

SCANSOURCE INC
Form 10-Q
February 02, 2010
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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 December 31, 2009

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post to such filed). 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.

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 January 28, 2010 |
|--------------------------------------|---------------------------------|
| Common Stock, no par value per share | 26,600,308 shares |

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SCANSOURCE, INC.

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FORWARD-LOOKING STATEMENTS

The forward-looking statements included in the Management's Discussion and Analysis of Financial Condition and Results of Operations, Quantitative and Qualitative Disclosures About Market Risk, Legal Proceedings, and Risk Factors, sections and elsewhere herein, which reflect our best judgment based on factors currently known, involve risks and uncertainties. Words such as expects, anticipates, believes, intends, plans, hopes, and variations of such words and similar expressions are intended to identify such forward-looking statements. Except as may be required by law, we expressly disclaim any obligation to update these forward-looking statements to reflect events or circumstances after the date of this Form 10-Q or to reflect the occurrence of unanticipated events. Actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors including, but not limited to, the factors discussed in such sections and, in particular, those set forth in the cautionary statements included in Risk Factors, contained in our Annual Report on Form 10-K for the year ended June 30, 2009. The forward-looking information we have provided in this Form 10-Q pursuant to the safe harbor established under the Private Securities Litigation Reform Act of 1995 should be evaluated in the context of these factors.

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

| | December 31, 2009 | June 30, 2009 * |
|--|------------------------------|----------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 38,000 | \$ 127,664 |
| Trade and notes receivable: | | |
| Trade, less allowance of \$22,956 at December 31, 2009 and \$16,883 at June 30, 2009 | 359,795 | 291,037 |
| Other receivables | 8,239 | 7,676 |
| Inventories | 308,996 | 216,829 |
| Prepaid expenses and other assets | 11,218 | 10,356 |
| Deferred income taxes | 8,747 | 8,735 |
| Total current assets | 734,995 | 662,297 |
| Property and equipment, net | 20,531 | 21,035 |
| Goodwill | 33,737 | 34,087 |
| Other assets, including identifiable intangible assets | 35,615 | 31,212 |
| Total assets | \$ 824,878 | \$ 748,631 |
| Liabilities and Shareholders Equity | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ | \$ |
| Trade accounts payable | 276,301 | 228,408 |
| Accrued expenses and other liabilities | 32,043 | 30,443 |
| Income taxes payable | 4,261 | 3,799 |
| Total current liabilities | 312,605 | 262,650 |
| Long-term debt | 30,429 | 30,429 |
| Borrowings under revolving credit facility | | |
| Other long-term liabilities | 12,072 | 10,106 |
| Total liabilities | 355,106 | 303,185 |
| 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, 26,590,008 and 26,565,870 shares issued and outstanding at December 31, 2009 and June 30, 2009, respectively | 107,327 | 104,461 |
| Retained earnings | 360,572 | 337,822 |
| Accumulated other comprehensive income | 1,873 | 3,163 |

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| | | |
|--|------------|------------|
| Total shareholders' equity | 469,772 | 445,446 |
| Total liabilities and shareholders' equity | \$ 824,878 | \$ 748,631 |

* Derived from audited consolidated financial statements
See accompanying notes to the condensed consolidated financial statements

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

| | Quarter ended December 31, | | Six months ended December 31, | |
|--|-------------------------------|------------|----------------------------------|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| Net sales | \$ 548,112 | \$ 477,093 | \$ 1,036,535 | \$ 1,016,918 |
| Cost of goods sold | 491,816 | 424,765 | 928,821 | 909,088 |
| Gross profit | 56,296 | 52,328 | 107,714 | 107,830 |
| Operating expenses: | | | | |
| Selling, general and administrative expenses | 38,167 | 33,934 | 71,898 | 68,808 |
| Operating income | 18,129 | 18,394 | 35,816 | 39,022 |
| Other expense (income): | | | | |
| Interest expense | 364 | 623 | 730 | 1,202 |
| Interest income | (422) | (424) | (685) | (775) |
| Other (income), net | (174) | (2,559) | (58) | (2,283) |
| Other (income), net | (232) | (2,360) | (13) | (1,856) |
| Income before income taxes | 18,361 | 20,754 | 35,829 | 40,878 |
| Provision for income taxes | 6,546 | 7,229 | 13,079 | 14,923 |
| Net income | \$ 11,815 | \$ 13,525 | \$ 22,750 | \$ 25,955 |
| Per share data: | | | | |
| Net income per common share, basic | \$ 0.44 | \$ 0.51 | \$ 0.86 | \$ 0.99 |
| Weighted-average shares outstanding, basic | 26,575 | 26,411 | 26,571 | 26,244 |
| Net income per common share, diluted | \$ 0.44 | \$ 0.51 | \$ 0.85 | \$ 0.98 |
| Weighted-average shares outstanding, diluted | 26,798 | 26,540 | 26,811 | 26,422 |

See accompanying notes to the condensed consolidated financial statements

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

(In thousands, except share data)

| | Common Stock (Shares) | Common Stock (Amount) | Retained Earnings | Accumulated Other Comprehensive Income | Total |
|--|-----------------------------|-----------------------------|----------------------|---|------------|
| Balance at June 30, 2009 | 26,565,870 | \$ 104,461 | \$ 337,822 | \$ 3,163 | \$ 445,446 |
| Comprehensive Income: | | | | | |
| Net income | | | 10,935 | | 10,935 |
| Unrealized loss on hedged transaction, net of tax of \$11 | | | | (19) | (19) |
| Foreign currency translation adjustment | | | | 772 | 772 |
| Total comprehensive income | | | | | 11,688 |
| Exercise of stock options and shares issued under share-based compensation plans | | | | | |
| | 3,500 | | | | |
| Share based compensation | | 1,269 | | | 1,269 |
| Tax effect of deductible compensation arising from the exercise or vesting of share-based payment arrangements | | 163 | | | 163 |
| Balance at September 30, 2009 | 26,569,370 | \$ 105,893 | \$ 348,757 | \$ 3,916 | \$ 458,566 |
| Comprehensive Income: | | | | | |
| Net income | | | 11,815 | | 11,815 |
| Unrealized gain on hedged transaction, net of tax of \$49 | | | | 76 | 76 |
| Foreign currency translation adjustment | | | | (2,119) | (2,119) |
| Total comprehensive income | | | | | 9,772 |
| Exercise of stock options and shares issued under share-based compensation plans | | | | | |
| | 20,638 | 111 | | | 111 |
| Share based compensation | | 1,421 | | | 1,421 |
| Tax effect of deductible compensation arising from the exercise or vesting of share-based payment arrangements | | (98) | | | (98) |
| Balance at December 31, 2009 | 26,590,008 | \$ 107,327 | \$ 360,572 | \$ 1,873 | \$ 469,772 |

