Net income per common share, basic  | \$ 0.42                    | \$ 0.39    | \$ 1.59                        | \$ 1.22      |
| Weighted-average shares outstanding, basic                                    | 26,038                     | 25,770     | 25,934                         | 25,749       |
| Net income per common share, diluted  | \$ 0.42                    | \$ 0.38    | \$ 1.56                        | \$ 1.19      |
| Weighted-average shares outstanding, diluted                                  | 26,423                     | 26,194     | 26,325                         | 26,213       |

*See Notes to Consolidated Financial Statements*

**Table of Contents****SCANSOURCE, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)**

(In thousands, except share data)

|  | Common<br>Stock<br>(Shares) | Common<br>Stock<br>(Amount) | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|--|-----------------------------|-----------------------------|----------------------|---|------------|
| Balance at June 30, 2007   | 25,855,724                  | \$ 83,653                   | \$ 234,502           | \$ 6,589  | \$ 324,744 |
| Comprehensive Income:  |                             |                             |                      |   |            |
| Net income   |                             |                             | 14,687               |   | 14,687     |
| Foreign currency translation adjustment  |                             |                             |                      | 1,108   | 1,108      |
| Total comprehensive income   |                             |                             |                      |   | 15,795     |
| Exercise of stock options  | 10,468                      | 129                         |                      |   | 129        |
| Share based compensation   |                             | 929                         |                      |   | 929        |
| Tax benefit of deductible compensation arising from exercise of stock options    |                             | 155                         |                      |   | 155        |
| Balance at September 30, 2007  | 25,866,192                  | \$ 84,866                   | \$ 249,189           | \$ 7,697  | \$ 341,752 |
| Comprehensive Income:  |                             |                             |                      |   |            |
| Net income   |                             |                             | 15,450               |   | 15,450     |
| Foreign currency translation adjustment  |                             |                             |                      | 4   | 4          |
| Total comprehensive income   |                             |                             |                      |   | 15,454     |
| Exercise of stock options  | 71,210                      | 1,342                       |                      |   | 1,342      |
| Share based compensation   |                             | 1,175                       |                      |   | 1,175      |
| Tax benefit of deductible compensation arising from exercise of stock options    |                             | 55                          |                      |   | 55         |
| Consideration received from certain officers related to remediation activities   |                             | 751                         |                      |   | 751        |
| Reclassification of additional-paid-in-capital related to remediation activities |                             | (393)                       |                      |   | (393)      |
| Balance at December 31, 2007   | 25,937,402                  | \$ 87,796                   | \$ 264,639           | \$ 7,701  | \$ 360,136 |
| Comprehensive Income:  |                             |                             |                      |   |            |
| Net income   |                             |                             | 11,028               |   | 11,028     |
| Unrealized loss on hedged transaction, net of tax                                |                             |                             |                      | (424)   | (424)      |
| Foreign currency translation adjustment  |                             |                             |                      | 1,758   | 1,758      |
| Total comprehensive income   |                             |                             |                      |   | 12,362     |
| Exercise of stock options  | 334,130                     | 5,389                       |                      |   | 5,389      |
| Share based compensation   |                             | 1,088                       |                      |   | 1,088      |

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|                           |            |           |            |          |            |
|---------------------------|------------|-----------|------------|----------|------------|
| Balance at March 31, 2008 | 26,271,532 | \$ 94,273 | \$ 275,667 | \$ 9,035 | \$ 378,975 |
|---------------------------|------------|-----------|------------|----------|------------|

*See Notes to Consolidated Financial Statements*



**Table of Contents****SCANSOURCE, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)****(In thousands)**

|  | <b>Nine months ended March 31,</b> |                 |
|--|------------------------------------|-----------------|
|  | <b>2008</b>                        | <b>2007</b>     |
| <b>Cash flows from operating activities:</b>   |                                    |                 |
| Net income   | \$ 41,165                          | \$ 31,323       |
| <b>Adjustments to reconcile net income to net cash provided by (used in) operating activities:</b> |                                    |                 |
| Depreciation   | 3,521                              | 3,808           |
| Amortization of intangible assets  | 1,806                              | 1,345           |
| Allowance for accounts and notes receivable  | 3,532                              | 7,017           |
| Share-based compensation and restricted stock  | 3,847                              | 2,884           |
| Asset impairment   | 202                                | 148             |
| Deferred income tax (expense)  | (641)                              | (1,346)         |
| Excess tax benefits from share-based payment arrangements  | (210)                              | (2,105)         |
| Minority interest in income of subsidiaries  |                                    | 57              |
| <b>Changes in operating assets and liabilities, net of acquisitions:</b>                           |                                    |                 |
| Trade and notes receivable   | 20,156                             | (27,853)        |
| Other receivables  | (12,509)                           | (2,795)         |
| Inventories  | (17,721)                           | (40,835)        |
| Prepaid expenses and other assets  | 5,746                              | (699)           |
| Other noncurrent assets  | (1,465)                            | (1,092)         |
| Trade accounts payable   | (40,385)                           | (22,611)        |
| Accrued expenses and other liabilities   | 2,954                              | 3,950           |
| Income taxes payable   | (138)                              | (411)           |
| <b>Net cash provided by (used in) operating activities</b>   | <b>9,860</b>                       | <b>(49,215)</b> |
| <b>Cash flows from investing activities:</b>   |                                    |                 |
| Capital expenditures   | (5,618)                            | (2,501)         |
| Net proceeds from sale of property and equipment   | 6,100                              |                 |
| Cash paid for business acquisitions, net of cash acquired  | (2,305)                            | (50,585)        |
| <b>Net cash used in investing activities</b>   | <b>(1,823)</b>                     | <b>(53,086)</b> |
| <b>Cash flows from financing activities:</b>   |                                    |                 |
| (Decreases) increases in short-term borrowings, net  | (2,513)                            | 2,877           |
| (Payments) advances on revolving credit, net of expenses   | (20,956)                           | 82,616          |
| Exercise of stock options & Section 16 remediation   | 7,350                              | 970             |
| Excess tax benefits from share-based payment arrangements  | 210                                | 2,105           |
| Advances (repayments) of long-term debt borrowings   | 11,471                             | 12,841          |
| <b>Net cash (used in) provided by financing activities</b>   | <b>(4,438)</b>                     | <b>101,409</b>  |
| Effect of exchange rate changes on cash and cash equivalents                                       | 510                                | 97              |
| <b>Increase (decrease) in cash and cash equivalents</b>  | <b>4,109</b>                       | <b>(795)</b>    |
| Cash and cash equivalents at beginning of period   | 1,864                              | 3,831           |

|  |          |          |
|--|----------|----------|
| Cash and cash equivalents at end of period | \$ 5,973 | \$ 3,036 |
|--|----------|----------|

*See Notes to Consolidated Financial Statements*

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**SCANSOURCE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**(1) Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of ScanSource, Inc. (the Company) have been prepared by the Company's management in accordance with U.S. generally accepted accounting principles for interim financial information and applicable rules and regulations of the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for annual financial statements. The unaudited condensed consolidated financial statements included herein contain all adjustments (consisting of normal recurring adjustments) which are, in the opinion of management, necessary to present fairly the financial position as of March 31, 2008 and June 30, 2007, the results of operations for the quarter and nine month periods ended March 31, 2008 and 2007 and the statement of cash flows for the nine month periods ended March 31, 2008 and 2007. The results of operations for the quarters and nine months ended March 31, 2008 and 2007 are not necessarily indicative of the results to be expected for a full year. These financial statements should be read in conjunction with the audited condensed consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2007.

**(2) Business Description**

The Company is a leading wholesale distributor of specialty technology products, providing value-added distribution sales to resellers in the specialty technology markets. The Company has two geographic distribution segments: one serving North America from the Southaven, Mississippi distribution center, and an international segment currently serving Latin America (including Mexico) and Europe from distribution centers located in Florida and Mexico, and in Belgium, respectively. The North American distribution segment markets automatic identification and data capture (AIDC) and point-of-sale (POS) products through its ScanSource POS and Barcoding sales unit; voice, data and converged communications equipment through its Catalyst Telecom sales unit; video conferencing, telephony, and communications products through its ScanSource Communications unit; and electronic security products and wireless infrastructure products through its ScanSource Security Distribution unit. The international distribution segment markets AIDC and POS products through its ScanSource Latin American and European sales units. On April 4, 2008, the Company announced it had expanded its communications business internationally through the acquisition of MTV Telecom (Distribution) PLC, a UK-based distributor of voice and data solutions.

**(3) Summary of Significant Accounting Policies and Accounting Standards Recently Issued**

*Consolidation Policy*

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All significant inter-company accounts and transactions have been eliminated.

*Minority Interest*

Minority interest represents that portion of the net equity of majority-owned subsidiaries of the Company held by minority shareholders. The minority shareholders' share of the subsidiaries' income or loss is listed separately in the Condensed Consolidated Income Statements. Effective July 1, 2007, the Company owns 100% of Netpoint International, Inc. (Netpoint).

*Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its estimates, including those related to the allowance for uncollectible accounts receivable and inventory reserves. Management bases its estimates on assumptions that management believes to be reasonable under the circumstances, the results of which form a basis for making judgments about the carrying value of assets and liabilities that are not readily available from other sources. Actual results may differ from these estimates under different assumptions or conditions; however, management believes that its estimates, including those for the above described items, are reasonable and that the actual results will not vary significantly from the estimated amounts.

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The following significant accounting policies relate to the more significant judgments and estimates used in the

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preparation of the condensed consolidated financial statements:

### *(a) Allowances for Trade and Notes Receivable*

The Company maintains an allowance for uncollectible accounts receivable for estimated losses resulting from customers' failure to make payments on accounts receivable due to the Company. Management determines the estimate of the allowance for uncollectible accounts receivable by considering a number of factors, including: (1) historical experience, (2) aging of the accounts receivable and (3) specific information obtained by the Company on the financial condition and the current creditworthiness of its customers. If the financial condition of the Company's customers were to deteriorate and reduce the ability of the Company's customers to make payments on their accounts, the Company may be required to increase its allowance by recording additional bad debt expense. Likewise, should the financial condition of the Company's customers improve and result in payments or settlements of previously reserved amounts, the Company may be required to record a reduction in bad debt expense to reverse the recorded allowance. A provision for estimated losses on returns and allowances is recorded at the time of sale based on historical experience.

### *(b) Inventory Reserves*

Management determines the inventory reserves required to reduce inventories to the lower of cost or market based principally on the effects of technological changes, quantities of goods on hand, and other factors. An estimate is made of the market value, less cost to dispose, of products whose value is determined to be impaired. If these products are ultimately sold at less than estimated amounts, additional reserves may be required. Likewise, if these products are sold for more than the estimated amounts, reserves may be reduced.

### *Reclassifications*

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

### *Cash and Cash Equivalents*

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. Checks released but not yet cleared at the Company's bank of \$30.3 million as of March 31, 2008 and \$45.7 million as of June 30, 2007 are included in accounts payable.

### *Derivative Financial Instruments*

The Company uses derivative instruments to manage certain exposures related to foreign currency as well as changes in interest rates as a result of our borrowing activities. We record all derivative instruments as either assets or liabilities in the balance sheet at fair value. The Company currently does not use derivative financial instruments for trading or speculative purposes.

The Company's foreign currency exposure results from purchasing and selling internationally in several foreign currencies. In addition, the Company has foreign currency risk related to debt that is denominated in currencies other than the U.S. Dollar. The Company may reduce its exposure to fluctuations in foreign exchange rates by creating offsetting positions through the use of derivative financial instruments or multi-currency borrowings. The market risk related to the foreign exchange agreements is offset by changes in the valuation of the underlying items. Derivative financial instruments related to foreign currency exposure are accounted for on an accrual basis with gains and losses on these contracts recorded in income in the period in which their value changes, with the offsetting entry for unsettled positions reflected in either other assets or other liabilities. These contracts are generally for a duration of 90 days or less. The Company has elected not to designate its foreign currency contracts as hedging instruments. They are, therefore, marked-to-market with changes in their value recorded in the Condensed Consolidated Income Statement each period. The underlying exposures are denominated primarily in British Pounds, Euros, and Canadian Dollars. To date, the activity and outstanding contracts related to these instruments have not been material.

In the quarter ended March 31, 2008, the Company entered into an interest rate swap and designated this instrument as a hedge of the cash flows on certain variable rate debt. To the extent the derivative instrument is effective in offsetting the variability of the hedged cash flows, changes in the fair value of the derivative instrument will not be included in current earnings, but will be reported as other comprehensive income (loss). The ineffective portion, if any, will be recorded as an adjustment to earnings.



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### *Inventories*

Inventories (consisting entirely of finished goods) are stated at the lower of cost (first-in, first-out method) or market.

### *Vendor Programs*

The Company receives incentives from vendors related to cooperative advertising allowances, volume rebates and other incentive agreements. These incentives are generally under quarterly, semi-annual or annual agreements with the vendors. Some of these incentives are negotiated on an ad hoc basis to support specific programs mutually developed between the Company and the vendor. Vendors generally require that the Company uses their cooperative advertising allowances exclusively for advertising or other marketing programs. Incentives received from vendors for specifically identified incremental cooperative advertising programs are recorded as adjustments to selling, general and administrative expenses. Emerging Issues Task Force ( EITF ) Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor* ( EITF 02-16 ) requires that the portion of these vendor funds in excess of our costs to be reflected as a reduction of inventory. Such funds are recognized as a reduction of the cost of products sold when the related inventory is sold.

The Company records unrestricted volume rebates received as a reduction of inventory and as a reduction of the cost of goods sold when the related inventory is sold. Amounts received or receivable from vendors that are not yet earned are deferred in the Condensed Consolidated Balance Sheets. In addition, the Company may receive early payment discounts from certain vendors. The Company records early payment discounts received as a reduction of inventory and recognizes the discount as a reduction of cost of goods sold when the related inventory is sold. EITF 02-16 requires management to make certain estimates of the amounts of vendor incentives that will be received. Actual recognition of the vendor consideration may vary from management estimates based on actual results.

### *Product Warranty*

The Company's vendors generally provide a warranty on the products distributed by the Company and allow the Company to return defective products, including those that have been returned to the Company by its customers. In one product line, the Company offers certain warranty service programs and records a provision for estimated service warranty costs at the time of sale, adjusting periodically to reflect actual experience. To date, neither warranty expense nor the accrual for warranty costs has been material to the Company's condensed consolidated financial statements. For all other product lines, the Company does not independently provide a warranty on the products it distributes; however, to maintain customer relations, the Company facilitates returns of defective products of the Company's customers by accepting for exchange, with the Company's prior approval, most defective products within 30 days of invoicing.

### *Property and Equipment, and Other Assets (except Other Identifiable Intangible Assets)*

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over estimated useful lives of 3 to 10 years for furniture, equipment and computer software, 40 years for buildings and 15 years for building improvements. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life. Maintenance, repairs and minor renewals are charged to expense as incurred. Additions, major renewals and betterments to property and equipment are capitalized.

### *Goodwill*

The Company accounts for recorded goodwill in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets*, which revised the standards of accounting for goodwill, by replacing the amortization of these assets with the requirement that they are reviewed annually for impairment, or more frequently if impairment indicators exist. See Note 8, *Goodwill and Intangible Assets* for a discussion of the annual goodwill impairment test.

### *Intangible Assets*

Intangible assets consist of customer lists, debt issue costs, trade names, and non-compete agreements. Customer lists are amortized using the straight-line method over their estimated useful lives, which range from 5 to 15 years. Debt issue costs are amortized over the term of the credit facility. Trade names are amortized over their estimated useful lives, which ranges from 2 to 10 years. Non-compete agreements are amortized over their contract life. These assets are included in other assets and are shown in detail in Note 8, *Goodwill and Intangible Assets* .





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### *Impairment of Long-Lived Assets*

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset or asset group may not be recoverable. Tests for recoverability of a long-lived asset to be held and used are measured by comparing the carrying amount of the long-lived asset to the sum of the estimated future undiscounted cash flows expected to be generated by the asset. In estimating the future undiscounted cash flows the Company uses projections of cash flows directly associated with, and which are expected to arise as a direct result of, the use and eventual disposition of the assets. If it is determined that a long-lived asset is not recoverable, an impairment loss would be calculated equal to the excess of the carrying amount of the long-lived asset over its fair value.

### *Fair Value of Financial Instruments*

The fair value of financial instruments is the amount at which the instrument could be exchanged in a current transaction between willing parties. The carrying values of financial instruments such as accounts receivable, accounts payable, accrued liabilities, borrowings under the revolving credit facility and subsidiary lines of credit approximate fair value based upon either short maturities or variable interest rates of these instruments.

### *Contingencies*

The Company accrues for contingent obligations, including estimated legal costs, when it is probable that a liability is incurred and the amount is reasonably estimable. As facts concerning contingencies become known, management reassesses its position and makes appropriate adjustments to the financial statements. Estimates that are particularly sensitive to future changes include tax, legal, and other regulatory matters, which are subject to change as events evolve and as additional information becomes available during the administrative and litigation process.

### *Revenue Recognition*

Revenue is recognized once four criteria are met: (1) the Company must have persuasive evidence that an arrangement exists; (2) delivery must occur, which happens at the point of shipment (this includes the transfer of both title and risk of loss, provided that no significant obligations remain); (3) the price must be fixed and determinable; and (4) collectability must be reasonably assured. A provision for estimated losses on returns is recorded at the time of sale based on historical experience.

