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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D. C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended June 30, 2004

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-23827

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**PC CONNECTION, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**02-0513618**

(I.R.S. Employer Identification No.)

**730 Milford Road,  
Merrimack, New Hampshire**

(Address of principal executive offices)

**03054**

(Zip Code)

**(603) 683-2000**

Registrant's telephone number, including area code

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Indicate by check mark () whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark () whether the registrant is an accelerated filer as defined in Rule 12b-2 of the Securities and Exchange Act of 1934, as amended.

YES  NO

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

The number of shares outstanding of the issuer's Common Stock, \$.01 par value, as of June 30, 2004 was 25,045,098.

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PC CONNECTION, INC. AND SUBSIDIARIES  
FORM 10-Q  
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of  
PC Connection, Inc.  
Merrimack, New Hampshire

We have reviewed the accompanying condensed consolidated balance sheet of PC Connection, Inc. and subsidiaries (the "Company") as of June 30, 2004, and the related condensed consolidated statements of income for the three-month and six-month periods ended June 30, 2004 and 2003, and the condensed consolidated statement of changes in stockholders' equity for the six-month period ended June 30, 2004, and the condensed consolidated statements of cash flows for the six-month periods ended June 30, 2004 and 2003. These interim financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of PC Connection, Inc. and subsidiaries as of December 31, 2003, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 18, 2004, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2003 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

DELOITTE & TOUCHE LLP

July 21, 2004  
Boston, Massachusetts

## PC CONNECTION, INC. AND SUBSIDIARIES

## Part I—Financial Information

## Item 1—Financial Statements

## CONDENSED CONSOLIDATED BALANCE SHEETS

*(amounts in thousands)*

	June 30, 2004	December 31, 2003
	(unaudited)	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 1,456	\$ 2,977
Restricted cash	—	5,000
Accounts receivable, net	119,820	144,337
Inventories – merchandise	80,372	80,140
Deferred income taxes	1,972	1,732
Income taxes receivable	868	2,190
Prepaid expenses and other current assets	4,066	3,649
<b>Total current assets</b>	<b>208,554</b>	<b>240,025</b>
Property and equipment, net	18,034	20,396
Goodwill, net	44,766	45,264
Other intangibles, net	3,217	3,393
Other assets	206	208
<b>Total assets</b>	<b>\$ 274,777</b>	<b>\$ 309,286</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Current maturities of capital lease obligation to affiliate	\$ 352	\$ 334
Note payable – bank	—	5,614
Accounts payable	88,962	112,538
Accrued expenses and other liabilities	15,901	13,063
Acquisition earn-out obligation	—	11,593
<b>Total current liabilities</b>	<b>105,215</b>	<b>143,142</b>
Capital lease obligation to affiliate, less current maturities	5,907	6,088
Deferred income taxes	2,704	2,867
<b>Total liabilities</b>	<b>113,826</b>	<b>152,097</b>
Stockholders' Equity:		
Common stock	254	253
Additional paid-in capital	76,775	76,428
Retained earnings	86,208	82,794
Treasury stock at cost	(2,286)	(2,286)
<b>Total stockholders' equity</b>	<b>160,951</b>	<b>157,189</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 274,777</b>	<b>\$ 309,286</b>

See accompanying notes to condensed consolidated financial statements.

## PC CONNECTION, INC. AND SUBSIDIARIES

## Part I—Financial Information

## Item 1—Financial Statements

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

*(amounts in thousands, except per share data)*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net sales	\$ 335,335	\$ 321,568	\$ 662,970	\$ 605,095
Cost of sales	299,173	288,611	592,883	539,663
<b>Gross profit</b>	<b>36,162</b>	<b>32,957</b>	<b>70,087</b>	<b>65,432</b>
Selling, general, and administrative expenses	31,483	30,018	62,173	59,657
Restructuring costs and other special charges	753	397	1,783	397
<b>Income from operations</b>	<b>3,926</b>	<b>2,542</b>	<b>6,131</b>	<b>5,378</b>
Interest expense	(341)	(276)	(725)	(579)
Other, net	54	54	101	98
<b>Income before taxes</b>	<b>3,639</b>	<b>2,320</b>	<b>5,507</b>	<b>4,897</b>
Income tax provision	(1,383)	(917)	(2,093)	(1,919)
<b>Net income</b>	<b>\$ 2,256</b>	<b>\$ 1,403</b>	<b>\$ 3,414</b>	<b>\$ 2,978</b>
Weighted average common shares outstanding:				
Basic	25,008	24,665	25,003	24,658
Diluted	25,225	25,013	25,295	24,960
Earnings per common share:				
Basic	\$ .09	\$ .06	\$ .14	\$ .12
Diluted	\$ .09	\$ .06	\$ .14	\$ .12

See accompanying notes to condensed consolidated financial statements.

## PC CONNECTION, INC. AND SUBSIDIARIES

## Part I—Financial Information

## Item 1—Financial Statements

## CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

Six Months Ended June 30, 2004

(Unaudited)

(amounts in thousands)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Treasury Shares		Total
	Shares	Amount			Shares	Amount	
<b>Balance – December 31, 2003</b>	25,342	\$ 253	\$ 76,428	\$ 82,794	(362)	\$ (2,286)	\$ 157,189
Exercise of stock options, including income tax benefits	28	1	142	—	—	—	143
Issuance of stock under employee stock purchase plan	37	—	205	—	—	—	205
Net income	—	—	—	3,414	—	—	3,414
<b>Balance – June 30, 2004</b>	<b>25,407</b>	<b>\$ 254</b>	<b>\$ 76,775</b>	<b>\$ 86,208</b>	<b>(362)</b>	<b>\$ (2,286)</b>	<b>\$ 160,951</b>

See accompanying notes to condensed consolidated financial statements.