See accompanying notes to the condensed consolidated financial statements

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

| | Six months ended December 31, | |
|--|--|------------------|
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net income | \$ 22,750 | \$ 25,955 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | |
| Depreciation | 2,006 | 2,184 |
| Amortization of intangible assets | 852 | 1,316 |
| Allowance for accounts and notes receivable | 8,708 | 3,906 |
| Share-based compensation and restricted stock | 2,690 | 2,110 |
| Deferred income taxes | (122) | (1,802) |
| Excess tax benefits from share-based payment arrangements | (66) | (1,538) |
| Changes in operating assets and liabilities: | | |
| Trade and notes receivable | (62,713) | 60,451 |
| Other receivables | (2,419) | 2,830 |
| Inventories | (86,055) | 9,135 |
| Prepaid expenses and other assets | (874) | (792) |
| Other noncurrent assets | (1,973) | 643 |
| Trade accounts payable | 35,637 | (17,655) |
| Accrued expenses and other liabilities | 3,418 | (7,280) |
| Income taxes payable | 491 | (1) |
| Net cash (used in) provided by operating activities | (77,670) | 79,462 |
| Cash flows used in investing activities: | | |
| Capital expenditures | (517) | (3,411) |
| Net proceeds from sale of property and equipment | | 612 |
| Cash paid for business acquisitions, net of cash acquired | (11,647) | |
| Net cash used in investing activities | (12,164) | (2,799) |
| Cash flows from financing activities: | | |
| Decreases in short-term borrowings, net | | (2,688) |
| Payments on revolving credit, net of expenses | | (6,141) |
| Exercise of stock options | 111 | 682 |
| Excess tax benefits from share-based payment arrangements | 66 | 1,538 |
| Proceeds from issuance of long-term debt | | 793 |
| Net cash provided by (used in) financing activities | 177 | (5,816) |
| Effect of exchange rate changes on cash and cash equivalents | (7) | (594) |
| (Decrease) increase in cash and cash equivalents | (89,664) | 70,253 |
| Cash and cash equivalents at beginning of period | 127,664 | 15,224 |
| Cash and cash equivalents at end of period | \$ 38,000 | \$ 85,477 |

See accompanying notes to the condensed 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 December 31, 2009 and June 30, 2009, the results of operations for the quarters and six months ended December 31, 2009 and 2008, and the statement of cash flows for the six months ended December 31, 2009 and 2008. The results of operations for the quarters and six months ended December 31, 2009 and 2008 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 consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2009.

(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, Germany and the United Kingdom, 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, POS and Barcode through its ScanSource Latin American and European sales units, while communication products are marketed through its ScanSource Communications sales unit in Europe.

On November 30, 2009 the Company acquired substantially all of the assets and certain liabilities of Algol Europe, GmbH, a value-added distributor specializing in convergence communications solutions. Algol, headquartered in Cologne, Germany, was renamed ScanSource Communications GmbH and will join ScanSource Communications UK as part of ScanSource Communications Europe.

(3) Summary of Significant Accounting Policies

Except as described below, there have been no material changes to the Company's significant accounting policies for the quarter ended December 31, 2009 from the information included in Note 2 of the Company's Consolidated Financial Statements included in the Form 10-K for the fiscal year ended June 30, 2009. For a discussion of the Company's significant accounting policies, please see the Company's Annual Report filed in our Form 10-K for the fiscal year ended June 30, 2009.

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 \$65.4 million and \$45.6 million as of December 31, 2009 and June 30, 2009, respectively, are included in accounts payable.

Recent Accounting Pronouncements

FASB Accounting Standards Codification

In June 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) 105 (Prior authoritative literature: Statement of Financial Accounting Standards (SFAS) No. 168, *The FASB Accounting Standards Codification and the Hierarchy of*

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Generally Accepted Accounting Principle (a replacement of FASB Statement 162). ASC 105 replaces SFAS 162 and establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. ASC 105 is effective for financial statements issued for interim and annual periods ended after September 15, 2009. The adoption of this pronouncement did have an impact to the Company's financial statement disclosures, as all references to authoritative accounting literature have been referenced in accordance with the Codification.

Table of Contents*Earnings Per Share*

In June 2008, the FASB issued ASC 260 (Prior authoritative literature: FASB Staff Position (FSP) No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, (FSP 03-6-1)). ASC 260 replaces FSP 03-6-1 and states that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are participating securities and should be included in the computation of earnings per share using the two-class method outlined in SFAS No. 128, *Earnings per Share*. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared and participation rights in undistributed earnings. ASC 260 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and requires that all prior period earnings per share data be adjusted retrospectively to conform to the provisions of the ASC. The adoption of these provisions did not have an impact on our Condensed Consolidated Financial Statements.

Business Combinations

In December 2007, the FASB issued FASB ASC 805-10 (Prior authoritative literature: SFAS 141 (R), *Business Combinations*, which replaces FASB Statement No. 141). FASB ASC 805-10 is effective for the Company April 1, 2009 and establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non controlling interest in the acquiree and the goodwill acquired. The Statement also establishes disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. FASB ASC 805-10 will change how business combinations are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. The adoption of this standard did not have a material impact on the Company's Condensed Consolidated Financial Statements and the Company's November 30, 2009 acquisition of substantially all of the assets and certain liabilities of Algot Europe, GmbH was accounted for under this standard.

In April 2009, the FASB issued FASB ASC 805-10-05 (Prior authoritative literature: FSP 141(R)-1 *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arises from Contingencies*). For business combinations, the standard requires the acquirer to recognize at fair value an asset acquired or liability assumed from a contingency if the acquisition date fair value can be determined during the measurement period. FASB ASC 805-10-05 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, with early adoption prohibited. The Company adopted these provisions at the beginning of the fiscal year July 1, 2009. The adoption of this standard did not have a material impact on the Company's Condensed Consolidated Financial Statements.

Fair Value Measurements

Effective July 1, 2009, the Company adopted the provisions of FASB ASC 820 for nonfinancial assets and liabilities which were previously deferred under the provisions of FASB ASC 820-10-65 (Prior authoritative literature: FSP FAS 157-2). The adoption did not have a significant impact on the Company's Condensed Consolidated Financial Statements.

Variable Interest Entities

In June 2009, the FASB issued FASB ASC 810 (Prior authoritative literature: SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*). ASC 810 amends FASB Interpretation No. 46(R), *Variable Interest Entities* for determining whether an entity is a variable interest entity (VIE) and requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a VIE. Under ASC 810, an enterprise has a controlling financial interest when it has a) the power to direct the activities of a VIE that most significantly impact the entity's economic performance and b) the obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE. ASC 810 also requires an enterprise to assess whether it has an implicit financial responsibility to ensure that a VIE operates as designed when determining whether it has power to direct the activities of the VIE that most significantly impact the entity's economic performance. ASC 810 also requires ongoing assessments of whether an enterprise is the primary beneficiary of a VIE, requires enhanced disclosures and eliminates the scope exclusion for qualifying special-purpose entities. ASC 810 is effective for annual and quarterly reporting periods that begin after November 15, 2009. The adoption of this standard on January 1, 2010 is not expected to have a material impact on the Company's Condensed Consolidated Financial Statements.