The Company has service revenue associated with configuration and marketing, which is recognized when the work is complete and all obligations are substantially met. The Company also sells third-party services, such as maintenance contracts. Since the Company is acting as an agent for these services, revenue is recognized net of cost at the time of sale. Revenue from multiple element arrangements is allocated to the various elements based on the relative fair value of the elements, and each revenue cycle is considered a separate accounting unit with recognition of revenue based on the criteria met for the individual element of the multiple deliverables.

### *Shipping Revenue and Costs*

Shipping revenue is included in net sales and related costs are included in cost of goods sold. Net shipping revenues for the quarters and nine months ended March 31, 2008 and 2007 were not material.

### *Advertising Costs*

The Company defers advertising related costs until the advertising is first run in trade or other publications, or in the case of brochures, until the brochures are printed and available for distribution. Advertising costs, included in marketing costs, after vendor reimbursement, were not significant in the quarters and nine months ended March 31, 2008 or 2007. Deferred advertising costs at March 31, 2008 and June 30, 2007 were not significant.

### *Foreign Currency*

The currency effects of translating the financial statements of the Company's foreign entities that operate in their local currency are included in the cumulative currency translation adjustment component of accumulated other comprehensive income. The assets and liabilities of these foreign entities are translated into U.S. Dollars using the exchange rate at the end of the respective period. Sales, costs and expenses are translated at average exchange rates effective during the respective period. Foreign currency transactional and re-measurement gains and losses are included in other expense (income) in the Condensed Consolidated Income Statement. Such amounts are not significant to any of the periods

presented.

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### *Income Taxes*

Income taxes are accounted for under the liability method. Deferred income taxes reflect tax consequences on future years of differences between the tax bases of assets and liabilities and their financial reporting amounts. Valuation allowances are provided against deferred tax assets in accordance with SFAS No. 109, *Accounting for Income Taxes*. Federal income taxes are not provided on the undistributed earnings of foreign subsidiaries because it has been the practice of the Company to reinvest those earnings in the business outside of the United States. Effective July 1, 2007, the Company adopted the Financial Accounting Standards Board ( FASB ) Interpretation No. 48 ( FIN 48 ), *Accounting for Uncertainty in Income Taxes – an interpretation of SFAS 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109 and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. See Note 11 for more information on the Company's adoption of the interpretation.

### *Share-Based Payment*

The Company accounts for share-based compensation using the provisions of FASB Statement No. 123(R) ( SFAS No. 123(R) ), Share-Based Payment, which requires the recognition of the fair value of share-based compensation. Under the fair value recognition provisions of SFAS No. 123(R), share-based compensation is estimated at the grant date based on the fair value of the awards expected to vest and is recognized as expense ratably over the requisite service period of the award.

### *Comprehensive Income*

SFAS 130, *Reporting Comprehensive Income*, defines comprehensive income as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. The primary components of comprehensive income for the Company include net income, foreign currency translation adjustments arising from the consolidation of the Company's foreign subsidiaries, and unrealized gains and losses on the Company's hedged transactions, net of tax.

### *Accounting Standards Recently Issued*

In March 2008, the FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*, or SFAS 161. This new standard requires enhanced disclosures for derivative instruments, including those used in hedging activities. It is effective for fiscal years and interim periods beginning after November 15, 2008, and will be applicable to the Company in the third quarter of fiscal 2009. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 161 on its condensed consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin No. 51*, or SFAS 160. SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008, and will be adopted by us in the first quarter of fiscal 2010. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 160 on our consolidated results of operations and financial condition.

In December 2007, the Financial Accounting Standards Board, or FASB, issued the Statement of Financial Accounting Standards, or SFAS, No. 141 (revised 2007), *Business Combinations*, or SFAS 141R. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008, and will be adopted by us in the first quarter of fiscal 2010. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 141R on our consolidated results of operations and financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which requires companies to provide additional information regarding the effect of a company's choice to use fair value on its earnings and to display the fair value of those assets and liabilities which the company has chosen to use on



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the face of the balance sheet. SFAS No. 159 is effective for the Company beginning July 1, 2008. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS No. 159 will have on its condensed consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for the Company beginning July 1, 2008. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS No. 157 will have on its condensed consolidated financial statements.

**(4) Earnings Per Share**

Basic earnings per share are computed by dividing net income by the weighted-average number of common shares outstanding. Diluted earnings per share are computed by dividing net income by the weighted-average number of common and potential common shares outstanding.

|  | Net<br>Income                         | Shares | Per Share<br>Amount |
|--|---------------------------------------|--------|---------------------|
|  | (in thousands, except per share data) |        |                     |
| <b>Quarter ended March 31, 2008:</b>     |                                       |        |                     |
| Income per common share, basic           | \$ 11,028                             | 26,038 | \$ 0.42             |
| Effect of dilutive stock options         |                                       | 385    |                     |
| Income per common share, diluted         | \$ 11,028                             | 26,423 | \$ 0.42             |
| <b>Nine months ended March 31, 2008:</b> |                                       |        |                     |
| Income per common share, basic           | \$ 41,165                             | 25,934 | \$ 1.59             |
| Effect of dilutive stock options         |                                       | 391    |                     |
| Income per common share, diluted         | \$ 41,165                             | 26,325 | \$ 1.56             |
| <b>Quarter ended March 31, 2007:</b>     |                                       |        |                     |
| Income per common share, basic           | \$ 10,071                             | 25,770 | \$ 0.39             |
| Effect of dilutive stock options         |                                       | 424    |                     |
| Income per common share, diluted         | \$ 10,071                             | 26,194 | \$ 0.38             |
| <b>Nine months ended March 31, 2007:</b> |                                       |        |                     |
| Income per common share, basic           | \$ 31,323                             | 25,749 | \$ 1.22             |
| Effect of dilutive stock options         |                                       | 464    |                     |
| Income per common share, diluted         | \$ 31,323                             | 26,213 | \$ 1.19             |

For the quarter and nine month period ended March 31, 2008, there were 520,650 and 692,918 weighted average shares, respectively, excluded from the computation of diluted earnings per share because their effect would have been anti-dilutive. For the quarter and nine month period ended March 31, 2007, there were 567,000 and 571,000 weighted average shares, respectively, excluded from the computation of diluted earnings per share because their effect would have been anti-dilutive.

**(5) Short Term Borrowings and Long Term Debt**

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### *Short Term Borrowings*

|                       | <i>(in thousands)</i> |                      |
|-----------------------|-----------------------|----------------------|
|                       | <b>March 31, 2008</b> | <b>June 30, 2007</b> |
| Short-term borrowings | \$ 1,266              | \$ 3,490             |

The Company has a 3.0 million secured revolving credit facility obtained on August 17, 2006. This facility bears interest at the 30 day Euro Interbank Offered Rate ( EURIBOR ) plus a spread of 0.75 per annum. The effective interest rate at March 31, 2008 was 5.11% and at June 30, 2007 was 4.86%. This facility is secured by the assets of our European

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operations and is guaranteed by ScanSource, Inc.

*Revolving Line of Credit*

|                           | <i>(in thousands)</i>     |                          |
|---------------------------|---------------------------|--------------------------|
|                           | <b>March 31,<br/>2008</b> | <b>June 30,<br/>2007</b> |
| Revolving credit facility | \$ 69,499                 | \$ 90,314                |

On September 28, 2007, the Company entered into a \$250 million multi-currency revolving credit facility with a syndicate of banks that matures on September 28, 2012. This revolving credit facility has a \$50 million accordion feature that allows the Company to increase the availability to \$300 million subject to obtaining commitments for the incremental capacity from existing or new lenders. This revolving credit facility refinances and replaces the Company's previous \$180 million multi-currency revolving credit facility. The new facility is guaranteed by the Company and certain of its subsidiaries and is secured by substantially all of the domestic assets of the Company and its domestic subsidiaries. The facility bears interest at a rate equal to a spread over the applicable London Interbank Offered Rate ( LIBOR ) rate or prime rate, as chosen by the Company. This spread is dependent on the Company's ratio of funded debt to EBITDA (as defined in the credit facility) and ranges from 0.50% to 1.25% for LIBOR-based loans, and from 0.00% to 0.25% for prime rate-based loans. The spread in effect as of March 31, 2008 was 0.50% for LIBOR-based loans and 0.00% for prime rate-based loans. The new agreement subjects the Company to certain financial covenants, including minimum fixed charge and leverage ratio covenants. The Company was in compliance with all covenants under the credit facility as of March 31, 2008.

The effective weighted average interest rate for the Company's revolving credit facility as of March 31, 2008 was 4.69% and at June 30, 2007 was 6.41%. The outstanding borrowings at March 31, 2008 were \$69.5 million on a total commitment of \$250 million, leaving \$180.5 million available for additional borrowings.

