ScanSource®

2000 ANNUAL REPORT

[A Driven Company
That Doesn't Have To Stop For Directions]

Corporate Overview

It's a brave new world in the specialty technology industry, a world filled with sweeping change and unprecedented opportunity. At ScanSource, it's our job to sort it all out, to make it easy for our customers, our manufacturer partners and our shareholders to reap the benefits of that opportunity. Eight years after our founding, that is still our mission.

ScanSource, Inc. is a North American value-added distributor of specialty technology products, including Automatic Data Capture (ADC) and Point-of-Sale (POS) products, along with Business Telephone Systems and Computer Telephony products through Catalyst Telecom. The ScanSource sales unit sells ADC products including bar code scanners and printers, portable data collection terminals, wireless networks, magnetic stripe readers and other related equipment. POS products include personal computer-based terminals, receipt printers, cash drawers, keyboards and related peripherals. Our Catalyst Telecom sales unit sells voice, data and video products, including key, hybrid and PBX phone systems, voice mail, peripherals, fax-on-demand, interactive voice response and several other messaging solutions.

ChannelMax is a strategic business unit created to improve delivery lead-times and order fill-rates for specialty technology manufacturers, while allowing them to focus less on filling orders and more on developing new technology and products. ChannelMax manages the information services (IS) and logistics functions and now offers Internet-based fulfillment services from its 234,000 square-foot distribution center in Memphis, Tennessee, strategically located near the headquarters of major shipping firms. This new e-logistics initiative is designed to drive costs out of the distribution channel by consolidating stock and fulfillment services in one location, helping both manufacturers and value-added resellers (VARs) enjoy increased efficiency and productivity.

Further, ChannelMax offers resellers the opportunity to become e-enabled for the future. The company's Black Arrow eCom offering creates customized web storefronts specifically designed for the ADC/POS/Telecom industries that match the look and feel of a reseller's website, allowing VARs to offer online ordering, conduct web-based marketing research and more.

ScanSource's principal executive office is located in Greenville, South Carolina. The company also has satellite sales offices in Georgia, California, Washington, New Jersey and Canada, each serviced by a centrally located distribution and logistics center in Memphis, Tennessee.

With over 16,000 unique products available from more than 50 companies, ScanSource and Catalyst are the unquestioned leaders in providing world-class specialty technology products.

Since our founding in 1992, we have been committed to providing VARs with the industry's most complete lineup of world-class products and services, to adding expertise and leadership in order to grow the reseller channel, and to holding true to our charter of never competing with resellers. To achieve those objectives, we value honesty and integrity in conducting our business, and respect and appreciation for our employees, customers and vendors. As always, we remain focused on these goals and on exceeding the expectations of our vendor partners and shareholders.


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The Power of Three > The famous business "curve" no longer waits patiently for someone with a smart new idea to "get ahead of it." The curve now moves too fast and breaks too sharply. Today, it takes an aggressive, strategic team approach for a company to lead a genuine industry revolution, to change the way business is viewed and conducted, and to be seen as the undisputed leader in its chosen field. At ScanSource, that approach is comprised of three key elements working together to fuel our growth: **reach** on behalf of our venders partners to identify and recruit new technology resellers; innovative new **solutions** that lower the barriers to entry for new resellers while accelerating their ability to grow their companies; and thirdly, and perhaps most importantly, **teamwork** . . . our charter of transcending the traditional relationships that typically exist between suppliers and customers by treating our vendors and resellers as our true partners.

Together our focus on providing reach and solutions, wrapped in a true spirit of teamwork, creates exponential power and strength, resulting in a profitable environment for customers, vendors and shareholders alike. This philosophy has created extraordinary, dynamic growth within our company. Great people, innovative thinking, and a single-minded devotion to providing value to our vendors, customers and shareholders has allowed us to help make the distribution channel wider, faster and more profitable.

Reach > As with any successful customer-driven company, our goal is to continue to empower our customers, providing them with the knowledge, resources, tools and value-added solutions they need to ensure their success. We remain committed to expanding the channel by seeking out, recruiting and empowering new resellers, and will continue to reach out on behalf of our customers to help them build business and obtain new sales leads.

Solutions > Quite simply, we can only grow and prosper when our customers do. For that reason, we are committed to providing a level of service unparalleled within our industry, and to earning the trust and loyalty of our reseller customers by making it easy for them to do business. If a VAR can sell a solution with our help, we both win. That's why we have made it easier for our customers to do just that by providing a comprehensive suite of web-based order-entry and configuration tools designed to build total solutions. These tools include our new Knowledge To Go™ educational program, created to provide resellers with training in financial, technological, human resources and other business issues. And our online Discover e-Zone™ features Easy*Answers*™, an application development tool for resellers that provides fast, accurate answers; Easy*Orders*™, which allows VARs to check available inventory, place orders and track shipments; and Quick*Quotes*™, which automatically configures solutions in minutes – complete with pricing. Best of all, these tools are available online 24/7 at www.scansource.com.

Teamwork > There's never been a better time for resellers to take advantage of the explosive growth in wireless technology. Our Professional Services Group is a veteran team of wireless experts who design and integrate mobile computing and wireless data collection systems. Further, our Wireless Business Development Team can help VARs build business and close deals.

Our System Integration Team remains the ultimate solution to any problem, large or small. They can custom-configure almost any POS, ADC or Computer Telephony system in a short time, then drop ship the total solution anywhere. Our team can handle any size order on a moment's notice, and they undergo comprehensive technical training on all of our vendors' products.

Finally, our VIR (Very Important Reseller) program rewards our top customers with benefits like flexible product returns, lead generation tools and an instant-access tech support line. We know how important it is to recognize our leading customers for who they are — valuable teammates who make our success possible.

Named One of ***Forbes***
"200 Hot Small Companies"
– November, 1999

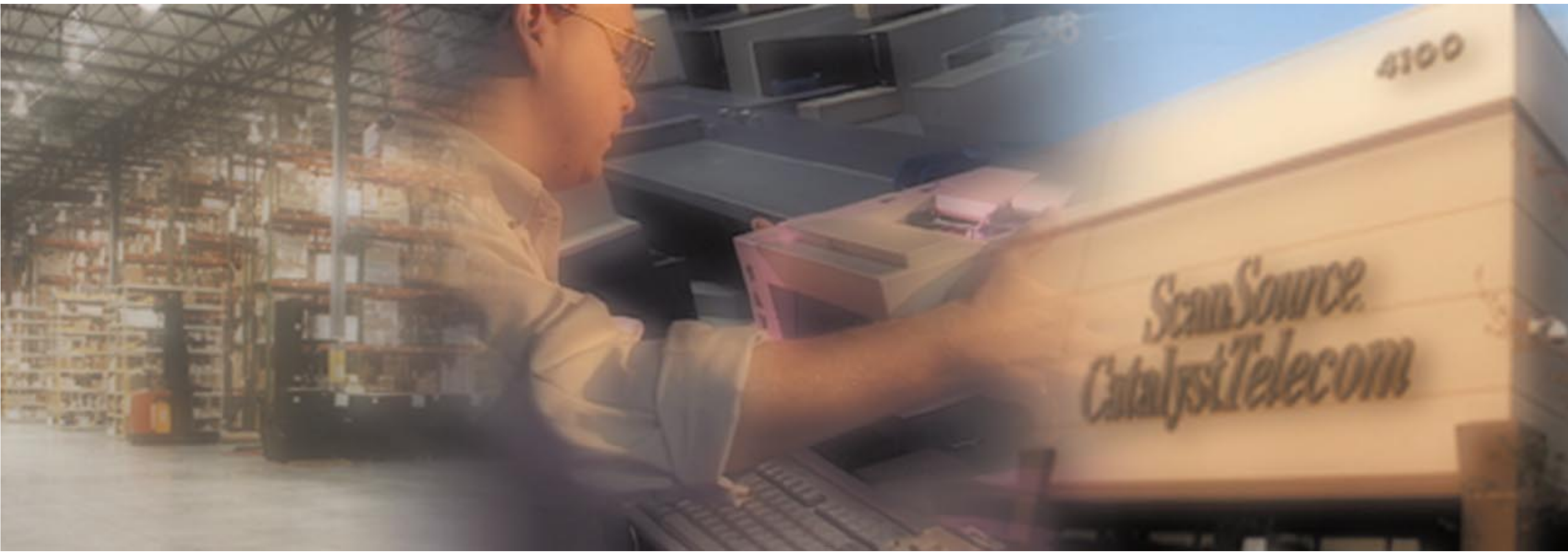
Ranked 113th in
Business Week's "Info Tech 200"
– June, 2000

Named One of ***Fortune's***
"100 Fastest Growing Companies"
– September, 2000

We proudly work with these best-of-breed vendors, our valued partners in growth.