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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 Income <i>(in thousands, except per share data)</i> | Shares | Per Share Amount |
|--|---|--------|---------------------|
| Quarter ended December 31, 2009: | | | |
| Income per common share, basic | \$ 11,815 | 26,575 | \$ 0.44 |
| Effect of dilutive stock options | | 223 | |
| Income per common share, diluted | \$ 11,815 | 26,798 | \$ 0.44 |
| Six months ended December 31, 2009: | | | |
| Income per common share, basic | \$ 22,750 | 26,571 | \$ 0.86 |
| Effect of dilutive stock options | | 240 | |
| Income per common share, diluted | \$ 22,750 | 26,811 | \$ 0.85 |
| Quarter ended December 31, 2008: | | | |
| Income per common share, basic | \$ 13,525 | 26,411 | \$ 0.51 |
| Effect of dilutive stock options | | 129 | |
| Income per common share, diluted | \$ 13,525 | 26,540 | \$ 0.51 |
| Six months ended December 31, 2008: | | | |
| Income per common share, basic | \$ 25,955 | 26,244 | \$ 0.99 |
| Effect of dilutive stock options | | 178 | |
| Income per common share, diluted | \$ 25,955 | 26,422 | \$ 0.98 |

For the quarter and six months ended December 31, 2009, there were 1,118,143 and 1,118,460 weighted average shares outstanding, respectively, that are excluded from the computation of diluted earnings per share because their effect would have been anti-dilutive.

For the quarter and six months ended December 31, 2008, there were 1,240,724 and 1,219,866 weighted average shares outstanding, respectively, excluded from the computation of diluted earnings per share because their effect would have been anti-dilutive.

(5) Goodwill and Acquisitions

The changes in the carrying amount of goodwill for the six months ended December 31, 2009, by operating segment, are as follows:

| North American Distribution Segment | International Distribution Segment | Total |
|---|--|-------|
|---|--|-------|

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| | <i>(in thousands)</i> | | |
|------------------------------------|-----------------------|-----------|-----------|
| Balance as of June 30, 2009 | \$ 20,081 | \$ 14,006 | \$ 34,087 |
| Goodwill acquired | | | |
| Fluctuations in foreign currencies | | (350) | (350) |
| Balance as of December 31, 2009 | \$ 20,081 | \$ 13,656 | \$ 33,737 |

The change in goodwill from June 30, 2009 relates entirely to foreign exchange fluctuations.

On November 30, 2009, the Company acquired substantially all of the assets and certain liabilities of Algol Europe, GmbH in our international distribution segment. Algol Europe is a value-added distributor of specialty technologies, including voice, data, and video communication products located in Cologne, Germany. This acquisition significantly expands the footprint of the ScanSource Communications sales unit outside of the United Kingdom and is part of the Company's strategy to become a pan-European distributor of communication products. The purchase price of this acquisition was preliminarily allocated to the assets acquired and the liabilities assumed based on their estimated fair values on the transaction date, resulting in approximately \$3.1 million of identifiable intangible assets primarily related to customer relationships and non-compete agreements with the former owners. The Company is using valuation specialists to assist in determining the fair value of these assets and expects to receive the results of these valuations in the subsequent quarter. All professional fees and other costs associated with our acquisition of these assets were expensed as incurred.

Included within other assets described in the balance sheet are net identifiable intangible assets of \$18.9 million and \$16.7 million at December 31, 2009 and June 30, 2009, respectively. These amounts relate primarily to customer relationships and trade

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names associated with prior period acquisitions. The increase in identifiable intangible assets resulting from the acquisition of Algol Europe during the quarter was offset by amortization expense and, to a lesser extent, foreign exchange fluctuations.

(6) Short Term Borrowings and Long Term Debt*Short-Term Borrowings*

| | December 31, 2009 | June 30, 2009 |
|-----------------------|-----------------------|------------------|
| | <i>(in thousands)</i> | |
| Short-term borrowings | \$ | \$ |

The Company has a 6.0 million secured revolving credit facility which bears interest at the 30 day Euro Interbank Offered Rate (EURIBOR) plus a spread of 1.25 per annum. At December 31, 2009 and at June 30, 2009, there were no outstanding borrowings against this facility. This facility is secured by the assets of our European operations and is guaranteed by ScanSource, Inc.

Revolving Credit Facility

| | December 31, 2009 | June 30, 2009 |
|---------------------------|-----------------------|------------------|
| | <i>(in thousands)</i> | |
| Revolving credit facility | \$ | \$ |

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. The 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) 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 December 31, 2009 was 0.50% for LIBOR-based loans and 0.00% for prime rate-based loans. The agreement subjects the Company to certain financial covenants, including minimum fixed charge and leverage ratio covenants. The agreement also has certain restrictive covenants that, among other things, place limitations on the payment of cash dividends. In October 2009, it was determined that the Company was not in compliance with a specific intercompany loan covenant within the agreement since June 30, 2008. This default was due to a technical misunderstanding of the underlying legal agreement which was immediately waived and the agreement amended to allow for such transactions in the future. The Company determined that revisions to prior period financial statements were not necessary. The Company was in compliance with all covenants under the credit facility as of December 31, 2009. There were no outstanding borrowings on this facility as of December 31, 2009 and June 30, 2009, leaving \$250 million available for additional borrowings.

Long-Term Debt

| | December 31, 2009 | June 30, 2009 |
|---|-----------------------|------------------|
| | <i>(in thousands)</i> | |
| Industrial Development Revenue Bond, monthly payments of interest only, 1.08% variable interest rate at December 31, 2009 and maturing in fiscal 2033 | \$ 5,429 | \$ 5,429 |
| Unsecured note payable to a bank, monthly payments of interest only, 0.88% variable interest rate at December 31, 2009 and maturing in fiscal 2013 (see Note 7) | 25,000 | 25,000 |

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| | | |
|----------------------|-----------|-----------|
| | 30,429 | 30,429 |
| Less current portion | | |
| Long-term portion | \$ 30,429 | \$ 30,429 |

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 allow 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 outstanding balance on this facility was \$5.4 million as of December 31, 2009, and the effective interest rate was 1.08%. As of December 31, 2009, the Company was in compliance with all covenants under this note payable.

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On January 2, 2008, the Company entered into a \$25 million promissory note with a financial institution. 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 the principal balance is fully re-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. As of December 31, 2009, the Company was in compliance with all covenants under this note payable.

(7) Derivatives and Hedging Activities

The Company's results of operations could be materially impacted by significant changes in foreign currency exchange rates and interest rates. These risks and the management of these risks are discussed in greater detail below. In an effort to manage the exposure to these risks, the Company periodically enters into various derivative instruments. The Company's accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments in accordance with generally accepted accounting principles in the United States. The Company records all derivatives on the balance sheet at fair value. Derivatives that are not designated as hedging instruments or the ineffective portions of cash flow hedges are adjusted to fair value through earnings in other income and expense.