*Long-Term Debt*

|  | <i>(in thousands)</i>     |                          |
|--|---------------------------|--------------------------|
|  | <b>March 31,<br/>2008</b> | <b>June 30,<br/>2007</b> |
| Industrial Development Revenue Bond, monthly payments of interest only, 3.96% variable interest rate at March 31, 2008 and maturing in fiscal 2032 | \$ 3,888                  | \$                       |
| Unsecured note payable to a bank, monthly payments of interest only, 3.77% variable interest rate at March 31, 2008 and maturing in fiscal 2032    | 25,000                    |                          |
| Unsecured note payable to a bank, monthly payments of interest only. Extinguished on December 31, 2007.  |                           | 13,000                   |
| Note payable to a bank, secured by distribution center land and building. Extinguished on September 28, 2007                                       |                           | 4,416                    |
|  | 28,888                    | 17,416                   |
| Less current portion   |                           | 200                      |
| Long-term portion  | \$ 28,888                 | \$ 17,216                |

On August 1, 2007, the Company entered into an agreement with the State of Mississippi in order to provide financing for the acquisition and installation of certain equipment to be utilized at the Company's new Southaven, Mississippi distribution facility, through the issuance of an industrial development revenue bond. The bond matures on September 1, 2032 and accrues interest at the 30-day LIBOR rate plus a spread of 0.85%. The terms of the bond allows for payment of interest only for the first 10 years of the agreement, and then, starting on September 1, 2018 through 2032, principal and

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interest payments are due until the maturity date or the redemption of the bond. The Company receives advances on this bond on an as-needed basis to pay the ongoing costs of the project, not to exceed \$6 million.

On January 2, 2008, the Company entered into a \$25 million promissory note with a third party lender. This note payable accrues interest on the unpaid balance at a rate per annum equal to the 30 day LIBOR plus 0.65% and matures on September 28, 2012. The terms of the note payable allow for payments to be due and payable in consecutive monthly payment terms of accrued interest only, commencing on January 31, 2008, and continuing on the last day of each month thereafter until fully paid. This note may be prepaid in whole or in part at any time without penalty. Under the terms of this agreement, the Company has agreed not to encumber its headquarters property, except as permitted by the lender.

**(6) Interest Rate Swap**

On January 4, 2008, the Company entered into an interest rate swap with a notional amount of \$25 million. The Company designated this interest rate swap as a cash flow hedge of our exposure to the variability in future cash flows attributable to interest payments of 30 day LIBOR plus a fixed spread of 0.65% due on the \$25 million promissory note payable discussed previously. Under the terms of the swap, the Company pays a fixed rate of 3.65% on the \$25 million notional amount and receives payments from a counterparty based on the 30 day LIBOR for a term ending on September 28, 2011. Interest rate differentials paid or received under the swap agreement are recognized as adjustments to interest expense. To the extent the swap is effective in offsetting the variability of the hedged cash flows, changes in the fair value of the swap are not included in current earnings but are reported as other comprehensive income (loss).

The components of the cash flow hedge included in accumulated other comprehensive income in the Condensed Consolidated Statement of Shareholders' Equity for the quarters ended March 31, 2008 and 2007, are as follows:

|  | <i>(in thousands)</i>     |                           |
|--|---------------------------|---------------------------|
|  | <b>Quarters Ended</b>     |                           |
|  | <b>March 31,<br/>2008</b> | <b>March 31,<br/>2007</b> |
| Net interest expense recognized as a result of interest rate swap  | \$ 5                      | \$                        |
| Changes in unrealized loss in fair value of interest swap rates    | (429)                     |                           |
| Net decrease in accumulated other comprehensive income, net of tax | \$ (424)                  | \$                        |

The Company did not note any ineffectiveness in the hedge during the quarter ended March 31, 2008.

**(7) Sale of Memphis Distribution Facility**

In December 2007, the Company completed the relocation of its North American distribution center from Memphis, Tennessee to its new location in Southaven, Mississippi, allowing for substantially expanded warehousing capacity. In January 2008, the Company sold the Memphis, Tennessee facility for cash proceeds of \$6.1 million, net of expenses. An immaterial loss was recorded in connection with the sale of this facility during the current quarter. This facility was previously classified as held-for-sale in the Company's financial statements for the period ended December 31, 2007.

**(8) Goodwill and Identifiable Intangible Assets**

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company performs its annual test of goodwill at the end of each fiscal year to determine if impairment has occurred. In addition, the Company performs an impairment analysis for goodwill whenever indicators of impairment are present. This testing includes the determination of each reporting unit's fair value using market multiples and discounted cash flows modeling. As of March 31, 2008, no impairment charge related to goodwill was recorded.

During the current fiscal year, the Company purchased the remaining outstanding shares of Netpoint, Inc. for \$1.1 million, of which \$0.6 million was allocated to goodwill. Changes in the carrying amount of goodwill for the nine months ended March 31, 2008, by operating segment, are as follows:





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|  | <i>(in thousands)</i>                     |  |           |
|--|---|--|-----------|
|  | North American<br>Distribution<br>Segment | International<br>Distribution<br>Segment | Total     |
| Balance as of June 30, 2007                      | \$ 20,081                                 | \$ 9,280                                 | \$ 29,361 |
| Purchase of outstanding shares of Netpoint, Inc. |   | \$ 584                                   | \$ 584    |
| Fluctuations in foreign currencies               |   | (36)                                     | (36)      |
| Balance as of March 31, 2008                     | \$ 20,081                                 | \$ 9,828                                 | \$ 29,909 |

Included within other assets are identifiable intangible assets, as follows:

|                        | <i>(in thousands)</i>       |                             |                      |                             |                             |                      |
|------------------------|-----------------------------|-----------------------------|----------------------|-----------------------------|-----------------------------|----------------------|
|                        | As of March 31, 2008        |                             |                      | As of June 30, 2007         |                             |                      |
|                        | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Book<br>Value | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Book<br>Value |
| Customer lists         | \$ 18,638                   | \$ 2,438                    | \$ 16,200            | \$ 18,338                   | \$ 1,538                    | \$ 16,800            |
| Debt issuance costs    | 841                         | 75                          | 766                  | 606                         | 420                         | 186                  |
| Trade names            | 818                         | 281                         | 537                  | 818                         | 82                          | 736                  |
| Non-compete agreements | 1,785                       | 1,041                       | 744                  | 1,785                       | 595                         | 1,190                |
| Total                  | \$ 22,082                   | \$ 3,835                    | \$ 18,247            | \$ 21,547                   | \$ 2,635                    | \$ 18,912            |

In March 2008, the Company purchased certain assets of PC4, a wholesale distributor of point-of-sale (POS) hardware. In connection with this acquisition, approximately \$0.3 million of the purchase price was allocated to a customer list.

On October 26, 2007, the Company announced the formation of the ScanSource Communications sales unit. Effective January 1, 2008, the Company's wholly owned subsidiary, T2 Supply, Inc., was renamed ScanSource Communications, Inc. and acquired all of the assets of the Paracon sales unit. In connection with the merger of these two sales units, the Company revised the remaining useful life of the T2 Supply trade name from ten years to two years to reflect the eventual abandonment of the T2 Supply trade name, after a two year transition period.

**(9) Segment Information**

The Company is a leading distributor of specialty technology products, providing value-added distribution sales to resellers in the specialty technology markets. The Company has two reporting segments, based on geographic location. The measure of segment profit is operating income, and the accounting policies of the segments are the same as those described in Note 3.

*North American Distribution*

North American Distribution offers products for sale in four primary categories: (i) AIDC and POS equipment sold by the ScanSource POS and Barcoding sales unit, (ii) voice, data and converged communications equipment sold by the Catalyst Telecom sales unit, (iii) video conferencing, telephony, and communications products sold by the ScanSource Communications unit, (iv) electronic security products and wireless infrastructure products through its ScanSource Security Distribution sales unit. These products are sold to more than 14,000 resellers and integrators of technology products that are geographically disbursed over the United States and Canada in a pattern that mirrors population concentration. No single account represented more than 7% of the Company's consolidated net sales for the quarter and nine month periods ended March 31, 2008 and 2007, respectively.

*International Distribution*

The international distribution segment sells to two geographic areas, Latin America (including Mexico) and Europe, and offers AIDC and POS equipment to more than 6,000 resellers and integrators of technology products. This segment began during fiscal 2002 with the Company's purchase of a majority interest in Netpoint and the start-up of the Company's European operations. Of this segment's customers, no single account represented more than 2% of the Company's consolidated net sales during the quarter and nine month periods ended March 31, 2008 and 2007.

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In April 2008, the Company expanded its communications business internationally with the acquisition of MTV Telecom (Distribution) PLC, a

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UK-based distributor of voice and data solutions.

Inter-segment sales consist of sales by the North American distribution segment to the international distribution segment. All inter-segment revenues and profits have been eliminated in the accompanying condensed consolidated financial statements.