APC Legendary Reliability
IBM Business Partner
POLYCOM
Axiohm Making Global Impressions
IDTECH Value through Innovation
PREH
AVAYA communication BUSINESSPARTNER
Intermec
PSC
Cognitive
ithaca a product of TRANSACT
PSION
CHERRY
CYBERCASH e-commerce. simply.
RJS
CITIZEN
JAVELIN SYSTEMS INC.
symbol
DatacardGroup
LOGIC CONTROLS
StrandWare For Anyone Who's Keeping Track.
DATAMAX BRANDED FOR SUCCESS
MAGTEK
SATO
Dialogic an Intel company
Metrologic
TEKLYNX
Eltron Bar Code Printer Products
MicroTouch
unitech
Eltron Card Printer Products
MMF
VeriFone A division of Hewlett-Packard
EPSON
Monarch PAXAR
ViewMagic Specialty Display
elo TOUCHSYSTEMS A Raychem Company
Opticon
Zebra Zebra Technologies Corporation

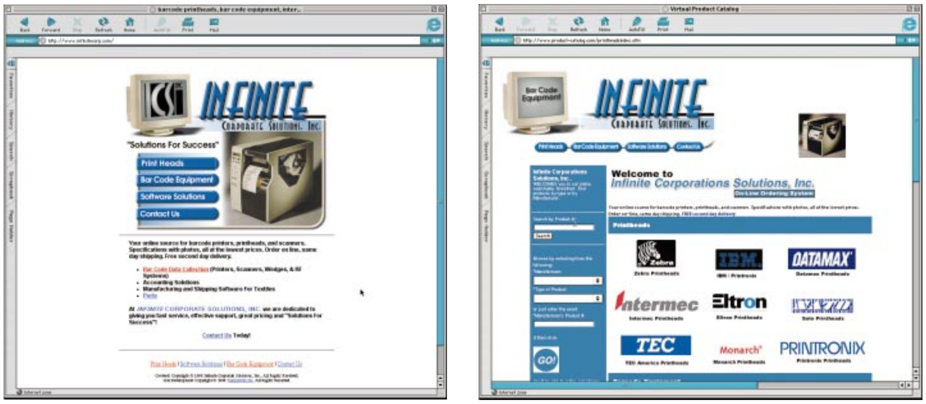
Team Memphis



The Company's 234,000 square-foot distribution center in Memphis, Tennessee is designed to maximize efficiency for all players in the channel, from manufacturers to distributors to resellers. Operating as a separate business unit with an independent management team, ChannelMax allows customers to place an order as late as 8:00 PM Eastern time to receive same-day shipment.

The ChannelMax team is also currently developing an even more powerful and flexible web-based systems infrastructure that will use Internet connectivity to provide for the seamless availability of information to the entire distribution channel – from manufacturers down to end users.

Our goal is to profoundly change the way manufacturers and resellers do business, bringing a new level of efficiency, productivity and convenience to the distribution channels of the industries we serve. By offering cutting-edge e-logistics and customized web storefronts through our Black Arrow offering, ChannelMax is poised to help resellers and manufacturers both improve customer satisfaction and lower their fulfillment expenses.



Home page for Infinite Corporate Solutions, Inc. and the matching Black Arrow eCommerce engine.

Stocking Shipping

System Integration

To Our Shareholders:

On behalf of everyone associated with ScanSource, Inc., I am pleased to bring you news of another outstanding year for our company. The year's results both reflected and rewarded our intense focus on extending our reach to customers by offering an enhanced lineup of solutions and services. This focus opened avenues to growth and profits for our vendor partners, and further established our standing as the industry's leading provider of specialty technology products.

In Fiscal Year 2000, we expanded on our consistent track record of growth by posting significant gains in sales for the eighth consecutive year, earning $497 million in revenue as compared to $298 million for the year ended on June 30, 1999. Net income rose 85 percent to $13.8 million compared to $7.5 million last year. And earnings per share increased 75 percent to $2.31 per share in 2000 as compared to $1.32 per share in 1999.

We have invested heavily in the Internet, and now 22% of our orders are entered by our customers directly into our computer system via the web. We believe that, as the Internet rapidly evolves into one of the most valuable business tools in history, our leadership position demands that we challenge conventional thinking and provide smarter, ever more relevant e-solutions for our value-added reseller (VAR) customers and vendor partners.

We have answered that challenge and created efficiency and productivity in order fulfillment by organizing our logistics business into an independently managed business unit called ChannelMax. ChannelMax provides an end-to-end Internet-based inventory and distribution service that automates and organizes the entire supply chain. As a result, our customers will receive products faster and more efficiently than ever before, while our vendor partners can spend less time and money filling orders, concentrating instead on developing new technology and products. In addition, we've made significant investments to prepare for the future growth we believe ChannelMax will provide; we have custom-configured a new 234,000-square foot distribution center in Memphis, equipped it with advanced, proprietary software systems, including the latest bar code scanning systems, and doubled the size of our MIS staff. This innovation will also allow ScanSource and Catalyst Telecom – our Automatic Data Capture (ADC)/Point-of-Sale (POS) and Telephony sales groups, respectively – to focus exclusively on providing the extraordinary value-added solutions our customers have come to expect from us, including world-class online configuration tools, educational programs, lead generation services, business development programs and customized web storefronts.

Our Catalyst Telecom sales group continues to enjoy explosive growth and outstanding results with our primary partnerships, Avaya (formerly Lucent) business telephone systems and Intel/Dialogic computer telephony solutions. We have made significant progress in our strategy to be the single source of total solutions for our reseller network, and now offer a complete line-up of voice, data, CT and Convergence (voice and data on the same network) products. We continue to add unique convergence products like video conferencing to our offerings, and recently began distributing Avaya data products, including the successful Cajun product lines. In addition, we have formed multiple relationships with independent software vendors to offer world-class application solutions.

We continue to post impressive gains in our sales of ADC and POS, outpacing the growth rates of the industry as a whole. Those increases are partly a result of the continuing emphasis our reseller customers have placed on serving the surging small-to-medium business marketplace. Further, our vendor partners are focusing more and more of their attention on ScanSource as they grow increasingly confident in the efficiencies of the indirect distribution channel and our company's ability to grow and enhance their customer base.

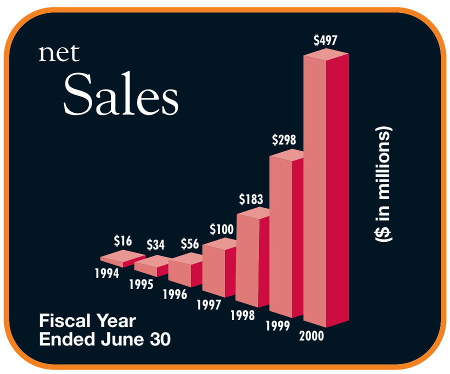
As part of our ongoing commitment to provide our reseller customers with total solutions, we have continued to enhance our value-added services and VAR programs. We recently introduced our Knowledge To Go™ educational program, an easily accessed web-based service designed to provide resellers with comprehensive, relevant training in financial, technological, human resources and other business issues. Knowledge To Go delivers a complete lineup of training courses and professional development seminars that are geared exclusively for value-added resellers, as well as classroom-style events in conjunction with nationally recognized institutions. We have also finished polishing our online Discover e-Zone™ at ScanSource.com, and now offer a complete suite of configuration, education and order-entry tools at our website. Discover e-Zone's Quick*Quotes*™ allows VARs to build and price complete systems in minutes; the Easy*Answers*™ section provides web-based access to our senior technical support specialists; and Easy*Orders*™ allows resellers to order products, check inventory and track shipments anytime, from anywhere. Our new One Stop Creative Shop™ provides a complete array of marketing and lead-generation tools, and our new Wireless Business Development Team assists VARs in expanding their wireless business, closing sales and designing cutting-edge wireless systems.