Foreign Currency the Company conducts a portion of its business internationally in a variety of foreign currencies. The exposure to market risk for changes in foreign currency exchange rates arises from foreign currency denominated assets and liabilities, and transactions arising from non-functional currency financing or trading activities. The Company's objective is to preserve the economic value of non-functional currency denominated cash flows. The Company attempts to hedge transaction exposures with natural offsets to the fullest extent possible and, once these opportunities have been exhausted, through forward contracts or other hedging instruments with third parties. At December 31, 2009, the Company had contracts outstanding with notional amounts of \$43 million to exchange foreign currencies, including the US Dollar, Euro, British Pound, Canadian Dollar, and Mexican Peso. To date, the Company has chosen not to designate these derivatives as hedging instruments, and accordingly, these instruments are adjusted to fair value through earnings in other income and expense. Summarized financial information related to these derivative contracts and changes in the underlying value of the foreign currency exposures are as follows:

| | Quarter ended December 31, 2009 | Quarter ended December 31, 2008 |
|--|--|---------------------------------------|
| | <i>(in thousands)</i> | |
| Net foreign exchange derivative contract (losses) gains | \$ (395) | \$ 4,475 |
| Net foreign currency transactional and re-measurement gains (losses) | 457 | (5,502) |
| Net foreign currency transactional and re-measurement gains (losses) | \$ 62 | \$ (1,027) |

| | Six months ended December 31, 2009 | Six months ended December 31, 2008 |
|--|---|---|
| | <i>(in thousands)</i> | |
| Net foreign exchange derivative contract (losses) gains | \$ (681) | \$ 5,802 |
| Net foreign currency transactional and re-measurement gains (losses) | 525 | (7,156) |
| Net foreign currency transactional and re-measurement (losses) | \$ (156) | \$ (1,354) |

Interest Rates the Company's earnings are also affected by changes in interest rates due to the impact those changes have on interest expense from floating rate debt instruments. To manage the exposure to interest rates, the Company may enter into interest rate swap hedges. In January 2008, the Company entered into an interest rate swap agreement to hedge the variability in future cash flows of interest payments related to the \$25 million promissory note payable discussed in Note 6. Interest rate differentials paid or received under the swap agreement are recognized as

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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 fair value of the swap was a liability of \$1.1 million as of December 31, 2009. To date, there has not been any ineffectiveness associated with this instrument, and there are no other swap agreements outstanding.

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The components of the cash flow hedge included in accumulated other comprehensive income, net of income taxes, in the Condensed Consolidated Statement of Shareholders' Equity for the quarters and six months ended December 31, 2009 and 2008, are as follows:

| | Quarter ended December 31, 2009 | Quarter ended December 31, 2008 |
|---|--|---------------------------------------|
| Net interest expense recognized as a result of interest rate swap | \$ 218 | \$ 68 |
| Unrealized loss in fair value of interest swap rates | (93) | (1,515) |
| Net increase (decrease) in accumulated other comprehensive income | 125 | (1,447) |
| Income tax effect | (49) | 550 |
| Net increase (decrease) in accumulated other comprehensive income, net of tax | \$ 76 | \$ (897) |

| | Six months ended December 31, 2009 | Six months ended December 31, 2008 |
|---|---|---|
| Net interest expense recognized as a result of interest rate swap | \$ 433 | \$ 143 |
| Unrealized loss in fair value of interest swap rates | (338) | (1,735) |
| Net increase (decrease) in accumulated other comprehensive income | 95 | (1,592) |
| Income tax effect | (38) | 605 |
| Net increase (decrease) in accumulated other comprehensive income, net of tax | \$ 57 | \$ (987) |

The Company has the following derivative instruments located on the Condensed Consolidated Balance Sheets and Income Statements, utilized for the risk management purposes detailed above:

| | As of December 31, 2009 | |
|------------------------------|---|---|
| | Fair Value of Derivatives Designated as Hedge Instruments | Fair Value of Derivatives Not Designated as Hedge Instruments |
| Derivative assets (a): | | |
| Foreign exchange contracts | \$ | \$ 114 |
| Derivative liabilities (b): | | |
| Foreign exchange contracts | \$ | \$ (96) |
| Interest rate swap agreement | \$ (1,098) | \$ |

(a) All derivative assets are recorded as prepaid expense and other assets in the Condensed Consolidated Balance Sheets.

(b) All derivative liabilities are recorded as accrued expenses and other liabilities in the Condensed Consolidated Balance Sheets.

(8) Fair Value of Financial Instruments

The Company's financial assets and liabilities measured at fair value are required to be grouped in one of three levels. The levels prioritize the inputs used to measure the fair value of the assets or liabilities. These levels are:

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Level 1 Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability;

Level 3 Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

The following table summarizes the valuation of the Company's short-term investments and financial instruments by the above categories as of December 31, 2009:

| | Total | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
|---|-----------------------|--|--|--|
| | <i>(in thousands)</i> | | | |
| Deferred compensation plan investments (1) | \$ 7,916 | \$ 7,916 | \$ | \$ |
| Derivative instruments (2) | | | | |
| Forward foreign currency exchange contracts | 18 | | 18 | |
| Interest rate swap liability | (1,098) | | (1,098) | |
| Total | \$ 6,836 | \$ 7,916 | \$ (1,080) | \$ |

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- (1) These investments are held in a rabbi trust and include mutual funds and cash equivalents for payment of certain non-qualified benefits for certain retired, terminated and active employees.
- (2) See Note 7, Derivatives and Hedging Activities .
- (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 2 of the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2009.

North American Distribution

North American Distribution offers products for sale in four primary categories: (i) AIDC, POS and barcoding 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, and (iv) electronic security products and wireless infrastructure products through the 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 quarters and six months ended December 31, 2009 or 2008, respectively.

International Distribution

The international distribution segment sells to two geographic areas, Latin America (including Mexico) and Europe, and offers AIDC and POS equipment as well as communications products to more than 6,000 resellers and integrators of technology products. Of this segment's customers, no single account represented more than 3% of the Company's consolidated net sales during the fiscal quarters ended December 31, 2009 or 2008, respectively.

Inter-segment sales consist primarily 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:

| | Quarter ended December 31, | | Six months ended December 31, | |
|---------------------------------------|----------------------------|------------|-------------------------------|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| Sales: | | | | |
| North American distribution | \$ 435,168 | \$ 389,252 | \$ 838,845 | \$ 842,551 |
| International distribution | 120,098 | 96,465 | 211,329 | 191,325 |
| Less intersegment sales | (7,154) | (8,624) | (13,639) | (16,958) |
| | \$ 548,112 | \$ 477,093 | \$ 1,036,535 | \$ 1,016,918 |
| Depreciation and amortization: | | | | |
| North American distribution | \$ 1,160 | \$ 1,448 | \$ 2,419 | \$ 2,886 |
| International distribution | 232 | 277 | 439 | 614 |
| | \$ 1,392 | \$ 1,725 | \$ 2,858 | \$ 3,500 |
| Operating income: | | | | |
| North American distribution | \$ 14,318 | \$ 14,497 | \$ 29,249 | \$ 32,222 |
| International distribution | 3,811 | 3,897 | 6,567 | 6,800 |
| | \$ 18,129 | \$ 18,394 | \$ 35,816 | \$ 39,022 |

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Capital expenditures:

| | | | | | | | | |
|-----------------------------|----|-----|----|-------|----|-----|----|-------|
| North American distribution | \$ | 292 | \$ | 1,115 | \$ | 380 | \$ | 3,237 |
| International distribution | | 77 | | 62 | | 137 | | 174 |
| | \$ | 369 | \$ | 1,177 | \$ | 517 | \$ | 3,411 |

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| | December 31, 2009 | June 30, 2009 |
|-----------------------------|-------------------|---------------|
| Assets: | | |
| North American distribution | \$ 719,364 | \$ 689,865 |
| International distribution | 105,514 | 58,766 |
| | \$ 824,878 | \$ 748,631 |

(10) Commitments and Contingencies

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

As of December 31, 2009 and June 30, 2009, the Company had approximately \$2.3 million and \$2.3 million of total gross unrecognized tax benefits including interest, respectively. Of this total, approximately \$2.0 million and \$2.0 million, respectively, represents the amount of unrecognized tax benefits that are permanent in nature and, if recognized, would affect the annual effective tax rate. The Company does not believe that the total amount of unrecognized tax benefits will significantly increase or decrease within twelve months of the reporting date.