Selected financial information of each business segment is presented below:

|                                       | <i>(in thousands)</i> |            |                      |              |
|---------------------------------------|-----------------------|------------|----------------------|--------------|
|                                       | Quarter ended         |            | Nine months ended    |              |
|                                       | March 31,             | March 31,  | March 31,            | March 31,    |
|                                       | 2008                  | 2007       | 2008                 | 2007         |
| <b>Sales:</b>                         |                       |            |                      |              |
| North American distribution           | \$ 425,366            | \$ 418,034 | \$ 1,351,012         | \$ 1,253,553 |
| International distribution            | 93,378                | 79,570     | 291,714              | 228,057      |
| Less intersegment sales               | (4,324)               | (4,926)    | (21,271)             | (18,968)     |
|                                       | \$ 514,420            | \$ 492,678 | \$ 1,621,455         | \$ 1,462,642 |
| <b>Depreciation and amortization:</b> |                       |            |                      |              |
| North American distribution           | \$ 1,554              | \$ 1,404   | \$ 4,738             | \$ 4,634     |
| International distribution            | 147                   | 175        | 589                  | 519          |
|                                       | \$ 1,701              | \$ 1,579   | \$ 5,327             | \$ 5,153     |
| <b>Operating income:</b>              |                       |            |                      |              |
| North American distribution           | \$ 16,789             | \$ 14,382  | \$ 57,864            | \$ 46,031    |
| International distribution            | 2,207                 | 2,860      | 11,918               | 8,607        |
|                                       | \$ 18,996             | \$ 17,242  | \$ 69,782            | \$ 54,638    |
| <b>Capital expenditures:</b>          |                       |            |                      |              |
| North American distribution           | \$ 130                | \$ 399     | \$ 4,787             | \$ 2,082     |
| International distribution            | 549                   | 143        | 831                  | 419          |
|                                       | \$ 679                | \$ 542     | \$ 5,618             | \$ 2,501     |
| <b>Assets:</b>                        |                       |            |                      |              |
|                                       | <b>March 31, 2008</b> |            | <b>June 30, 2007</b> |              |
| North American distribution           | \$ 628,245            |            | \$ 636,553           |              |
| International distribution            | 123,411               |            | 101,895              |              |
|                                       | \$ 751,656            |            | \$ 738,448           |              |

**(10) Commitments and Contingencies**

On November 21, 2006, a purported stockholder filed a derivative lawsuit in the United States District Court for the District of South Carolina in Greenville, South Carolina against certain current and former officers and directors of the Company and against the Company, as a nominal defendant, asserting causes of action based on alleged violations of securities laws (including alleged violations of Section 10(b), 14(a), and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 of the SEC) and other common law claims including, breach of fiduciary duty, aiding and abetting and unjust enrichment relating to allegations concerning certain of the Company's prior stock option grants. The lawsuit seeks relief in the form of an accounting, rescission, unspecified money damages, disgorgement, attorneys' fees, fees and expenses and other relief. On April 2, 2007, the Court appointed the plaintiff as lead plaintiff and ordered that any later actions filed in the same court and that

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related to the same facts shall be consolidated.

On April 11, 2007, another purported stockholder filed a substantially similar derivative lawsuit also related to the Company's prior grants of stock options. This action was also filed in the United States District Court for the District of South Carolina in Greenville, South Carolina against certain current and former officers and directors of the Company and against the Company, as nominal defendant, and asserts substantially similar causes of action and claims for relief. The plaintiff in this second action has filed a motion to vacate the prior Order and to consolidate the two actions and appoint the plaintiff as a co-lead plaintiff.

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On November 27, 2006 and April 13, 2007, the Company provided notice to its insurance carrier of these actions. The Company's insurance carrier, subject to a reservation of rights, provided a preliminary position on the coverage of these derivative claims in which the carrier indicated that these lawsuit allegations appear to constitute a claim within coverage of the Company's insurance policy. The carrier continues to assess coverage of these matters.

On January 24, 2008, the Company announced that it had received written notice from the SEC declaring that the investigation concerning the Company's historical stock option grant practices had been completed and that no enforcement action was recommended.

The Company and its subsidiaries are, from time to time, parties to lawsuits arising out of operations. Although there can be no assurance, based upon information known to the Company, the Company believes that any liability resulting from an adverse determination of such lawsuits would not have a material adverse effect on the Company's financial condition or results of operations.

### **(11) Income Taxes**

Effective July 1, 2007, the beginning of fiscal year 2008, the Company adopted the provisions of FIN 48, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109, *Accounting for Income Taxes* and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The adoption of FIN 48 did not have a material impact on the Company's financial statements. As of the adoption date, the Company had gross unrecognized tax benefits of \$1.6 million, \$1.1 million of which, if recognized, would affect the effective tax rate. As of March 31, 2008, the Company had gross unrecognized tax benefits of \$1.9 million, \$1.3 million of which, if recognized, would affect the effective tax rate. This represents an increase of \$0.3 million and \$0.2 million, respectively. The Company does not expect that the total amounts of unrecognized tax benefits will significantly increase or decrease within the next twelve months.

The Company conducts business globally and, as a result, one or more of its subsidiaries files income tax returns in the U.S. federal, various state, local and foreign jurisdictions. In the normal course of business, the Company is subject to examination by taxing authorities in countries in which it operates. With few exceptions, the Company is no longer subject to state and local, or non-U.S. income tax examinations by tax authorities for the years before 2004. U.S. federal income tax returns for fiscal years 2003, 2004, 2005, and 2006 previously under examination by the taxing authorities were closed during the quarter. All expected adjustments arising from the examinations had been accrued and there were no material adjustments.

The Company's continuing practice is to recognize interest and penalties related to income tax matters in income tax expense. As of March 31, 2008, the Company had approximately \$0.5 million accrued for interest and penalties, of which less than \$0.1 million was a current period expense.

The Company's effective tax rate differs from the federal statutory rate of 35% primarily as a result of state income taxes.

### **(12) Subsequent Events**

On April 4, 2008, the Company expanded its communications business internationally with the acquisition of MTV Telecom (Distribution) PLC, a UK-based distributor of voice and data solutions.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Results of Operations***Net Sales*

The following table summarizes our net sales results (net of inter-segment sales) for the quarter and nine months ended March 31, 2008:

| <i>(in thousands)</i>       | Quarter ended |            | \$ Change | % Change |
|-----------------------------|---------------|------------|-----------|----------|
|                             | 2008          | 2007       |           |          |
| North American distribution | \$ 421,042    | \$ 413,108 | \$ 7,934  | 1.9%     |
| International distribution  | 93,378        | 79,570     | 13,808    | 17.4%    |
| Net sales                   | \$ 514,420    | \$ 492,678 | \$ 21,742 | 4.4%     |

| <i>(in thousands)</i>       | Nine months ended |              | \$ Change  | % Change |
|-----------------------------|-------------------|--------------|------------|----------|
|                             | 2008              | 2007         |            |          |
| North American distribution | \$ 1,329,741      | \$ 1,234,585 | \$ 95,156  | 7.7%     |
| International distribution  | 291,714           | 228,057      | 63,657     | 27.9%    |
| Net sales                   | \$ 1,621,455      | \$ 1,462,642 | \$ 158,813 | 10.9%    |

*North American Distribution*

North American distribution sales include sales to technology resellers in the United States and Canada from our Southaven, Mississippi distribution center. For the quarter and year-to-date periods ended March 31, 2008, net sales increased over the comparative prior year periods by \$7.9 million and \$95.2 million, respectively. This represented a 1.9% and 7.7% increase in net sales for these periods.

The Company's POS, Barcoding, and security product category sales increased 12% in comparison to the prior year quarter and 12.3% for the prior year nine-month period. This increase was primarily driven by sales growth in our scanning and mobility products in comparison to the prior year periods as well as growth in our newer product lines. The Company continues to grow by attracting business from resellers who were previously buying directly from manufacturers and other distributors.

The Company's Communications product category sales decreased 9% in comparison to the prior year quarter and increased 2.7% from the comparative prior year, nine month period. The current quarter decrease was largely attributable to our Catalyst *Telecom* sales unit, which was negatively impacted by a key vendor's unsuccessful new product rollout during the quarter. As a result, purchases by our resellers were either delayed or lost to competitive products of other vendors due to an adverse reaction to the terms and conditions of the new product. While the vendor did announce corrective changes to the program shortly after the quarter was completed, our sales were negatively impacted during the current quarter.

Partially offsetting the sales decrease in Catalyst *Telecom* was the performance of our newly formed ScanSource Communications sales unit, which increased sales by 10% in comparison to the prior year quarter. As previously announced, this new sales unit formally merged the Paracon and T2 Supply sales units effective January 1, 2008. The Company believes this merger will enable more sales and support resources for their customers.