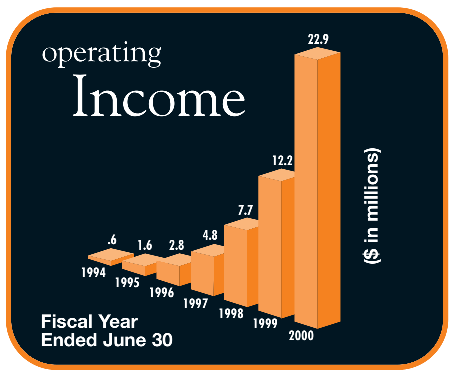
Our recent acquisition of Black Arrow eCom allows us to provide VARs with customized web storefronts that seamlessly match the look and feel of their own websites, allowing VARs to offer online ordering without incurring the cost and inconvenience of a custom website redesign. More importantly, these web storefronts provide real-time information from our computer system. Further, we have greatly expanded our System Integration services, adding more of the highly trained staff members we're so well known for and opening a state-of-the-art System Integration facility inside our Memphis distribution center.

Our record growth hasn't gone unnoticed. We continue to earn recognition from our vendor partners, as well as from leading publications and industry observers. We were recognized as a nationwide leader among IT companies with our inclusion in *Business Week*'s "InfoTech 200" ranking. *Forbes* magazine named us one of the country's "200 Hot Small Companies," while *Fortune* magazine named ScanSource 64th on its list of "America's 100 Fastest-Growing Companies."

We remain committed to making a positive difference in our community through the ScanSource Charitable Foundation. Operated entirely by ScanSource employees, the ScanSource Charitable Foundation's funding is provided by employees, our vendor partners and the company to provide assistance to local families and schools in need.

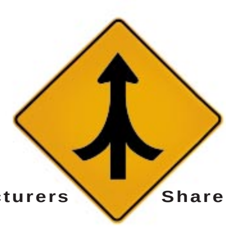
Our marketing and sales initiatives for the future will remain centered upon the commitment we have made to extending our company's reach – finding new customers for our vendors and making it easier for our VARs to sell and succeed in their chosen markets by providing them with accurate information, quick answers, competitive prices and total solutions. We believe the future offers us an opportunity to reach a greater number of customers by reducing barriers to entry and making the channel wider, faster and more profitable. We will continue to investigate new technologies and new geographies for growth. We remain convinced that our value-added services are more than marketing tools – they define and shape our company. Service and innovation both drive us and fuel our growth. They will continue to be our fundamental mission in the future. I look forward to bringing you more good news in the years ahead.





Sincerely,

Michael L. Baur
President and Chief Executive Officer



Manufacturers **Shareholders**
VARs

Selected Financial Data

The following table sets forth certain selected financial data, which should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Company's consolidated financial statements and related notes thereto included elsewhere in this annual report.

	Fiscal Year Ended June 30,				
	1996	1997	1998	1999	2000
	(In thousands, except per share data)				
Statement of Income Data:					
Net sales	$56,383	$99,839	$182,795	$297,717	$497,421
Cost of goods sold	48,413	86,024	159,410	263,941	443,716
Gross profit	7,970	13,815	23,385	33,776	53,705
Selling, general and administrative expenses	5,063	8,940	15,620	21,410	30,685
Amortization of intangibles	83	81	113	137	147
Total operating expenses	5,146	9,021	15,733	21,547	30,832
Operating income	2,824	4,794	7,652	12,229	22,873
Gain from contract termination, net	200	—	—	—	—
Cost of business combinations (1)	—	—	(305)	—	—
Other income (expense), net (2)	75	(465)	160	(367)	(639)
Total other income (expense)	275	(465)	(145)	(367)	(639)
Income before income taxes	3,099	4,329	7,507	11,862	22,234
Income taxes	1,193	1,556	2,736	4,392	8,449
Net income (1)(3)	$ 1,906	$ 2,773	$ 4,771	$ 7,470	$ 13,785
Basic net income per share	$ 0.55	$ 0.80	$ 0.99	$ 1.37	$ 2.48
Basic weighted average shares outstanding	3,482	3,481	4,833	5,460	5,556
Diluted net income per share (1)(3)	$ 0.50	$ 0.75	$ 0.95	$ 1.32	$ 2.31
Diluted weighted average shares outstanding	3,799	3,704	5,035	5,661	5,969

	As of June 30,				
	1996	1997	1998	1999	2000
	(In thousands)				
Balance Sheet Data:					
Working capital	$17,137	$20,496	$ 48,154	$ 51,160	$ 80,544
Total assets	29,183	40,268	72,112	125,727	205,880
Total bank debt	3,779	5,391	6,580	1,697	26,592
Total shareholders' equity	15,504	18,650	49,781	58,702	74,466

(1) Excluding the effect of the cost of business combinations, the Company's net income and net income per share for fiscal 1998 would have been $4,960,000 and $0.99 per share, respectively.

(2) Includes net interest income (expense) and net other income (expense).

(3) Excluding the net effect in fiscal year 1996 of a one-time gain from a contract termination payment by Gates/FA Distributing, Inc., the Company's net income and net income per share for fiscal 1996 would have been $1,786,000 and $0.47.

Management's Discussion and Analysis

The following discussion and analysis contains forward-looking statements which involve risks and uncertainties. The Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors. This discussion and analysis should be read in conjunction with "Selected Financial Data" and the Financial Statements and the Notes thereto included elsewhere in this Report.

Overview

ScanSource, Inc., incorporated in December 1992, serves North America as a value-added distributor of specialty technologies, including automatic data capture (ADC) and point-of-sale (POS) products and business telephone equipment. The Company sells its products exclusively through technology resellers and integrators in markets, which are large and growing. All of the Company's products are shipped from a single, centrally located distribution center located near the FedEx hub in Memphis, Tennessee.

The single warehouse and a sophisticated management information system form the cornerstone of the Company's cost-driven operational strategy which has caused operating income to grow 68.7% over the past five years, compounded annually, while sales have grown 72.3% to $497.4 million over the same period. The Company's key ADC vendors include Symbol Technologies, Intermec and Zebra Technologies, and its leading POS lines include IBM, Javelin and Epson. Lucent Technologies (soon to be Avaya Communication) is the Company's premier business telephone partner, while Intel/Dialogic supplies key components for computer telephony integration (CTI) sold by the Company's Catalyst Telecom sales team.

Growth in net sales has been principally driven by competitive product pricing, selective expansion of the Company's product line, intensive marketing efforts to the reseller channel and strategic acquisitions. Results have benefitted significantly from expanded marketing efforts to recruit new reseller customers and from the addition of new vendor relationships.

In fiscal year 2000 the Company organized a new business unit called ChannelMax, which provides real-time inventory availability and web catalog, order entry, order tracking and logistics for manufacturers in the bar code, point-of-sale and business phone markets. This unit also creates customized web storefronts that integrate with a reseller's website, allowing resellers to offer on-line ordering and marketing to its customers.

The Company's operating income growth has been driven by increasing gross profit and disciplined control of operating expenses. The Company's business strategy features a scalable information system, streamlined management, and centralized distribution, enabling it to achieve the economies of scale necessary for cost-effective order fulfillment. From its inception, the Company has tightly managed its general and administrative expenses by maintaining strong internal controls. Historically, general and administrative expenses have decreased as a percentage of net sales. However, this decline has been offset by costs associated with new initiatives including the organization of a systems integration department, investments in new markets such as telephones and electronic commerce, and the expansion into a new geographic market in Canada.