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 2006.

The Company's continuing practice is to recognize interest and penalties related to income tax matters in income tax expense. As of December 31, 2009, the Company had approximately \$0.9 million accrued for interest and penalties, none of which was a current period expense.

Income taxes for the interim period presented have been included in the accompanying financial statements on the basis of an estimated annual effective tax rate. In addition to the amount of tax resulting from applying the estimated annual effective tax rate to pre-tax income, the Company includes certain items treated as discrete events to arrive at an estimated overall tax amount. There were no significant discrete items in the period.

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

(12) Settlement Recovery

During the quarter ended December 31, 2008, the Company settled a claim against a former legal service provider resulting in a \$3.5 million recovery. This settlement was received by the Company on December 5, 2008 and was recorded as other income in the Condensed Consolidated Income Statements.

(13) Subsequent Events

Subsequent events have been evaluated through February 2, 2009, the date these financial statements were issued.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Overview

ScanSource, Inc. is a leading wholesale distributor of specialty technology products, providing value-added distribution sales to resellers in the specialty technology markets. The Company distributes more than 58,300 products worldwide. 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, Germany, and the United Kingdom, respectively. The North American distribution segment markets automatic identification and data capture (AIDC) and point-of-sale (POS) products through the 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 sales unit; and electronic security products and wireless infrastructure products through its ScanSource Security sales unit. The international distribution segment markets POS and Barcode products through its ScanSource Latin America and European sales units, while communication products are marketed through its ScanSource Communications sales unit in Europe. The Company was incorporated in December 1992 and is headquartered in Greenville, South Carolina.

On November 30, 2009 the Company acquired substantially all of the assets and certain liabilities of Algol Europe, GmbH, a value-added distributor specializing in convergence communications solutions. Algol, headquartered in Cologne, Germany, was renamed ScanSource Communications GmbH, and will join ScanSource Communications UK as part of ScanSource Communications Europe.

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Evaluating Financial Condition and Operating Performance

The Company's management places a significant emphasis on operating income and return on invested capital (ROIC) in evaluating and monitoring the Company's financial condition and operating performance. ROIC is used by the Company to assess its efficiency at allocating the capital under its control to generate returns. ROIC is computed by the Company as net income plus income taxes, interest expense, depreciation and amortization, divided by invested capital, and then annualized.

The following table summarizes the Company's annualized return on invested capital ratio for the quarter ended December 31, 2009 and 2008, respectively:

| | Quarter ended December 31, | |
|--|-----------------------------------|-------------|
| | 2009 | 2008 |
| Return on invested capital ratio, annualized | 16.3% | 18.6% |

The discussion that follows this overview explains the decrease in ROIC from the comparative period shown above. The Company uses ROIC as a performance measurement because it believes that this metric best balances the Company's operating results with its asset and liability management, excludes the results of capitalization decisions, is easily computed, communicated and understood and drives changes in shareholder value. The components of this calculation and a reconciliation to the Company's financial statements is shown below:

Reconciliation of EBITDA to net income:

| | Quarter Ended December 31, | |
|-----------------------------------|---------------------------------------|------------------|
| | 2009 | 2008 |
| | <i>(in thousands)</i> | |
| Net income | \$ 11,815 | \$ 13,525 |
| Plus: income taxes | 6,546 | 7,229 |
| Plus: interest expense | 364 | 623 |
| Plus: depreciation & amortization | 1,391 | 1,725 |
| EBITDA (numerator) | \$ 20,116 | \$ 23,102 |

Invested capital calculations:

| | 2009 | 2008 |
|---|-----------------------|-------------------|
| | <i>(in thousands)</i> | |
| Equity beginning of the quarter | \$ 458,566 | \$ 406,702 |
| Equity end of the quarter | 469,772 | 417,348 |
| Average equity | 464,169 | 412,025 |
| Average debt ⁽¹⁾ | 30,987 | 84,789 |
| Invested capital (denominator) | \$ 495,156 | \$ 496,814 |
| Return on invested capital (annualized) | 16.3% | 18.6% |

⁽¹⁾ Average debt is based upon average outstanding daily debt.

Table of Contents**Results of Operations***Net Sales*

The following table summarizes our net sales results (net of inter-segment sales) for the quarters and six months ended December 31, 2009 and 2008:

| | Quarter ended December 31, | | \$ Change | % Change |
|-----------------------------|-------------------------------|------------------------|-----------|----------|
| | 2009 | 2008 (in thousands) | | |
| North American distribution | \$ 428,014 | \$ 380,628 | \$ 47,386 | 12.4% |
| International distribution | 120,098 | 96,465 | 23,633 | 24.5% |
| Net sales | \$ 548,112 | \$ 477,093 | \$ 71,019 | 14.9% |

| | Six months ended December 31, | | \$ Change | % Change |
|-----------------------------|----------------------------------|------------------------|-----------|----------|
| | 2009 | 2008 (in thousands) | | |
| North American distribution | \$ 825,206 | \$ 825,593 | \$ (387) | (0.0%) |
| International distribution | 211,329 | 191,325 | 20,004 | 10.5% |
| Net sales | \$ 1,036,535 | \$ 1,016,918 | \$ 19,617 | 1.9% |

On a comparative basis, consolidated worldwide net sales for the quarter ended December 31, 2009 increased 14.9% to \$548.1 million. For the six months ended December 31, 2009, net sales increased slightly to \$1.04 billion, a 1.9% increase from the comparative prior year period. During both the current quarter and year-to-date periods, the Company experienced stronger demand in all of our geographic segments due to improved economic conditions and heavier year-end capital spending by end users.

North American Distribution

The North American distribution segment includes sales to technology resellers in the United States and Canada from our Southaven, Mississippi distribution center. For the quarter ended December 31, 2009, net sales increased over the comparative prior year period by \$47.4 million, or 12.4%, while comparative net sales for the year-to-date period were flat.

The Company's North American POS, bar-coding, and security product categories saw revenues increase by 8.4% in comparison to the prior year quarter. However, on a year-to-date basis, comparative revenues were still down approximately 3.4%. In the current quarter, sales of all of our major product categories were up in comparison to the prior year. In addition, the Company continues to see strong growth in our security product lines on a comparative and sequential basis, driven by our video surveillance and card printer product lines. It is also notable that the Company began to see a return of the larger deals that drive revenues and have been absent from previous quarters, especially in our POS and bar-coding product lines.