*International Distribution*

The international distribution segment includes sales to Latin America (including Mexico) and Europe from the ScanSource Latin American and European selling units. Sales for the overall international segment increased 17.4% or \$13.8 million for the quarter ended March 31, 2008 and 27.9% or \$63.7 million for the nine month period as compared to the same periods in the prior year. Excluding the impact of foreign exchange fluctuations, the increase in sales for the quarter and nine months ended March 31, 2008 would have been \$4.1 million or 5.2% and \$39.5

million or 17.3%, respectively.



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Sales growth for the Company's international segment was affected in the quarter ended March 31, 2008 by a pricing issue in Europe caused by the strengthening of the Euro against the US Dollar. This made the Company significantly less competitive during the current quarter and, as a result, the Company believes that it experienced a loss of market share. The Company is working with its vendors to prevent this from occurring in future periods.

**Gross Profit**

The following tables summarize the Company's gross profit for the quarter and nine month period ended March 31, 2008:

| <i>(in thousands)</i>       | Quarter ended<br>March 31, |                  |               |             | % of Sales<br>March 31, |              |
|-----------------------------|----------------------------|------------------|---------------|-------------|-------------------------|--------------|
|                             | 2008                       | 2007             | \$<br>Change  | % Change    | 2008                    | 2007         |
| North American distribution | \$ 42,168                  | \$ 41,351        | \$ 817        | 2.0%        | 10.0%                   | 10.0%        |
| International distribution  | 9,551                      | 9,686            | (135)         | -1.4%       | 10.2%                   | 12.2%        |
| <b>Gross profit</b>         | <b>\$ 51,719</b>           | <b>\$ 51,037</b> | <b>\$ 682</b> | <b>1.3%</b> | <b>10.1%</b>            | <b>10.4%</b> |

| <i>(in thousands)</i>       | Nine months ended<br>March 31, |                   |                  |             | % of Sales<br>March 31, |              |
|-----------------------------|--------------------------------|-------------------|------------------|-------------|-------------------------|--------------|
|                             | 2008                           | 2007              | \$<br>Change     | % Change    | 2008                    | 2007         |
| North American distribution | \$ 134,466                     | \$ 127,228        | \$ 7,238         | 5.7%        | 10.1%                   | 10.3%        |
| International distribution  | 34,554                         | 28,424            | 6,130            | 21.6%       | 11.8%                   | 12.5%        |
| <b>Gross profit</b>         | <b>\$ 169,020</b>              | <b>\$ 155,652</b> | <b>\$ 13,368</b> | <b>8.6%</b> | <b>10.4%</b>            | <b>10.6%</b> |

*North American Distribution*

Gross profit for the North American distribution segment increased 2.0% or \$0.8 million for the quarter ended March 31, 2008 and 5.7% or \$7.2 million for the nine month period as compared to the same periods in the prior year. The increase in both periods relates to increased sales volumes in comparison to the prior period.

Gross profit as a percentage of net sales for the North American distribution remained at 10% for the current and prior year quarter. However, on a year-to-date basis, this percentage was 10.1% and 10.3% for the nine months ended March 31, 2008 and 2007, respectively. This decrease is somewhat attributable to a less favorable product mix resulting from lower sales in the Company's Catalyst *Telecom* sales unit.

*International Distribution*

Gross profit for the international distribution segment decreased by 1.4% or \$0.1 million for the quarter ended March 31, 2008, but increased 21.6% or \$6.1 million for the nine month period as compared to the same periods in the prior year. As previously discussed, sales volumes were down in the current quarter which resulted in lower gross profit. However, on a year-to-date basis, higher sales volumes have driven increased gross profit.

Gross profits, measured as a percentage of net sales, are typically higher in the international distribution segment versus North America. However, in the current quarter, gross profit percentage was negatively impacted in Europe due to the foreign currency issues previously mentioned. The weakening US Dollar allowed our competitors who purchase inventory in that currency the ability to lower their pricing without impacting their profitability. This made us significantly less competitive during the current quarter as the US Dollar continued to weaken against the Euro at a record rate and vendor pricing adjustments were not sufficient.



**Table of Contents****Operating Expenses**

The following table summarizes our operating expenses for the quarter and nine months ended March 31, 2008:

| <i>(in thousands)</i> | Period ended<br>March 31, |           |            |          | % of Sales<br>March 31, |      |
|-----------------------|---------------------------|-----------|------------|----------|-------------------------|------|
|                       | 2008                      | 2007      | \$ Change  | % Change | 2008                    | 2007 |
| Quarter               | \$ 32,723                 | \$ 33,795 | \$ (1,072) | -3.2%    | 6.4%                    | 6.9% |
| Nine months           | 99,238                    | 101,014   | (1,776)    | -1.8%    | 6.1%                    | 6.9% |

For the quarter ended March 31, 2008, operating expenses decreased by 3.2% or \$1.1 million, as compared to the same comparative period in the prior year. This decrease is largely driven by approximately \$3.0 million of legal and professional fees incurred during the comparative prior year quarter in connection with our stock option investigation and remediation activities. In the current quarter, these expenditures were not material. After excluding these costs, the Company's operating expenditures actually increased by \$1.9 million in comparison to the prior year quarter. This increase is largely attributable to overall higher expenditures associated with increased headcounts in comparison to the prior year quarter, and to a lesser extent, incremental costs associated with the lease of the Company's new Southaven, Mississippi distribution facility which opened in December 2007. Internationally, the Company's operating expenses were adversely impacted by the weakening of the US Dollar in comparison to the prior year comparative periods. However, in local currency terms, the Company did not experience any significant increase in operating expenses.

For the year-to-date period ended March 31, 2008, operating expenses decreased by 1.8%, or \$1.8 million, as compared to the comparative period in the prior year. As discussed above, this decrease is largely driven by significantly lower expenditures related to our stock option investigation and remediation activities. To date, the Company has incurred \$1.0 million of legal fees related to this investigation versus \$7.9 million for the prior year-to-date period. Excluding these expenditures, operating expenses increased by \$5.1 million for the year-to-date period ended March 31, 2008 in comparison to the prior year due primarily to overall higher expenditures associated with increased headcounts and the weaker US Dollar, as previously discussed.

Operating expenses as a percentage of sales decreased to 6.4% and 6.1% for the current year quarter and year-to-date periods, respectively. This percentage was 6.9% for both prior year comparative periods. As discussed, this decrease is largely attributable to the legal and professional fees incurred during the comparative prior periods in connection with our stock option investigation and remediation activities.

**Operating Income**

The following table summarizes our operating income for the quarter and nine months ended March 31, 2008:

| <i>(in thousands)</i> | Period ended<br>March 31, |           |           |          | % of Sales<br>March 31, |      |
|-----------------------|---------------------------|-----------|-----------|----------|-------------------------|------|
|                       | 2008                      | 2007      | \$ Change | % Change | 2008                    | 2007 |
| Quarter               | \$ 18,996                 | \$ 17,242 | \$ 1,754  | 10.2%    | 3.7%                    | 3.5% |
| Nine months           | 69,782                    | 54,638    | 15,144    | 27.7%    | 4.3%                    | 3.7% |

Operating income increased 10.2% or \$1.8 million for the quarter ended March 31, 2008 and 27.7% or \$15.1 million for the nine month period ended March 31, 2008 as compared to the same periods in the prior year. This increase for both periods is attributable to higher sales volumes achieved in both North America and international distribution segments, as well as significantly lower expenditures related to the Special Committee investigation into our stock option granting practices.

**Table of Contents****Total Other Expense (Income)**

The following table summarizes our total other expense (income) for the quarter and nine months ended March 31, 2008:

| <i>(in thousands)</i>           | Quarter ended<br>March 31, |                 |                 |               | % of Sales<br>March 31, |             |
|---------------------------------|----------------------------|-----------------|-----------------|---------------|-------------------------|-------------|
|                                 | 2008                       | 2007            | \$ Change       | % Change      | 2008                    | 2007        |
| Interest expense                | \$ 1,097                   | \$ 1,939        | \$ (842)        | -43.4%        | 0.2%                    | 0.4%        |
| Interest income                 | (401)                      | (246)           | (155)           | 63.0%         | -0.1%                   | 0.0%        |
| Net foreign exchange loss       | 262                        | 235             | 27              | 11.5%         | 0.1%                    | 0.0%        |
| Other, net                      | 24                         | (94)            | 118             | -125.5%       | 0.0%                    | 0.0%        |
| <b>Total other expense, net</b> | <b>\$ 982</b>              | <b>\$ 1,834</b> | <b>\$ (852)</b> | <b>-46.5%</b> | <b>0.2%</b>             | <b>0.4%</b> |

| <i>(in thousands)</i>            | Nine months ended<br>March 31, |                 |                   |               | % of Sales<br>March 31, |             |
|----------------------------------|--------------------------------|-----------------|-------------------|---------------|-------------------------|-------------|
|                                  | 2008                           | 2007            | \$ Change         | % Change      | 2008                    | 2007        |
| Interest expense                 | \$ 4,496                       | \$ 5,464        | \$ (968)          | -17.7%        | 0.3%                    | 0.3%        |
| Interest income                  | (1,108)                        | (529)           | (579)             | 109.5%        | -0.1%                   | 0.0%        |
| Net foreign exchange loss (gain) | 111                            | (153)           | 264               | -172.5%       | 0.0%                    | 0.0%        |
| Other, net                       | (229)                          | (267)           | 38                | -14.2%        | -0.1%                   | 0.0%        |
| <b>Total other expense, net</b>  | <b>\$ 3,270</b>                | <b>\$ 4,515</b> | <b>\$ (1,245)</b> | <b>-27.6%</b> | <b>0.2%</b>             | <b>0.3%</b> |