Management's Discussion and Analysis

Results of Operations

The following table sets forth for the periods indicated certain income and expense items as a percentage of net sales:

	Fiscal Year Ended June 30		
	1998	1999	2000
Net sales	100.0%	100.0%	100.0%
Cost of goods sold	87.2	88.7	89.2
Gross profit	12.8	11.3	10.8
Selling, general and administrative expenses	8.5	7.2	6.2
Amortization of intangibles	0.1	0.0	0.0
Total operating expenses	8.6	7.2	6.2
Operating income	4.2	4.1	4.6
Cost of business combinations	(0.2)	—	—
Other income (expense), net	0.1	(0.1)	(0.1)
Total other income (expense)	(0.1)	(0.1)	(0.1)
Income before income taxes	4.1	4.0	4.5
Income taxes	1.5	1.5	1.7
Net income	2.6	2.5	2.8

Comparison of Fiscal Years Ended June 30, 2000, 1999 and 1998

Net Sales. Net sales consist of sales of specialty technology products billed to North American customers when shipped, net of sales discounts and returns. Net sales increased by 67.1% to $497.4 million in fiscal 2000 from $297.7 million in fiscal 1999, and increased by 62.9% in fiscal 1999 from $182.8 million in fiscal 1998. The Company is organized in two business units. Sales through value-added distribution increased 64.5% to $447.2 million in 2000, from $271.9 million in 1999, and rose by 50.3% in 1999 from $180.9 million in 1998. Web order fulfillment sales increased 94.5% to $50.2 million in 2000 from $25.8 million in 1999, and increased by a factor of 12.8 in 1999 from $1.9 million in 1998. Canada sales have been less than 5.0% of the Company total in each year presented. Growth in net sales resulted primarily from additions to the Company's sales force, competitive product pricing, selective expansion of its product line and increased marketing efforts to specialty technology resellers.

Gross Profit. Cost of sales is comprised of purchase costs and freight, net of early payment and volume discounts. Gross profit as a percentage of net sales is affected by several factors including the mix of high margin and low margin products and the proportion of large orders on which the Company extends volume discounts to resellers. Gross profit increased by 59% to $53.7 million from $33.8 million in fiscal 1999, and increased by 44.4% in fiscal 1999 from $23.4 million in fiscal 1998. Gross profit as a percentage of net sales was 10.8% in fiscal 2000, 11.3% in fiscal 1999, and 12.8% in fiscal 1998. Gross margins from value-added distribution were 12.8%, 11.7% and 10.8% for each of the years ended June 30, 1998, 1999 and 2000, respectively. The decrease in gross profit as a percentage of net sales was a result of a change in the mix of sales of more lower-margin products and volume discounts provided to resellers on large orders. Gross margins for web order fulfillment were 8% in 1998 and 1999, and 10.9% in 2000. The increase in margins for 2000 was caused by the addition of a net revenue program which began in September 1999.

Management's Discussion and Analysis

Operating Expenses. Operating expenses include commissions paid to sales representatives; compensation paid to marketing, technical and administrative personnel; the costs of marketing programs to reach resellers; telephone expense; provision for bad debt losses; and amortization of intangibles. Fluctuations in operating expenses as a percentage of net sales can result from the amount of value-added services which accompany higher or lower gross margin sales; investments by the Company in additional marketing programs and hiring additional technical support personnel; and general and administrative efficiencies gained through higher sales volumes and accompanying economies of scale.

Operating expenses increased by 43.1% to $30.8 million in fiscal 2000 from $21.5 million in fiscal 1999, and increased by 37.0% in fiscal 1999 from $15.7 million in fiscal 1998. Operating expenses as a percentage of net sales declined to 6.2% in fiscal 2000, from 7.2% in fiscal 1999 and 8.6% in fiscal 1998. The decrease in operating expenses as a percentage of net sales resulted from efficiencies gained through increased sales volumes.

Operating Income. Operating income increased by 87.0% to $22.9 million in fiscal 2000 from $12.2 million in fiscal 1999, and increased by 59.8% in fiscal 1999 from $7.7 million in fiscal 1998, driven by the improvement in gross profit as described above. Operating income as a percentage of net sales was 4.6% in fiscal 2000, 4.1% in fiscal 1999, and 4.2% in fiscal 1998.

Total Other Income (Expense). Total other income (expense) consists of interest income (expense), net, and other expense. Net interest expense in 2000 included interest of $855,000 paid on the Company's long term debt offset by interest income of $216,000 from invested cash. Other income (expense) in fiscal 1999 consisted primarily of $470,000 of costs on warehouses closed by the Company in 1999 and interest income of $302,000 offset by $199,000 of interest expense. Other income (expense) in fiscal 1998 consisted primarily of $305,000 of business combination expenses and interest income of $383,000 offset by interest expense of $223,000 paid on the Company's long term debt.

Income Taxes. Income tax expense was $8.4 million, $4.4 million, and $2.7 million, in fiscal 2000, 1999 and 1998, respectively, reflecting an effective tax rate of 38.0%, 37.0% and 36.5%, respectively. Tax expense for 1998 reflects the effects of a business combination. The effective tax rate for consolidated net income for periods following July 1, 2000 is expected to continue to be 38%.

Net Income. Net income increased by 84.5% to $13.8 million in fiscal 2000 from $7.5 million in fiscal 1999, and increased by 56.6% in fiscal 1999 from $4.8 million in fiscal 1998. Net income as a percentage of net sales was 2.8% for fiscal 2000, 2.5% for fiscal 1999 and 2.6% for fiscal 1998.

Management's Discussion and Analysis

Quarterly Results

The following tables set forth certain unaudited quarterly financial data and such data expressed as a percentage of net sales. The information has been derived from unaudited financial statements that, in the opinion of management, reflect all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of such quarterly information. The operating results for any quarter are not necessarily indicative of the results to be expected for any future period.

	Three Months Ended							
	Fiscal 1999				Fiscal 2000			
	Sept. 30, 1998	Dec. 31, 1998	Mar. 31, 1999	June 30, 1999	Sept. 30, 1999	Dec. 31, 1999	Mar. 31, 2000	June 30, 2000
Net sales	$60,719	$65,543	$76,932	$94,523	$113,179	$113.922	$120,391	$149,929
Cost of goods sold	53,732	57,931	68,351	83,927	102,159	100,707	107,021	133,829
Gross profit	6,987	7,612	8,581	10,596	11,020	13,215	13,370	16,100
Selling, general and administrative expenses	4,459	4,854	5,349	6,748	6,681	8,411	8,040	7,552
Amortization of intangibles	33	34	33	37	34	34	34	46
Total operating expenses	4,492	4,888	5,382	6,785	6,715	8,445	8,074	7,598
Operating income	2,495	2,724	3,199	3,811	4,305	4,770	5,296	8,502
Cost of business combinations	—	—	—	—	—	—	—	—
Other income (expense), net	(41)	18	(65)	(279)	105	(138)	(274)	(331)
Total other income (expense)	(41)	18	(65)	(279)	105	(138)	(274)	(331)
Income before income taxes	2,454	2,742	3,134	3,532	4,410	4,632	5,022	8,171
Income taxes	908	1,015	1,161	1,308	1,676	1,760	1,909	3,104
Net income	$ 1,546	$ 1,727	$ 1,973	$ 2,224	$ 2,734	$ 2,872	$ 3,113	$ 5,067
Basic net income per share	$ 0.29	$ 0.32	$ 0.36	$ 0.40	$ 0.50	$ 0.52	$ 0.56	$ 0.90
Basic weighted average shares outstanding	5,404	5,464	5,479	5,493	5,512	5,531	5,577	5,604
Diluted net income per share	$ 0.28	$ 0.31	$ 0.35	$ 0.39	$ 0.47	$ 0.48	$ 0.51	$ 0.85
Diluted weighted average shares outstanding	5,585	5,624	5,699	5,736	5,850	5,994	6,057	5,975

	Three Months Ended							
	Fiscal 1999				Fiscal 2000			
	Sept. 30, 1998	Dec. 31, 1998	Mar. 31, 1999	June 30, 1999	Sept. 30, 1999	Dec. 31, 1999	Mar. 31, 2000	June 30, 2000
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	88.5	88.4	88.8	88.8	90.3	88.4	88.9	89.3
Gross profit	11.5	11.6	11.2	11.2	9.7	11.6	11.1	10.7
Selling, general and administrative expenses	7.3	7.4	7.0	7.2	5.9	7.4	6.7	5.0
Amortization of intangibles	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total operating expenses	7.4	7.4	7.0	7.2	5.9	7.4	6.7	5.0
Operating income	4.1	4.2	4.2	4.0	3.8	4.2	4.4	5.7
Cost of business combinations	—	—	—	—	—	—	—	—
Other income (expense), net	(0.1)	0.0	(0.1)	(0.3)	0.1	(0.1)	(0.2)	(0.2)
Total other income (expense)	(0.1)	0.0	(0.1)	(0.3)	0.1	(0.1)	(0.2)	(0.2)
Income before income taxes	4.0	4.2	4.1	3.7	3.9	4.1	4.2	5.5
Income taxes	1.5	1.6	1.5	1.4	1.5	1.6	1.6	2.1
Net income	2.5	2.6	2.6	2.3	2.4	2.5	2.6	3.4

Management's Discussion and Analysis

Liquidity and Capital Resources

The Company's primary sources of liquidity are results of operations, borrowings under its revolving credit facility, and proceeds from the sales of securities. In October 1997, the Company completed a secondary offering of stock which provided the Company approximately $26.2 million for general corporate purposes.