The Company has two North American sales units that sell communications products to our customers—the Catalyst *Telecom* sales unit and the ScanSource Communications sales unit. The combined sales of these units increased by 17.8% and 4.3% over the comparable quarter and year-to-date periods ended December 31, 2009. Substantially all of our major vendors experienced sales growth over the comparable periods in these sales units.

International Distribution

The international distribution segment includes sales to Latin America (including Mexico) and Europe from the ScanSource POS and Barcoding sales units and in Europe through the ScanSource Communications sales unit. For the quarter and six months ended December 31, 2009, net

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sales for this segment increased by \$23.6 million and \$20 million, or 24.5% and 10.5%, respectively. While the Company did experience sales improvement in both Europe and Latin America, a portion of this increase can be attributable to the impact of foreign currency exchange rates between the two periods in Europe. In the prior year quarter, the US dollar was significantly stronger versus the Euro and the British Pound in comparison to the current period. As a result, sales originating in Europe and the United Kingdom which are denominated in Euros and Pounds, respectively, converted into fewer US dollars of sales in the prior year. On a constant exchange rate basis, the sales increase for the quarter and six-month period ending December 31, 2009 was 14.1% and 7.4%, respectively.

The current quarter also includes incremental revenues associated with the Company's acquisition of substantially all of the assets and certain liabilities of Algol Europe, GmbH, which occurred on November 30, 2009. Algol Europe is a value-added distributor of specialty technologies, including voice, data, and video communications products located in Cologne, Germany. This acquisition significantly expands the

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footprint of the ScanSource Communications sales unit outside of the United Kingdom and is part of the Company's strategy to become a pan-European distributor of communication products.

Gross Profit

The following tables summarize the Company's gross profit for the quarters and six month periods ended December 31, 2009 and 2008, respectively:

| | Quarter ended December 31, | | | | % of Sales December 31, | |
|-----------------------------|-------------------------------|------------------|-----------------|-------------|----------------------------|--------------|
| | 2009 | 2008 | \$ Change | % Change | 2009 | 2008 |
| | <i>(in thousands)</i> | | | | | |
| North American distribution | \$ 42,846 | \$ 39,946 | \$ 2,900 | 7.3% | 10.0% | 10.5% |
| International distribution | 13,450 | 12,382 | 1,068 | 8.6% | 11.2% | 12.8% |
| Gross profit | \$ 56,296 | \$ 52,328 | \$ 3,968 | 7.6% | 10.3% | 11.0% |

| | Six months ended December 31, | | | | % of Sales December 31, | |
|-----------------------------|----------------------------------|-------------------|-----------------|---------------|----------------------------|--------------|
| | 2009 | 2008 | \$ Change | % Change | 2009 | 2008 |
| | <i>(in thousands)</i> | | | | | |
| North American distribution | \$ 83,292 | \$ 83,599 | \$ (307) | (0.0%) | 10.1% | 10.1% |
| International distribution | 24,422 | 24,231 | 191 | 0.0% | 11.6% | 12.7% |
| Gross profit | \$ 107,714 | \$ 107,830 | \$ (116) | (0.0%) | 10.4% | 10.6% |

North American Distribution

Gross profit for the North American distribution segment increased 7.3% or \$2.9 million for the quarter ended December 31, 2009, as compared to the prior year period. However, for the six month period ended December 31, 2009, gross profit was consistent with the prior year period. The increase in gross profit in the current quarter is largely the result of higher sales volumes in all of our sales units as previously discussed, offset slightly by lower gross margins. Gross profit as a percentage of net sales for the North American distribution segment decreased to 10% for the quarter ended December 31, 2009, compared to 10.5% in the comparative quarter. A portion of this decrease relates to specific vendor program changes effected in the prior year quarter that resulted in the accelerated recognition of vendor credits for that period. However, in the current quarter, the Company also saw an increase in larger deals that carry lower margins, especially in our POS & Bar-coding sales unit. On a year-to-date basis, gross profit expressed as a percentage of net sales remained consistent for the two comparative periods at 10.1%.

International Distribution

In our international distribution segment, gross profit increased by 8.6% or \$1.1 million for the quarter ended December 31, 2009, as compared to the same period in the prior year. As discussed previously, current quarter gross profit in the Company's international segment includes activity from the Company's acquisition of substantially all of the assets and liabilities of Algol Europe, which occurred on November 30, 2009. Gross margin, expressed as a percentage of revenues, decreased to 11.2% and 11.6% for the quarter and six months ended December 31, 2009, respectively. This decrease is primarily attributable to vendor price increases effected in Europe during the prior year quarter that temporarily improved gross margins on lower cost product already in inventory.

Operating Expenses

The following table summarizes our operating expenses for the quarters and six months ended December 31, 2009 and 2008, respectively:

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| | Period ended December 31, | | | | % of Sales December 31, | |
|------------|------------------------------|-----------|-----------|----------|----------------------------|------|
| | 2009 | 2008 | \$ Change | % Change | 2009 | 2008 |
| | <i>(in thousands)</i> | | | | | |
| Quarter | \$ 38,167 | \$ 33,934 | \$ 4,233 | 12.5% | 7.0% | 7.1% |
| Six months | \$ 71,898 | \$ 68,808 | \$ 3,090 | 4.5% | 6.9% | 6.8% |

Operating expenses increased 12.5% or \$4.2 million for the quarter ended December 31, 2009, and 4.5% or \$3 million for the six month period as compared to the same periods in the prior year. The increase in operating expenses for both periods is

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primarily attributable to bad debt expense recognized during the current quarter, in addition to incremental operating expenditures associated with our acquisition of Algol Europe, as discussed previously. The majority of the increase in bad debt expense during the current quarter reflects an adjustment to our allowance for doubtful accounts for a specific account exposure. Despite the increase in bad debt expense, operating expenses as a percentage of sales were largely consistent for both periods ended December 31, 2009 in comparison to the prior year periods.

Operating Income

The following table summarizes our operating income for the quarters and six months ended December 31, 2009 and 2008, respectively:

| | Quarter ended December 31, | | | | % of Sales December 31, | |
|-----------------------------|-------------------------------|-----------|-----------|----------|----------------------------|------|
| | 2009 | 2008 | \$ Change | % Change | 2009 | 2008 |
| | <i>(in thousands)</i> | | | | | |
| North American distribution | \$ 14,318 | \$ 14,497 | \$ (179) | (1.2%) | 3.3% | 3.8% |
| International distribution | 3,811 | 3,897 | (86) | (2.2%) | 3.2% | 4.0% |
| | \$ 18,129 | \$ 18,394 | \$ (265) | (1.4%) | 3.3% | 3.9% |

| | Six months ended December 31, | | | | % of Sales December 31, | |
|-----------------------------|----------------------------------|-----------|------------|----------|----------------------------|------|
| | 2009 | 2008 | \$ Change | % Change | 2009 | 2008 |
| | <i>(in thousands)</i> | | | | | |
| North American distribution | \$ 29,249 | \$ 32,222 | \$ (2,973) | (9.3%) | 3.5% | 3.9% |
| International distribution | 6,567 | 6,800 | (233) | (3.4%) | 3.1% | 3.6% |
| | \$ 35,816 | \$ 39,022 | \$ (3,206) | (8.2%) | 3.5% | 3.8% |

Operating income decreased 1.4% or \$0.3 million and 8.2% or \$3.2 million, respectively, for the quarter and six months ended December 31, 2009. The decrease in operating income for both segments is primarily attributable to changes in sales and higher operating expenses for both periods, as discussed previously.