Interest expense reflects interest paid on borrowings on the Company's line of credit and long-term debt. Interest expense for the quarter and nine months ended March 31, 2008 was \$1.1 million and \$4.5 million, respectively, compared to \$1.9 million and \$5.5 million for the comparative prior year periods. The improvement in interest expense for both periods is primarily attributable to lower average debt balances, and to a lesser extent, lower interest rates. The Company achieved lower debt by negotiating extended payment terms for certain key vendors which increased average accounts payable as well as reducing outstanding debt by applying proceeds received from the sale of the Memphis warehouse and the exercise of stock options.

Net foreign exchange gains and losses consist of foreign currency transactional and functional currency re-measurements, offset by net foreign currency exchange contract gains and losses. The change in foreign exchange gains for the quarter ended March 31, 2008 as compared to the prior year are primarily the result of fluctuations in the value of the Euro versus the British Pound, and to a lesser extent, the U.S. Dollar versus other currencies. The Company utilizes foreign exchange contracts and debt in non-functional currencies to hedge foreign currency exposure. The Company's foreign exchange policy prohibits entering into speculative transactions.

**Provision for Income Taxes**

Income tax expense was \$7.0 million and \$25.3 million for the quarter and nine months ended March 31, 2008, respectively, reflecting an effective income tax rate of 38.8% and 38.1%, respectively. The effective rate for the prior fiscal year was 37.8%.

**Minority Interest in Income of Consolidated Subsidiaries**

The Company consolidates subsidiaries that have a minority ownership interest. In the comparative prior year periods, the Company recorded a minority interest reflecting outside ownership of Netpoint, which is included in our international distribution segment. Effective July 1, 2007, the Company owns 100% of this subsidiary.

**Net Income**

The following table summarizes our net income for the quarter and nine months ended March 31, 2008:



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| <i>(in thousands)</i> | Period ended |           |           |          | % of Sales |      |
|-----------------------|--------------|-----------|-----------|----------|------------|------|
|                       | March 31,    |           | \$ Change | % Change | March 31,  |      |
|                       | 2008         | 2007      |           |          | 2008       | 2007 |
| Quarter               | \$ 11,028    | \$ 10,071 | \$ 957    | 9.5%     | 2.1%       | 2.0% |
| Nine months           | 41,165       | 31,323    | 9,842     | 31.4%    | 2.5%       | 2.1% |

The increase in net income for both periods shown above is attributable to the changes in operations discussed above.

**Liquidity and Capital Resources**

The Company's primary sources of liquidity are cash flow from operations, borrowings under the revolving credit facility, secured and unsecured borrowings, and, to a lesser extent, borrowings under the subsidiary's line of credit, and proceeds from the exercise of stock options.

The Company's cash and cash equivalent balance totaled \$6.0 million at March 31, 2008 compared to \$1.9 million at June 30, 2007. The Company's working capital increased to \$402 million at March 31, 2008 from \$353 million at June 30, 2007. This increase resulted primarily from a \$34.7 million decrease in accounts payable and a \$24.9 million increase in inventories, partially offset by a \$12.3 million decrease in accounts receivable.

The number of days sales in receivables (DSO) was 59 at March 31, 2008, compared to 60 days at June 30, 2007, which can reflect collection improvement in our operations as well as a favorable change in business unit sales mix, as certain of our domestic business units have higher DSO's than others.

Vendor payable days decreased to 43 days for the quarter ended March 31, 2008 compared to 63 days for the previous quarter ended December 31, 2007 and 49 days as of June 30, 2007. The twenty day quarter over quarter decrease is due primarily to lower purchases and the timing of the payment of those purchases and to a lesser degree lower outstanding checks.

Inventory turnover decreased slightly to 5.8 times for the quarter ended March 31, 2008 from 6.7 times for the quarter ended June 30, 2007 and 6.3 times for the quarter ended December 31, 2007. This decrease is largely attributable to lower than anticipated sales volume relative to the comparative period.

Cash provided by operating activities was \$9.9 million for the nine months ended March 31, 2008 compared to \$49.2 million of cash used in operating activities for the nine months ended March 31, 2007. Lower than anticipated sales during the current quarter resulted in lower A/R balances and fewer inventory purchases than expected during the period. In addition, the Company generated approximately \$10 million of additional net income than in the comparative period. As a result, the Company generated positive cash flows from operations for the nine month period.

Cash used in investing activities for the nine months ended March 31, 2008 was \$1.8 million, compared to \$53.1 million used in the comparative prior year period. In the comparable prior year period, the Company acquired T2 Supply for \$50.6 million, which accounts for the majority of this variance, as acquisition activity in the current year-to-date period was not material. The Company purchased the assets of PC4 in January 2008 for \$1.2 million and purchased the remaining outstanding shares of Netpoint for \$1.1 million. The Company had capital expenditures of \$5.6 million in the current year-to-date period, which was approximately \$2.5 million higher than the comparative prior year period. The large majority of the current year's expenditures reflect purchases of equipment, software, and furniture related to the Company's new distribution facility located in Southaven, Mississippi. Cash used for acquisitions and capital expenditures were offset by the receipt of approximately \$6.1 million, net of commissions, related to the sale of our former distribution facility in Memphis, Tennessee.

Cash used in financing activities was \$4.4 million for the nine month period ended March 31, 2008 compared to cash provided of \$101.4 million for the nine month period ended March 31, 2007. At March 31, 2008, the Company's interest

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bearing debt was \$99.7 million, compared to \$111 million at June 30, 2007. This reduction in debt outstanding is largely attributable to reduced inventory purchases in the current quarter and, to some extent, extended terms on certain vendors' payables. In the comparative prior period, the Company increased its borrowings to finance the acquisition of T2 Supply in the quarter ended September 30, 2006. In the current quarter, the Company also received over \$7.3 million in proceeds related to the exercise of stock options and remediation payments from Section 16 officers in connection with our stock option investigation previously discussed. In the comparative prior year period, the Company only received \$1 million related to stock option exercises.

On January 2, 2008, the Company entered into a \$25 million promissory note with a third party lender. This note payable accrues interest on the unpaid balance at a rate per annum equal to the 30 day LIBOR plus 0.65% and matures on September 28, 2012. The terms of the note payable allow for payments to be due and payable in consecutive monthly payment terms of accrued interest only, commencing on January 31, 2008, and continuing on the last day of each month thereafter until fully paid. In any event, all principal and accrued interest will be due and payable on September 28, 2012. The note may be prepaid in whole or in part at any time without penalty. On January 4, 2008, the Company entered into an interest rate swap with a notional amount of \$25 million and designated this instrument as a cash flow hedge of our exposure to variability in future cash flows associated with the \$25 million note payable. Under the terms of the swap, the Company pays a fixed rate of 3.65% on the \$25 million notional amount and receives payments from a counterparty based on 30 day LIBOR for a term ending on September 28, 2011.

On September 28, 2007, the Company entered into a \$250 million multi-currency revolving credit facility with a syndicate of banks that matures on September 28, 2012. This revolving credit facility has a \$50 million accordion feature that allows the Company to increase the availability to \$300 million subject to obtaining commitments for the incremental capacity from existing or new lenders. This revolving credit facility refinances and replaces the Company's previous \$180 million multi-currency revolving credit facility. The new facility is guaranteed by the Company and certain of its subsidiaries and is secured by substantially all of the domestic assets of the Company and its domestic subsidiaries. The facility bears interest at a rate equal to a spread over the applicable LIBOR rate or prime rate, as chosen by the Company. This spread is dependent on the Company's ratio of funded debt to EBITDA (as defined in the credit facility) and ranges from 0.50% to 1.25% for LIBOR-based loans, and from 0.00% to 0.25% for prime rate-based loans. The spread in effect as of March 31, 2008 was 0.50% for LIBOR-based loans and 0.00% for prime rate-based loans. The new agreement subjects the Company to certain financial covenants, including minimum fixed charge and leverage ratio covenants. The Company was in compliance with all covenants under the credit facility as of March 31, 2008.