The Company has a revolving credit agreement with a bank extending to October 31, 2001 with a borrowing limit of $35.0 million at an interest rate equal to the 30-day LIBOR rate plus a rate varying from 1.50% to 2.00% tied to the Company's debt-to-net worth ratio ranging from 0.75:1 to 2:1. The borrowing base available under the credit facility is limited to 80% of eligible accounts receivable and 40% of eligible inventory. The effective interest rate at June 30, 2000 was 8.64% and the outstanding balance on the revolving credit was $24.9 million on a loan base, which exceeded $35 million, leaving $10.1 million available at June 30, 2000.

In December 1999, the Company purchased a new distribution center in Memphis for a purchase price of approximately $7 million of which $6.1 million was allocated to the building and $900,000 was allocated to land. The Company temporarily funded the purchase with borrowings from the revolving credit and closed a real-estate loan in August 2000 in the amount of $7.4 million.

For the fiscal year ended June 30, 2000, operating activities used cash in the amount of $24.1 million primarily to fund increases in inventory and accounts receivable partially offset by increases in accounts payable. For the fiscal year ended June 30, 1999, operating activities provided cash in the amount of $20.7 million, primarily from an increase in accounts payable which exceeded the amount needed to fund increases in receivables and inventory.

Cash used in investing activities for fiscal 2000 of $13.5 million included $7.0 for the building purchase and $6.5 million for other capital expenditures. For the fiscal year ended June 30, 1999, cash was used in investing activities for $2.1 million of capital expenditures.

Cash provided by financing activities for fiscal 2000 was $26.9 million primarily from advances on the Company's line of credit. For the fiscal year ended June 30, 1999, cash used in financing activities was $3.4 million primarily due to payments on the Company's line of credit.

The Company believes that cash flows from operations, its bank revolving credit facility and vendor financing will be sufficient to meet its forecasted cash requirements for at least the next year.

Backlog

The Company does not consider backlog to be material to its business. Virtually all orders are filled within 24 hours of receipt.

Recent Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS"). This statement establishes requirements for accounting and reporting of derivative instruments and hedging activities. SFAS 133 was updated by the issuance of SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FAS No. 133" and SFAS No. 138 "Accounting for Derivative Instruments and Hedging Activities" and is effective for fiscal years beginning after June 15, 2000. The future impact of this statement on the Company's results of operations is not expected to be material.

In December 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 101, Revenue Recognition (SAB 101), which provides guidance on the recognition, presentation and disclosure of revenue in financial statements filed with the SEC. SAB 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for disclosure related to revenue recognition policies. Management believes that the Company's revenue recognition policy is in compliance with the provisions of SAB 101 and that SAB 101 will have no material effect on the financial position or results of operations of the Company.

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.

Quantitative and Qualitative Disclosures About Market Risks

The Company is exposed to changes in financial market conditions in the normal course of its business as a result of its selective use of bank debt as well as transacting in Canadian currency in connection with its Canadian operations.

The Company is exposed to changes in interest rates primarily as a result of its borrowing activities, which includes a revolving credit facility with a bank 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. The definitive extent of the Company's interest rate risk is not quantifiable or predictable because of the variability of future interest rates and business financing requirements, but the Company does not believe such risk is material. The Company does not currently use derivative instruments to adjust the Company's interest rate risk profile.

The Company is exposed to changes in foreign exchange rates in connection with its Canadian operations. It is the Company's policy to enter into foreign currency transactions only to the extent considered necessary to support its Canadian operations. The amount of the Company's cash deposits denominated in Canadian currency has not been, and is not expected to be, material. Furthermore, the Company has no capital expenditure or other purchase commitments denominated in any foreign currency. The Company does not utilize forward exchange contracts, currency options or other traditional hedging vehicles to adjust the Company's foreign exchange rate risk profile. The Company does not enter into foreign currency transactions for speculative purposes.

The Company does not utilize financial instruments for trading or other speculative purposes, nor does it utilize leveraged financial instruments. On the basis of the fair value of the Company's market sensitive instruments at June 30, 2000, the Company does not consider the potential near-term losses in future earnings, fair values and cash flows from reasonably possible near-term changes in interest rates and exchange rates to be material.

Management's Discussion and Analysis

Forward Looking Statements

Certain of the statements contained in this report to shareholders as well as in the Company's other filings with the Securities and Exchange Commission 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 2000 and beyond to differ materially from those expressed in any such forward-looking statements. These factors include, without limitation, the Company's dependence on vendors, product supply, senior management, centralized functions, and third-party shippers, the Company's ability to compete successfully in a highly competitive market and manage significant additions in personnel and increases in working capital, the Company's entry into new products markets in which it has no prior experience, the Company's susceptibility to quarterly fluctuations in net sales and results of operations, the Company's ability to manage successfully price protection or stock rotation opportunities associated with inventory value decreases, and other factors described in other reports and documents filed by the Company with the Securities and Exchange Commission.

SCAN*SOURCE*, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

June 30, 1999 and 2000

Assets	1999	2000
	(In thousands)	
Current assets		
Cash	$ 15,282	4,612
Receivables:		
Trade, less allowance for doubtful accounts of $5,002,000 and $5,464,000 at June 30, 1999 and 2000, respectively	42,774	66,983
Other	2,443	3,060
	45,217	70,043
Inventories	50,282	101,654
Prepaid expenses and other assets	464	451
Deferred income taxes	5,197	8,632
Total current assets	116,442	185,392
Property and equipment:		
Land	585	1,485
Building	3,812	12,135
Furniture, fixtures and equipment	5,708	9,953
	10,105	23,573
Less accumulated depreciation	(2,652)	(5,183)
	7,453	18,390
Intangible assets, net	1,520	1,635
Other assets	312	463
Total assets	$125,727	205,880
Liabilities and Shareholders' Equity		
Current liabilities:		
Current portion of long-term debt	$ 24	26
Trade accounts payable	59,728	98,627
Accrued expenses and other liabilities	4,399	5,083
Income taxes payable	1,131	1,112
Total current liabilities	65,282	104,848
Deferred income taxes	70	—
Long-term debt	1,673	1,647
Borrowings under revolving credit facility	—	24,919
Total liabilities	67,025	131,414
Shareholders' equity:		
Preferred stock, no par value; 3,000,000 shares authorized, none issued	—	—
Common stock, no par value; 10,000,000 shares authorized; 5,503,512 and 5,610,875 shares issued and outstanding at June 30, 1999 and 2000, respectively	40,161	42,140
Retained earnings	18,541	32,326
Total shareholders' equity	58,702	74,466
Total liabilities and shareholders' equity	$125,727	205,880

See accompanying notes to financial statements.

SCAN*SOURCE*, INC. AND SUBSIDIARIES

Consolidated Statements of Income

Years ended June 30, 1998, 1999 and 2000

	1998	1999	2000
	(In thousands, except per share data)		
Net sales	$182,795	297,717	497,421
Cost of goods sold	159,410	263,941	443,716
Gross profit	23,385	33,776	53,705
Selling, general and administrative expenses	15,620	21,410	30,685
Amortization of intangibles	113	137	147
Total operating expenses	15,733	21,547	30,832
Operating income	7,652	12,229	22,873
Other income (expense):			
Interest income (expense), net	160	(367)	(639)
Cost of business combinations	(305)	—	—
Total other expense	(145)	(367)	(639)
Income before income taxes	7,507	11,862	22,234
Income taxes	2,736	4,392	8,449
Net income	$ 4,771	7,470	13,785
Per share data:			
Basic			
Earnings per share	$ .99	1.37	2.48
Weighted average shares outstanding	4,833	5,460	5,556
Diluted			
Earnings per share	$ .95	1.32	2.31
Weighted average shares outstanding	5,035	5,661	5,969

See accompanying notes to financial statements.