Total Other Expense (Income)

The following table summarizes our total other expense (income) for the quarters and six months ended December 31, 2009 and 2008, respectively:

| | Quarter ended December 31, | | | | % of Sales December 31, | |
|-------------------------------------|-------------------------------|------------|-----------|----------|----------------------------|-------|
| | 2009 | 2008 | \$ Change | % Change | 2009 | 2008 |
| | <i>(in thousands)</i> | | | | | |
| Interest expense | \$ 364 | \$ 623 | \$ (259) | (41.6%) | 0.0% | 0.1% |
| Interest income | (422) | (424) | 2 | (0.0%) | -0.0% | -0.1% |
| Net foreign exchange (gains) losses | (62) | 1,027 | (1,089) | 106.0% | -0.0% | 0.2% |
| Other, net | (112) | (3,586) | 3,474 | (96.9%) | -0.0% | -0.8% |
| Total other expense, net | \$ (232) | \$ (2,360) | \$ 2,128 | (895.3) | -0.0% | -0.5% |

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| | Six months ended December 31, | | | | % of Sales December 31, | |
|-----------------------------------|----------------------------------|------------|------------|----------|----------------------------|-------|
| | 2009 | 2008 | \$ Change | % Change | 2009 | 2008 |
| | <i>(in thousands)</i> | | | | | |
| Interest expense | \$ 730 | \$ 1,202 | \$ (472) | (39.3%) | 0.0% | 0.1% |
| Interest income | (685) | (775) | 90 | (11.6%) | -0.0% | -0.1% |
| Net foreign exchange losses | 156 | 1,354 | (1,198) | 88.5% | -0.0% | 0.1% |
| Other (income), net | (214) | (3,637) | 3,423 | (94.1%) | 0.0% | -0.4% |
| Total other (income) expense, net | \$ (13) | \$ (1,856) | \$ (1,843) | (99.3%) | -0.0% | -0.2% |

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Interest expense reflects interest paid related to borrowings on the Company's revolving credit facility and other long-term debt agreements. Interest expense for the quarter and six months ended December 31, 2009 was \$0.4 million and \$0.7 million, respectively. The decrease in interest expense for both comparative periods is primarily the result of lower average debt balances between the respective periods.

Interest income for the quarter and six months ended December 31, 2009 was slightly lower than the comparative prior year periods. The Company generates interest income on longer-term interest bearing receivables, and, to a much lesser extent, interest earned on cash and cash-equivalent balances on hand.

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. Foreign exchange losses and gains are generated as the result of fluctuations in the value of the Euro versus the British Pound and the U.S. Dollar versus other currencies. While the Company utilizes foreign exchange contracts and debt in non-functional currencies to hedge foreign currency exposure, our foreign exchange policy prohibits us from entering into speculative transactions.

During the prior year quarter ended December 31, 2008, the Company settled a claim against a former legal service provider resulting in a \$3.5 million recovery. This settlement was received by the Company on December 5, 2008 and was recorded as other income.

Provision for Income Taxes

Income tax expense for the quarter ended December 31, 2009 was \$6.5 million, reflecting an effective tax rate of 35.7%. In the comparative prior year quarter, the effective rate was 34.8%. The increase in the effective tax rate from the prior year quarter reflects a favorable tax ruling from a state tax jurisdiction received in December 2008 that was retroactive to fiscal 2008 and was recognized in the prior year period. The net effect of this discrete item in that quarter was a benefit of approximately \$0.4 million, which had the effect of decreasing the effective tax rate for that quarter.

For the six month period ended December 31, 2009, income tax expense was \$13.1 million, reflecting an effective tax rate of 36.5%, which was consistent with the comparative prior year period.

Net Income

The following table summarizes our net income for the quarters and six month periods ended December 31, 2009 and 2008, respectively:

| | Period ended December 31, | | \$ Change | % Change | % of Sales December 31, | |
|------------|------------------------------|-----------|------------|----------|----------------------------|------|
| | 2009 | 2008 | | | 2009 | 2008 |
| | <i>(in thousands)</i> | | | | | |
| Quarter | \$ 11,815 | \$ 13,525 | \$ (1,710) | (12.6%) | 2.2% | 2.8% |
| Six months | \$ 22,750 | \$ 25,955 | \$ (3,205) | (12.3%) | 2.2% | 2.6% |

The decrease in net income for both periods is attributable to the changes in operations, as discussed above.

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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 borrowings under the subsidiary's line of credit. The Company's cash and cash equivalent balance totaled \$38 million at December 31, 2009, compared to \$127.7 million at June 30, 2009. The Company's working capital increased to \$422.4 million at December 31, 2009 from \$399.6 million at June 30, 2009. The \$22.8 million increase in working capital is primarily due to higher inventory and accounts receivable balances between the two periods, offset by lower cash balances. As of December 31, 2009, there is no outstanding balance on the Company's revolving credit facility.

The number of days sales in receivables (DSO) was 59 at December 31, 2009, compared to 59 days at June 30, 2009 and 58 days at September 30, 2009.

Inventory turnover increased to 6.8 times in the current quarter versus 6.2 times in the comparative, prior year quarter. This increase is largely the function of significantly higher revenues in the current quarter versus the comparative prior year quarter.

Cash used in operating activities was approximately \$77.7 million for the six months ended December 31, 2009, compared to \$79.5 million of cash provided by operating activities for the comparative prior year period. The \$157.2 million swing in cash flow was driven primarily by the overall improvement in demand discussed previously. This resulted in a significant increase in accounts receivable and inventory balances during the current year-to-date period.

Cash used in investing activities for the six month period ended December 31, 2009 was \$12.2 million, compared to \$2.8 million used in the comparative prior year period. On November 30, 2009, the Company acquired substantially all of the assets and certain liabilities of Algot Europe, GmbH, a value-added distributor of specialty technologies, including voice, data, and video communications based in Cologne, Germany. There was no acquisition activity in the prior year period. Capital expenditures in the current year-to-date period totaled \$0.5 million, a \$2.9 million decrease from prior year capital purchases of \$3.4 million. For both periods, these amounts reflect net capital expenditures purchased in the ordinary course of business.

In the current year-to-date period, cash provided by financing activities amounted to \$0.2 million, in comparison with cash used of \$5.8 million in the comparative prior year period. In the current period, there was minimal activity in terms of financing activities, with the exception of proceeds received by the Company as a result of the stock option exercises by employees. The Company's average outstanding balance on its revolving credit facility was \$0.6 million during the quarter and the Company had cash on hand of \$38 million at December 31, 2009. In contrast, in the comparative prior year period, the Company was in the process of reducing its outstanding debt balances as cash flows from operations increased due to lower sales volumes and a decrease in inventory purchases due to lack of overall demand.