The effective weighted average interest rate on the Company's revolving credit facility as of March 31, 2008 was 4.69% and as of June 30, 2007 was 6.41%. The outstanding borrowings at March 31, 2008 were \$69.5 million on a total commitment of \$250 million, leaving approximately \$180.5 million available for additional borrowings, as of this date.

On August 1, 2007, the Company entered into an agreement with the State of Mississippi in order to provide financing for the acquisition and installation of certain equipment to be utilized at the Company's new Southaven, Mississippi distribution facility, through the issuance of an industrial development revenue bond. The bond matures on September 1, 2032 and accrues interest at the 30-day LIBOR rate plus a spread of 0.85%. The terms of the bond allows for payment of interest only for the first 10 years of the agreement, and then, starting on September 1, 2018 through 2032, principal and interest payments are due until the maturity date or the redemption of the bond. The Company receives advances on this loan on an as needed basis to pay the ongoing costs of the project, not to exceed \$6 million. The outstanding balance on this facility was \$3.9 million as of March 31, 2008, and the effective interest rate was 3.96%.

On August 17, 2006, the Company obtained a secured revolving credit facility with a borrowing limit of \$3.0 million. At March 31, 2008, the balance was \$0.8 million or \$1.3 million, and the effective rate of interest was 5.11%.

The Company believes that its existing sources of liquidity, including cash resources and cash provided by operating activities, supplemented as necessary with funds under the Company's credit agreements, will provide sufficient resources to meet the Company's present and future working capital and cash requirements for at least the next twelve months.

**Accounting Standards Recently Issued**

In March 2008, the Financial Accounting Standards Board, or ( FASB ), issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*, or SFAS 161. This new standard requires enhanced disclosures for derivative instruments, including those used in hedging activities. It is effective for fiscal years and interim periods beginning after November 15, 2008, and will be applicable to the Company in the third quarter of fiscal 2009. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 161 on its condensed consolidated financial statements.

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In December 2007, the FASB issued the Statement of Financial Accounting Standards, or SFAS, No. 141 (revised 2007), *Business Combinations*, or SFAS 141R. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired,



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the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008, and will be adopted by us in the first quarter of fiscal 2010. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 141R on its condensed consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of Accounting Research Bulletin No. 51*, or SFAS 160. SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008, and will be adopted by us in the first quarter of fiscal 2010. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 160 on its condensed consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which requires companies to provide additional information regarding the effect of a company's choice to use fair value on its earnings and to display the fair value of those assets and liabilities which the company has chosen to use on the face of the balance sheet. SFAS No. 159 is effective for the Company beginning July 1, 2008. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS No. 159 will have on its condensed consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for the Company beginning July 1, 2008. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS No. 157 will have on its condensed consolidated financial statements.

## **Impact of Inflation**

The Company has not been adversely affected by inflation as technological advances and competition within specialty technology markets has generally caused prices of the products sold by the Company to decline. Management believes that any price increases could be passed on to its customers, as prices charged by the Company are not set by long-term contracts.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The Company's principal exposure to changes in financial market conditions in the normal course of its business is a result of its selective use of bank debt and transacting business in foreign currencies in connection with its foreign operations.

*Interest Rate Risk*

The Company is exposed to changes in interest rates primarily as a result of its borrowing activities, which include revolving credit facilities with a group of banks used to maintain liquidity and fund the Company's business operations. The nature and amount of the Company's debt may vary as a result of future business requirements, market conditions and other factors. A hypothetical 100 basis point increase or decrease in interest rates on borrowings on the Company's revolving line of credit, variable rate long term debt and subsidiary line of credit for the quarter and nine months ended March 31, 2008 would have resulted in an approximately \$0.2 million and \$0.7 million increase or decrease, respectively, in pre-tax income.

To mitigate the risk of interest rate fluctuations associated with the Company's variable rate long-term debt, the Company has implemented an interest rate risk management strategy that incorporates the use of an interest rate swap designated as a cash flow hedge to minimize the significant unplanned fluctuations in earnings caused by interest rate volatility. The Company's use of derivative instruments has the potential to expose the Company to certain market risks including the possibility of (1) the Company's hedging activities not being as effective as anticipated in reducing the volatility of the Company's cash flows, (2) the counterparty not performing its obligations under the applicable hedging arrangement, (3) the hedging arrangement being imperfect or ineffective, or (4) the terms of the swap or associated debt may change. The Company seeks to lessen such risks by having established a policy to identify, control, and manage market risks which may arise from changes in interest rates, as well as limiting its counterparties to major financial institutions.

*Foreign Currency Exchange Rate Risk*

The Company is exposed to foreign currency risks that arise from its foreign operations in Canada, Mexico and Europe. These risks include the translation of local currency balances of foreign subsidiaries, inter-company loans with foreign subsidiaries and transactions denominated in non-functional currencies. These risks may change over time as business practices evolve and could have a material impact on the Company's financial results in the future. In the normal course of business, foreign exchange risk is managed by using foreign currency forward contracts to hedge these exposures, as well as balance sheet netting of exposures. The Company's Board of Directors has approved a foreign exchange hedging policy to minimize foreign currency exposure. The Company's policy is to utilize financial instruments to reduce risks where internal netting cannot be effectively employed and not to enter into foreign currency derivative instruments for speculative or trading purposes. The Company monitors its risk associated with the volatility of certain foreign currencies against its functional currencies and enters into foreign exchange derivative contracts to minimize short-term currency risks on cash flows. The Company continually evaluates foreign exchange risk and may enter into foreign exchange transactions in accordance with its policy. Foreign currency gains and losses are included in other expense (income).

The Company has elected not to designate its foreign currency contracts as hedging instruments, and therefore, the instruments are marked to market with changes in their values recorded in the Condensed Consolidated Income Statement each period. The underlying exposures are denominated primarily in British Pounds, Euros, and Canadian Dollars. At March 31, 2008, the Company's currency forward contracts outstanding were immaterial. The Company does not utilize financial instruments for trading or other speculative purposes.

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**Item 4. Controls and Procedures**

An evaluation was carried out under the supervision and with the participation of the Company's management, including its Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of the Company's disclosure controls and procedures as of March 31, 2008. Based on that evaluation, the Company's management, including the CEO and CFO, has concluded that the Company's disclosure controls and procedures are effective as of March 31, 2008. During the third quarter of fiscal 2008, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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**Part II. Other Information**

**Item 1. Legal Proceedings**

On November 21, 2006, a purported stockholder filed a derivative lawsuit in the United States District Court for the District of South Carolina in Greenville, South Carolina against certain current and former officers and directors of the Company and against the Company, as a nominal defendant, asserting causes of action based on alleged violations of securities laws (including alleged violations of Section 10(b), 14(a), and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 of the SEC) and other common law claims including, breach of fiduciary duty, aiding and abetting and unjust enrichment relating to allegations concerning certain of the Company's prior stock option grants. The lawsuit seeks relief in the form of an accounting, rescission, unspecified money damages, disgorgement, attorneys' fees, fees and expenses and other relief. On April 2, 2007, the Court appointed the plaintiff as lead plaintiff and ordered that any later actions filed in the same court and that related to the same facts shall be consolidated.

On April 11, 2007, another purported stockholder filed a substantially similar derivative lawsuit also related to the Company's prior grants of stock options. This action was also filed in the United States District Court for the District of South Carolina in Greenville, South Carolina against certain current and former officers and directors of the Company and against the Company, as nominal defendant, and asserts substantially similar causes of action and claims for relief. The plaintiff in this second action has filed a motion to vacate the prior Order and to consolidate the two actions and appoint the plaintiff as a co-lead plaintiff.

On November 27, 2006 and April 13, 2007, the Company provided notice to its insurance carrier of these actions. The Company's insurance carrier, subject to a reservation of rights, provided a preliminary position on the coverage of these derivative claims in which the carrier indicated that these lawsuit allegations appear to constitute a claim within coverage of the Company's insurance policy. The carrier continues to assess coverage of these matters.

On January 24, 2008, the Company announced that it had received written notice from the SEC declaring that the investigation concerning the Company's historical stock option grant practices had been completed and that no enforcement action was recommended.

The Company and its subsidiaries are, from time to time, parties to other lawsuits arising out of operations. Although there can be no assurance, based upon information known to the Company, the Company believes that any liability resulting from an adverse determination of such lawsuits would not have a material adverse effect on the Company's financial condition or results of operations.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year-ended June 30, 2007, which could materially affect our business, financial condition or future operating results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially and adversely affect the Company's business, financial condition, or operating results.

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**Item 6. Exhibits**  
Exhibits

- 31.1 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.
- 31.2 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.
- 32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**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.

SCANSOURCE, INC.

/s/ Michael L. Baur  
Michael L. Baur  
Chief Executive Officer  
(Principal Executive Officer)

/s/ Richard P. Cleys  
Richard P. Cleys  
Vice President and Chief Financial Officer  
(Principal Financial Officer)

Date: May 9, 2008