SCAN*SOURCE*, INC. AND SUBSIDIARIES

Consolidated Statements of Shareholders' Equity

Years ended June 30, 1998, 1999 and 2000

	Common Stock	Retained Earnings	Total
	(In thousands)		
Balance at June 30, 1997	$12,350	6,300	18,650
Issuance of common stock in public offering, net of offering costs	25,820	—	25,820
Issuance of stock due to exercise of options, net	165	—	165
Tax benefit of deductible compensation arising from exercise of stock options	225	—	225
Issuance of stock and stock options in business combinations	150	—	150
Net income	—	4,771	4,771
Balance at June 30, 1998	38,710	11,071	49,781
Issuance of stock due to exercise of options, net	663	—	663
Tax benefit of deductible compensation arising from exercise of stock options	788	—	788
Net income	—	7,470	7,470
Balance at June 30, 1999	40,161	18,541	58,702
Issuance of stock due to exercise of options, net	1,433	—	1,433
Tax benefit of deductible compensation arising from exercise of stock options	474	—	474
Issuance of stock in business combinations	72	—	72
Net income	—	13,785	13,785
Balance at June 30, 2000	$42,140	32,326	74,466

See accompanying notes to financial statements.

SCANSOURCE, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended June 30, 1998, 1999 and 2000

	1998	1999	2000
		(In thousands)	
Cash flows from operating activities:			
Net income	$ 4,771	7,470	13,785
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation	797	1,119	2,531
Amortization of intangible assets	113	137	147
Provision for doubtful accounts	(1,230)	(3,582)	(2,983)
Deferred income taxes, net	(839)	(2,770)	(3,649)
Changes in operating assets and liabilities:			
Trade receivables	(13,651)	(10,994)	(21,226)
Other receivables	(792)	(919)	(617)
Inventories	(7,549)	(18,838)	(51,372)
Prepaid expenses and other assets	45	(196)	13
Trade accounts payable	(3,112)	45,699	38,899
Accrued expenses and other liabilities	404	2,701	634
Income taxes payable	(31)	1,131	(19)
Other noncurrent assets	98	(251)	(159)
Net cash provided by (used in) operating activities	(20,976)	20,707	(24,016)
Cash flows from investing activities:			
Capital expenditures	(1,928)	(2,081)	(6,478)
Purchase of building	(1,627)	—	(6,990)
Cash paid in business combination	(1,100)	—	(110)
Net cash used in investing activities	(4,655)	(2,081)	(13,578)
Cash flows from financing activities:			
Advances (payments) on revolving credit	(1,085)	(4,861)	24,919
Exercise of stock options including tax benefits	555	1,451	2,029
Proceeds from stock offering, net of offering costs	25,820	—	—
Payments on building loan	—	(22)	(24)
Net cash provided by (used in) financing activities	25,290	(3,432)	26,924
Increase (decrease) in cash	(341)	15,194	(10,670)
Cash at beginning of year	429	88	15,282
Cash at end of year	$ 88	15,282	4,612
Supplemental information:			
Interest paid	$ 166	186	1,009
Income taxes paid	$ 3,054	3,261	8,563

See accompanying notes to financial statements.

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 1999 and 2000

(1) Organization and Summary of Significant Accounting Policies

Consolidation Policy

The consolidated financial statements include the accounts of Scan*Source*, Inc. ("Company") and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with 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. Actual results could differ from those estimates.

Revenue Recognition

Revenues are recognized for the sale of products upon shipment.

Sales of products are primarily recorded on a gross basis with a separate display of cost of goods sold to arrive at gross profit. However revenues associated with service-based order fulfillment contracts, in which the Company earns a fee determined as a percentage of the value of products shipped, are recorded on a net basis. That is, the net fee retained by the Company is included in net sales. Criteria used in the determination include whether the Company has received the risks and rewards of ownership of the products, such as risk of loss of collection, delivery, or returns.

Vendor Programs

Funds received from vendors for price protection, product rebates, marketing or training programs are recorded net of direct costs as adjustments to product costs, or a reduction of selling, general and administrative expenses according to the nature of the program.

The Company does not provide warranty coverage of its product sales. However, to maintain customer relations, the Company facilitates vendor warranty policies by accepting for exchange, with the Company's prior approval, most defective products within 30 days of invoicing.

Inventories

Inventories (consisting of automatic data capture, point-of-sale, business phone and computer telephony equipment) are stated at the lower of cost (first-in, first-out method) or market.

Long-Lived Assets

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over estimated useful lives of 2-5 years for furniture and equipment, 40 years for the building 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.

Intangible assets consist primarily of goodwill which is being amortized on a straight-line basis over 5-15 years. Accumulated amortization was $556,000 and $703,000 at June 30, 1999 and 2000, respectively.

The Company reviews its long-lived assets for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. If the sum of the expected cash flows, undiscounted and without interest, is less than the carrying amount of the asset, an impairment loss is recognized as the amount by which the carrying amount of the asset exceeds its fair value.

Concentration of Credit Risk

The Company sells its products generally on net 20 day terms to a large base of value-added resellers throughout North America. The Company performs ongoing credit evaluations of its customers financial condition and generally does not require collateral.

Income Taxes

The Company records income taxes under the asset and liability method whereby deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Accounting for Stock-Based Compensation

Statement of Financial Accounting Standards No. 123 (SFAS 123) allows an entity to continue to apply the provisions of APB Opinion No. 25 and provide pro forma net income and, if earnings per share is presented, pro forma earnings per share disclosures for employee stock options granted as if the fair-value-based method defined in SFAS 123 had been applied. The Company has elected to continue to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosure provisions of SFAS 123.

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 and borrowings under revolving credit facility approximate fair value, based upon either short maturities or variable interest rates of these instruments.

Business Segments

During 1999, the Company adopted Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information (SFAS 131). SFAS 131 requires companies to report financial and descriptive information about its reportable operating segments, including segment profit or loss, certain specific revenue and expense items, and segment assets, as well as information about the revenues derived from the Company's products and services, the countries in which the Company earns revenues and holds assets, and major customers.

Comprehensive Income

Comprehensive income is recognized as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Comprehensive income was not different from net income in 1998, 1999 or 2000.

Foreign Operations

The Company's only operations outside the U.S. are two Canadian sales offices. Foreign currency transaction and translation gains and losses are included in selling, general and administrative expenses; currency transaction losses were less than $100,000 for the period ended June 30, 2000.

(2) Revolving Credit Facility

The Company has a line of credit agreement with a bank extending to October 31, 2001 with a borrowing limit of $35 million, based upon 80% of eligible accounts receivable and 40% of eligible inventory at the 30 day LIBOR rate of interest plus a rate varying from 1.50% to 2.00% tied to the Company's debt to net worth ratio ranging from .75:1 to 2:1. The revolving credit facility is collateralized by accounts receivable and eligible inventory. The agreement contains certain financial covenants including minimum net worth, capital expenditure limits and a maximum debt to tangible net worth ratio. The effective interest rate at June 30, 2000 was 8.64% and the outstanding balance on the line of credit was $24.9 million on a loan base which exceeded $35 million, leaving $10.1 million available at June 30, 2000. The Company was either in compliance or had obtained waivers of noncompliance with the various covenants at June 30, 2000. The Company has the ability and intent to maintain outstanding amounts for a period longer than one year.

(3) Long-term Debt

In June 1998, the Company assumed a nonrecourse loan in the amount of $1,719,000, in connection with the acquisition of its office building. This transaction was a non-cash item for statement of cash flow purposes. The loan has a fixed interest rate of 9.19%, is due in November 2006, and is collateralized by the land and building acquired.

Scheduled maturity of long-term debt at June 30, 2000 is as follows:

2001	$ 26,000
2002	29,000
2003	31,000
2004	35,000
2005	38,000
Thereafter	1,514,000
Total	$1,673,000

The fair value of long-term debt is estimated by discounting the scheduled payment streams to present value based on current rates for similar instruments and was approximately $1,926,000 and $1,717,000 at June 30, 1999 and 2000, respectively.