In addition to our domestic revolving credit facility, the Company has a \$6.0 million secured revolving credit facility utilized by our European operations which bears interest at the 30 day Euro Interbank Offered Rate (EURIBOR) plus a spread of 1.25 per annum. At December 31, 2009 and at June 30, 2009, there were no outstanding borrowings against this facility. This facility is secured by the assets of our European operations and is guaranteed by ScanSource, Inc.

On January 2, 2008, the Company entered into a \$25 million promissory note with a financial institution. 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 the principal balance is fully re-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. As of December 31, 2009, the Company was in compliance with all covenants under this note payable.

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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 this note payable. Under the terms of the swap, the Company pays a fixed rate of 3.65% plus a fixed spread of 0.65% on the \$25 million notional amount and receives payments from a counterparty based on 30 day LIBOR plus a fixed spread of 0.65% 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. The 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) 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 December 31, 2009 was 0.50% for LIBOR-based loans and 0.00% for prime rate-based loans. The agreement subjects the Company to certain financial covenants, including minimum fixed charge and leverage ratio covenants. The agreement also has certain restrictive covenants that, among other things, place limitations on the payment of cash dividends. In October 2009, it was determined that the Company was not in compliance with a specific intercompany loan covenant within the agreement since June 30, 2008. This default was due to a technical misunderstanding of the underlying legal agreement which was immediately waived and the agreement amended to allow for such transactions in the future. The Company determined that revisions to prior period financial statements were not necessary. The Company was in compliance with all covenants under the credit facility as of December 31, 2009. There were no outstanding borrowings on this facility as of December 31, 2009 and June 30, 2009, leaving \$250 million available for additional borrowings.

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 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 allow 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 outstanding balance on this facility was \$5.4 million as of December 31, 2009, and the effective interest rate was 1.08%. The Company was in compliance with all covenants associated with this agreement as of December 31, 2009.

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

See Note 3 to our Condensed Consolidated Financial Statements.

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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 credit facility, variable rate long term debt and subsidiary line of credit for the quarter ended December 31, 2009 would have resulted in a less than \$0.1 million increase or decrease, respectively, in pre-tax income for the period.

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. These positions are based upon our forecasted purchases and sales denominated in certain foreign currencies. The Company continually evaluates foreign exchange risk and may enter into foreign exchange transactions in accordance with its policy. Actual variances from these forecasted transactions can adversely impact foreign exchange results. 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, Mexican Pesos and Canadian Dollars. At December 31, 2009, the fair value of the Company's currency forward contracts outstanding was a net receivable of less than \$0.1 million. The Company does not utilize financial instruments for trading or other speculative purposes.

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 December 31, 2009. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures are effective as of December 31, 2009. During the second quarter of fiscal 2010, 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.

Table of Contents**PART II. OTHER INFORMATION****Item 1A. Risk Factors**

Credit exposure *We have credit exposure to our reseller customers. Any adverse trends in their businesses could cause us to suffer credit losses.*

We have credit exposure to our reseller customers and negative trends in their businesses could increase our credit risk. As is customary in our industry, we extend credit to our reseller customers and most of our sales are on open accounts. We may be unable to collect on receivables if our reseller customers experience decreases in demand for their products and services, do not manage their businesses adequately, or otherwise become less able to pay due to adverse economic conditions. As we grow and compete for business, our typical payment terms tend to be longer, and therefore may increase our credit risk.

While we evaluate resellers' qualifications for credit and monitor our extensions of credit, these efforts cannot prevent all credit losses, and credit losses in excess of historical levels would negatively impact our performance. In addition, for financial reporting purposes we estimate future credit losses and establish an appropriate reserve. To the extent that our credit losses exceed those reserves, our financial performance will be negatively impacted. For example, for the quarter ended December 31, 2009, our operating expenses increased as a result of a bad debt expense that we recognized during this period. The majority of the bad expense recognized in the quarter ended December 31, 2009 reflected an adjustment to our allowance for doubtful accounts to reflect an account exposure from a single customer. There is no guarantee that our operating expenses will not increase as a result of the recognition of additional bad debt expense from this customer or from our other reseller customers.

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

The Company's annual meeting of shareholders was held on December 5, 2009. At the annual meeting, the shareholders (i) elected six directors who constitute all the directors continuing on the Board of Directors after the meeting (ii) ratified the appointment of independent auditors for fiscal 2009 and (iii) approved an amendment to the Company's Amended and Restated 2002 Long-Term Incentive Plan to increase the number of available shares and amend certain terms designed to preserve the tax deductibility of certain compensation under the plan pursuant to Section 162(m) of the Internal Revenue Code of 1986.

Votes on each matter presented at the annual meeting were as follows:

(i) Election of directors:

| | Number of Shares | |
|-----------------------|------------------|-----------|
| | For | Withheld |
| Michael L. Baur | 23,097,306 | 2,366,657 |
| Steven R. Fischer | 23,901,655 | 1,562,208 |
| James G. Foody | 23,241,784 | 2,222,179 |
| Michael J. Grainger | 24,476,212 | 987,751 |
| John P. Reilly | 24,475,923 | 988,040 |
| Charles R. Whitchurch | 23,990,609 | 1,473,354 |

(ii) Proposal to ratify the appointment of Ernst & Young LLP as the Company's independent auditors for the fiscal year ending June 30, 2010:

| | Number of Shares |
|---------|------------------|
| For | 25,429,621 |
| Against | 28,184 |
| Abstain | 6,158 |

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(iii) Proposal to approve the 2002 Long-Term Incentive Plan:

| | Number of Shares |
|---------|-----------------------------|
| For | 19,434,364 |
| Against | 4,210,672 |
| Abstain | 159,842 |

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Item 6. Exhibits

| Exhibit Number | Description |
|-----------------------|---|
| 10.1 | Amendment No. 1 to Credit Agreement and Waiver entered into as of October 30, 2009, among ScanSource, Inc., the Subsidiary Borrowers party thereto, J.P. Morgan Chase Bank, N.A. individually and as administrative agent and the other financial institutions signatory thereto (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q filed with the SEC on November 9, 2009). |
| 10.2 | Amended and Restated 2002 Long-Term Incentive Plan (as amended and restated through December 3, 2009) (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on December 7, 2009).* |
| 10.3 | Form of Restricted Stock Award Certificate under the Amended and Restated 2002 Long-Term Incentive Plan for grants on or after December 3, 2009 (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed with the SEC on December 7, 2009).* |
| 10.4 | Form of Incentive Stock Option Award Certificate under the Amended and Restated 2002 Long-Term Incentive Plan for grants on or after December 3, 2009 (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed with the SEC on December 7, 2009).* |
| 10.5 | Form of Non-Qualified Stock Option Award Certificate under the Amended and Restated 2002 Long-Term Incentive Plan for grants on and after December 3, 2009 (incorporated by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed with the SEC on December 7, 2009).* |
| 31.1 | Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 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. |

* Executive compensation plan or arrangement

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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

Date: February 2, 2010

(Principal Executive Officer)

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

Date: February 2, 2010

(Principal Financial Officer)

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EXHIBIT INDEX TO QUARTERLY REPORT ON FORM 10-Q

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