(4) Equity and Earnings Per Share

(a) Stock Option Plans:

- The 1993 Incentive Stock Option Plan reserved 280,000 shares of common stock for issuance to key employees. The plan provides for three-year vesting of the options at a rate of 33% annually. The options are exercisable over 10 years, and options are not to be granted at less than the fair market value of the underlying shares at the date of grant.
- The Directors' Stock Option Plan under which 65,000 shares of common stock have been reserved for issuance to non-employee directors, provides for vesting six months after grant date and an option term of five years. Options under this plan are to be granted at fair market value of the underlying shares on the date of grant.
- The amended 1997 Stock Incentive Plan reserved 600,000 shares of stock for issuance to officers, directors, employees, consultants or advisors to the Company. This plan provides for incentive stock options, nonqualified options, stock appreciation rights and restricted stock awards to be granted at exercise prices to be determined by the Compensation Committee of the Board of Directors. The term of each option will be 10 years from the grant date.

A summary of stock option activity for the years ended June 30, 1998, 1999 and 2000 is as follows:

	1998 Shares	Weighted Average Exercise Price	1999 Shares	Weighted Average Exercise Price	2000 Shares	Weighted Average Exercise Price
Options outstanding:						
Beginning of year	566,583	$ 9.96	731,483	$14.51	754,534	$14.70
Granted	237,750	18.23	445,000	15.90	187,439	30.70
Exercised	(46,183)	4.31	(150,202)	4.61	(105,864)	13.16
Terminated	(26,667)	14.88	(271,747)	17.43	(12,901)	16.40
End of year	731,483	14.51	754,534	14.70	823,208	18.50
Exercisable, end of year	412,844	$ 9.81	358,117	$13.60	446,181	$15.18

The following table summarizes information about stock options outstanding under the plans at June 30, 2000:

Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Number Exercisable	Weighted Average Exercise Price
$1.50–9.75	51,533	4.95 years	51,533	$ 8.63
10.75–13.50	55,300	5.53 years	55,300	11.13
14.00–15.75	255,588	7.36 years	138,243	14.66
16.50–21.125	310,037	7.08 years	191,105	17.44
25.00–27.125	11,250	9.43 years	—	N/A
33.625–36.00	139,500	9.18 years	10,000	35.37
	823,208		446,181	

(b) Fair Value and Pro Forma Information

The per share weighted-average fair value of stock options granted during the years ended June 30, 1998, 1999 and 2000 was $10.22, $9.65 and $25.09 on the date of grant using the Black Scholes option-pricing model with the following weighted-average assumptions:

	1998	1999	2000
Risk-free interest rate	5.7%	4.8%	6.2%
Expected dividend yield	0.0%	0.0%	0.0%
Expected volatility factor	32.1%	41.7%	62.8%
Expected life	10 years	10 years	10 years

The Company applies APB Opinion No. 25 in accounting for its stock options and accordingly, no compensation cost has been recognized for its stock options in the financial statements. Had the Company determined compensation cost based on the fair value at the grant date for stock options in its Plan under SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

		1998	1999	2000
Net income	As Reported	$4,771,000	7,470,000	13,785,000
	Pro forma	4,094,000	6,580,000	11,883,000
Earnings per share				
Basic	As Reported	$ .99	1.37	2.48
	Pro forma	.85	1.21	2.14
Diluted	As Reported	$ .95	1.32	2.31
	Pro forma	$ .81	1.16	1.99

Pro forma net income reflects only options granted during the years ended June 30, 1998, 1999 and 2000. Therefore, the full impact of calculating compensation cost for stock options under SFAS

No. 123 is not reflected in net income effected above because compensation cost is reflected over the options vesting period of 3 years for options issued under the incentive stock option plans.

(c) Earnings Per Share Reconciliation

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

	Income	Shares	Per Share Amount
1998:			
Basic income per share	$ 4,771,000	4,833,000	$0.99
Effect of dilutive stock options	—	202,000	
Diluted income per share	$ 4,771,000	5,035,000	$0.95
1999:			
Basic income per share	$ 7,470,000	5,460,000	$1.37
Effect of dilutive stock options	—	201,000	
Diluted income per share	$ 7,470,000	5,661,000	$1.32
2000:			
Basic income per share	$13,785,000	5,556,000	$2.48
Effect of dilutive stock options	—	413,000	
Diluted income per share	$13,785,000	5,969,000	$2.31

(5) Income Taxes

Income tax expense (benefit) attributable to income before income taxes consists of:

	Current	Deferred	Total
Year ended June 30, 1998:			
U.S. Federal	$ 3,150,000	(705,000)	2,445,000
State and local	425,000	(134,000)	291,000
	$ 3,575,000	(839,000)	2,736,000
Year ended June 30, 1999:			
U.S. Federal	6,298,000	(2,406,000)	3,892,000
State and local	864,000	(364,000)	500,000
	$ 7,162,000	(2,770,000)	4,392,000
Year ended June 30, 2000:			
U.S. Federal	10,661,000	(3,169,000)	7,492,000
State and local	1,437,000	(480,000)	957,000
	$12,098,000	(3,649,000)	8,449,000

Income tax expense attributable to income before income taxes for the years ended June 30, 1998, 1999 and 2000, respectively, differed from the amount computed by applying the U.S. federal income tax rate of 34 percent to pretax income for 1998 and 35 percent for 1999 and 2000 as a result of the following:

	1998	1999	2000
Computed "expected" tax expense	$2,552,000	4,152,000	7,782,000
Increase (decrease) in income taxes resulting from:			
State and local income taxes, net of Federal income tax expense	192,000	325,000	622,000
Income tax related to earnings of subchapter S-Corporation	(103,000)	—	—
Other	95,000	(85,000)	45,000
	$2,736,000	4,392,000	8,449,000

The tax effects of temporary differences that give rise to significant portions of the deferred tax asset and deferred tax liability at June 30, 1999 and 2000 are presented below:

	1999	2000
Deferred tax assets derived from:		
Allowance for doubtful accounts	$2,381,000	2,654,000
Inventories	2,816,000	5,978,000
Intangible assets	44,000	95,000
Plant and equipment	—	49,000
	5,241,000	8,776,000
Deferred tax liability derived from:		
Plant and equipment	(114,000)	—
Net deferred tax asset	$5,127,000	8,776,000

As of June 30, 1999 and 2000 no valuation allowance has been provided. Management believes that a valuation allowance is not necessary based upon the level of historical taxable income and the projections for future taxable income over the periods during which the temporary differences are deductible.

(6) Commitments and Contingencies

The Company leases office space under noncancellable operating leases which expire through June 2005. The Company also leases a portion of its building to third-parties under noncancellable operating leases which expire through March 2004. Future minimum lease payments and sublease income are as follows:

	Payments	Sublease Income
2001	$ 593,000	239,000
2002	272,000	149,000
2003	194,000	96,000
2004	144,000	42,000
2005	119,000	—
	$1,322,000	526,000

Lease expense was approximately $680,000, $759,000 and $724,000 for the years ended June 30, 1998, 1999 and 2000, respectively. There was no sublease income for the year ended June 30, 1998. Sublease income was approximately $331,000 and $263,000 for the years ended June 30, 1999 and 2000, respectively.

The Company also has commitments based on the financial results of acquired operations or contracts that may result in potential payments of up to $350,000 over the next two years.

A majority of the Company's net revenues in 1998, 1999 and 2000 were received from the sale of products purchased from the Company's top ten vendors. The Company has entered into written distribution agreements with substantially all of its major vendors. While the Company's agreements with most of its vendors contain standard provisions for periodic renewals, these agreements generally permit termination by either party without cause upon 30 to 120 days notice.

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

(7) Employee Benefit Plan

Effective October 22, 1993, the Company established a defined contribution plan under Section 401(k) of the Internal Revenue Code. This plan covers all employees meeting certain eligibility requirements. For the years ended June 30, 1998, 1999 and 2000 the Company provided a matching contribution of $54,000, $160,000 and $148,000, respectively, which was equal to one-half of each participant's contribution, up to a maximum matching contribution per participant of $500 for 1998 and $800 for both 1999 and 2000. The Company determines its matching contributions annually and can make discretionary contributions in addition to matching contributions. Employer contributions are vested over a period of 3 to 5 years.

(8) Segment Information

SFAS 131 requires the use of the management approach to determine segment information to be reported. The management approach is based on the way management organizes the enterprise to assess performance and make operating decisions regarding the allocation of resources.

The Company sells only in the United States and Canada. Its sales to Canada were $3,670,000, $11,953,000 and $19,489,000 for each of the three years ended June 30, 1998, 1999 and 2000, respectively.

Prior to April 2000, the Company operated within a single reportable segment; however, in the fourth quarter of its fiscal year, the Company named a president of its second business unit creating two reportable segments: value-added distribution and a web-based order fulfillment unit called ChannelMax. Each business unit is directed by a President who reports to the Chairman of the Board. The Chairman evaluates performance and allocates resources, in part, based upon the gross margin of each unit, as described below.

The first reportable segment, value-added distribution, offers 16,000 products for sale in two primary categories: i) automatic data capture and point-of-sale equipment sold by the Scan*Source* sales team and ii) business telephones and computer telephony integration devices sold by the Catalyst Telecom sales team. These products are sold to more than 11,000 resellers and integrators of technology products, who are geographically disbursed over North America in a pattern that mirrors population concentration. Of its customers, no single account represented more than 2% of the Company's net sales in 2000. All valued-added distribution sales are recognized on a gross revenue basis when products are shipped.

The second reportable segment is the web order fulfillment unit which provides real-time inventory availability and web catalog, order entry, order tracking and logistics for customers in the bar code and business telephone markets. This unit serves less than 15 customers, the largest of whom accounted for less than 7% of total Company sales at June 30, 2000. Sales by this unit include some programs that meet gross revenue recognition criteria and others that require net revenue recognition.

Business unit operating performance is evaluated by the Chairman using gross profit rather than operating income, because products for both business units are shipped from a single, centrally located distribution center. Each business unit is supported by a single credit and customer service department and uses the same information system and freight program. Therefore operating expenses are considered to be corporate and are not allocable to each reportable segment.

Accounts receivable and a portion of inventories can be identified by segment, but cash, other current assets, and other noncurrent assets are not distinguishable between business segments. Property, plant and equipment are not identified by segment, therefore capital expenditures, depreciation and amortization are assigned entirely to corporate.

Operating results for each business unit are summarized below with historical data for 1998 and 1999 restated to conform to the new organization structure:

	1998		1999		2000	
Sales						
Value added distribution	$180,926,000	99%	$271,901,000	91%	$447,216,000	90%
Web-based order fulfillment	1,869,000	1%	25,816,000	9%	50,205,000	10%
	$182,795,000	100%	$297,717,000	100%	$497,421,000	100%
Operating Income						
Value added distribution	$ 23,235,000	12.8%	$ 31,711,000	11.7%	$ 48,211,000	10.8%
Web-based order fulfillment	150,000	8.0%	2,065,000	8.0%	5,494,000	10.9%
Gross profit	$ 23,385,000	12.8%	$ 33,776,000	11.3%	$ 53,705,000	10.8%
Corporate operating and distribution center expenses	(15,733,000)		(21,547,000)		(30,832,000)	
Operating income	$ 7,652,000		$ 12,229,000		$ 22,873,000	
Assets						
Value added distribution	$ 59,642,000		$ 93,056,000		$168,637,000	
Web-based order fulfillment	2,149,000		8,731,000		21,040,000	
Corporate cash and other assets	10,321,000		23,940,000		16,203,000	
	$ 72,112,000		$125,727,000		$205,880,000	

(9) Subsequent Event (unaudited)

In August 2000, the Company closed a real estate loan in the amount of $7.4 million. The loan has a term of 5 years, is collateralized by the Memphis distribution center land and building, and has a variable interest rate similar to that of the revolving credit.

Independent Auditors' Report

The Board of Directors
Scan*Source,* Inc.:

We have audited the accompanying consolidated balance sheets of Scan*Source,* Inc. and subsidiaries as of June 30, 1999 and 2000 and the related consolidated statements of income, shareholders' equity and cash flows for each of the years in the three-year period ended June 30, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Scan*Source,* Inc. and subsidiaries as of June 30, 1999 and 2000 and the results of their operations and their cash flows for each of the years in the three-year period ended June 30, 2000, in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Greenville, South Carolina
August 16, 2000

Management's Statement of Responsibility

The management of Scan*Source* is responsible for the information contained in the financial statements and other parts of this report. The accompanying consolidated financial statements of Scan*Source,* Inc. and subsidiaries have been prepared in accordance with generally accepted accounting principles. In preparing these statements, management has made judgments based upon available information. To ensure that this information will be as accurate and factual as possible, management has communicated to all appropriate employees the requirements for accurate recordkeeping and accounting.

The Company maintains a system of internal accounting controls designed to provide reasonable assurances for the safeguarding of assets and the reliability of financial records. The system is subject to continuous review with appropriate management follow-up action. Management believes that through the careful selection of employees, the division of responsibilities and the application of formal policies and procedures, the Company has an effective and responsible system of internal accounting controls.

The Company's independent accountants are responsible for conducting an audit of the Company's consolidated financial statements in accordance with generally accepted auditing standards and for expressing their opinion as to whether these consolidated financial statements present fairly, in all material respects, the financial position, results of operations and cash flows of the Company and its subsidiaries in conformity with generally accepted accounting principles. There is an Audit Committee of the Board of Directors composed of two nonemployee directors who meet regularly with management and the independent accountants to discuss specific accounting, reporting and internal control matters. The independent accountants have full and free access to the Audit Committee.

Price Range of Common Stock

The Company's Common Stock is quoted on the Nasdaq National Market under the symbol "SCSC." The following table sets forth, for the periods indicated, the high and low closing prices of the Common Stock on The Nasdaq National Market.

	High	Low
Fiscal Year 1999		
First quarter	19¼	14¾
Second quarter	21 13/16	13½
Third quarter	23⅜	16⅝
Fourth quarter	23	18 3/16
Fiscal Year 2000		
First quarter	31⅜	22
Second quarter	45⅛	25
Third quarter	48	34⅞
Fourth quarter	38⅞	26¼

On August 31, 2000, there were approximately 58 shareholders of record of Common Stock. Certain of these shareholders of record hold shares in nominee or street name for other beneficial owners.

Dividend Policy

The Company has never declared or paid cash dividends on its Common Stock, and it is currently the intention of the Board of Directors not to pay cash dividends in the foreseeable future. The Company intends to retain earnings, if any, to finance its operations.

Board of Directors

Steven H. Owings
Chairman

Michael L. Baur
President &
Chief Executive Officer

Steven R. Fischer
Executive Vice-President
Transamerica Business
Credit Corporation

James G. Foody
Business Consultant

Officers

Steven H. Owings
Chairman

Michael L. Baur
President &
Chief Executive Officer

Jeffery A. Bryson
Chief Financial Officer
and Treasurer

John K. Black
President – Catalyst Telecom

Robert T. Collins
President – ChannelMax

Robert S. McLain, Jr.
Vice President – Marketing

Glen D. (Buck) Baker
Vice President – Merchandising

R. Scott Benbenek
Vice President – Merchandising

Farrar R. Pittman
Vice President – Sales &
Merchandising

Sharon M. Huffman
Vice President – Sales

William T. Mauldin
Vice President – Operations

Gregory B. Dixon
Chief Technology Officer

Stock Listing

The Company's Stock is traded on the Nasdaq National Market under the symbol SCSC.

General Counsel

Nexsen Pruet Jacobs & Pollard, LLP
Greenville, South Carolina

Transfer Agent

First Union National Bank
Charlotte, North Carolina

Independent Accountants

KPMG LLP
Greenville, South Carolina

Shareholder Inquiries

ScanSource, Inc., welcomes inquiries from its shareholders and other interested investors. For further information or a copy of SEC form 10K, contact our Investor Relations Department. (800)-944-2439, x4375 or ScanSource.com.

Annual Meeting

The annual meeting of shareholders of the Company will be held at 10:00 a.m. on December 7, at the GSP Airport Marriott, 1 Parkway East, Greenville, South Carolina.

Corporate Headquarters

Greenville, South Carolina
800-944-2432

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800-292-3631

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800-944-2432

Bellingham, Washington 98225
800-830-2422

Cranford, New Jersey
908-931-1212

Richmond, British Columbia
604-303-9711

Etobicoke, Ontario
416-213-1926

Distribution Center

Memphis, Tennessee

ScanSource

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800.944.2432