## PC CONNECTION, INC. AND SUBSIDIARIES

## Part I—Financial Information

## Item 1—Financial Statements

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(amounts in thousands)

	Six Months Ended June 30,	
	2004	2003
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 3,414	\$ 2,978
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,539	4,408
Deferred income taxes	(403)	(829)
Provision for doubtful accounts	2,076	1,294
Loss on disposal of fixed assets	1	—
Changes in assets and liabilities:		
Accounts receivable	22,441	12,010
Inventories	(232)	(9,696)
Prepaid expenses and other current assets	905	(2,869)
Other non-current assets	2	146
Accounts payable	(23,576)	4,844
Income tax benefits from exercise of stock options	85	110
Accrued expenses and other liabilities	2,838	1,166
Net cash provided by operating activities	<u>11,090</u>	<u>13,562</u>
<b>Cash Flows from Investing Activities:</b>		
Purchases of property and equipment	(1,002)	(1,325)
Payment of acquisition earn-out obligation	(11,095)	(10,800)
Cash escrow distributed for acquisition	5,000	5,000
Net cash used for investing activities	<u>(7,097)</u>	<u>(7,125)</u>
<b>Cash Flows from Financing Activities:</b>		
Proceeds from short-term borrowings	174,121	76,465
Repayment of short-term borrowings	(179,735)	(76,465)
Repayment of capital lease obligation to affiliate	(163)	(92)
Exercise of stock options	58	42
Issuance of stock under employee stock purchase plan	205	212
Net cash (used for) provided by financing activities	<u>(5,514)</u>	<u>162</u>
(Decrease) increase in cash and cash equivalents	(1,521)	6,599
Cash and cash equivalents, beginning of period	2,977	1,797
Cash and cash equivalents, end of period	<u>\$ 1,456</u>	<u>\$ 8,396</u>

See accompanying notes to condensed consolidated financial statements.

**PC CONNECTION, INC. AND SUBSIDIARIES**

**Part I—Financial Information**

**Item 1—Financial Statements**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*(amounts in thousands, except per share data)*

**Note 1—Basis of Presentation**

The accompanying condensed consolidated financial statements of PC Connection, Inc. and its subsidiaries (“PC Connection”) have been prepared in accordance with accounting principles generally accepted in the United States of America. Such principles were applied on a basis consistent with those of the financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Securities and Exchange Commission. The accompanying condensed consolidated financial statements should be read in conjunction with the financial statements contained in our Annual Report on Form 10-K. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation. The operating results for the three and six months ended June 30, 2004 may not be indicative of the results expected for any succeeding quarter or the entire year ending December 31, 2004.

***Revenue Recognition***

Revenue on product sales is recognized at the point in time when persuasive evidence of an arrangement exists, the price is fixed and final, delivery has occurred and there is a reasonable assurance of collection of the sales proceeds. We generally obtain oral or written purchase authorizations from our customers for a specified amount of product at a specified price. Because we either (i) have a general practice of covering customer losses while products are in transit despite title transferring to the customer at the point of shipment or (ii) have FOB – destination specifically set out in our arrangements with federal agencies, delivery is deemed to have occurred at the point in time when the product is received by the customer.

We provide our customers with a limited thirty-day right of return generally limited to defective merchandise. Revenue is recognized at delivery and a reserve for sales returns is recorded. We have demonstrated the ability to make reasonable and reliable estimates of product returns in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 48, “Revenue Recognition When Right of Return Exists,” based on significant historical experience. Should such returns no longer prove estimable, we believe that the impact on our financials would not necessarily be significant since the return privilege expires 30 days after shipment.

All amounts billed to a customer in a sale transaction related to shipping and handling, if any, represent revenues earned for the goods provided and have been classified as “net sales.” Costs related to such shipping and handling billings are classified as “cost of sales.”

***Restricted Cash***

In connection with the acquisition of MoreDirect, Inc. (see Note 6 – Acquisition of MoreDirect, Inc.), we established a \$10,000 cash escrow to fund a portion of the contingent consideration. We used \$5,000 of these escrowed funds in the first quarter of 2003 and the remaining \$5,000 in the first quarter of 2004 to satisfy a portion of the earn-out obligation.



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### **Goodwill and Other Intangible Assets**

Intangible assets subject to amortization, consisting of customer lists, were \$2,027 and \$2,203 at June 30, 2004 and December 31, 2003 (net of accumulated amortization of \$793 and \$617, respectively). Intangible assets not subject to amortization are as follows:

	June 30, 2004	December 31, 2003
Goodwill	\$ 44,766	\$ 45,264
Trademarks	1,190	1,190

A rollforward of goodwill is as follows:

Balance, December 31, 2003	\$ 45,264
Adjustment to earn-out obligation	(498)
Balance, June 30, 2004	\$ 44,766

We have designated January 1 of each year as the date we intend to perform our annual impairment tests relative to goodwill. This test was completed in the first quarter of 2004, and no impairment was recorded.

For the six months ended June 30, 2004 and 2003, we recorded amortization expense of \$176 and \$176 on intangible assets, respectively.

The estimated amortization expense for each of the five succeeding years and thereafter is as follows:

#### For the Year Ended December 31,

2004	\$177	(A)
2005	353	
2006	353	
2007	353	
2008	353	
2009 and thereafter	438	

(A) Represents estimated amortization expense for the six months ending December 31, 2004.

### **Use of Estimates**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions. These estimates and assumptions affect the amounts reported in the accompanying consolidated financial statements. Actual results could differ from those estimates.

### **Stock-Based Compensation**

Compensation expense associated with awards of stock or options to employees and directors is measured using the intrinsic value method in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees." The intrinsic value method requires that compensation expense, if any, be measured by the difference between the fair value of our common stock and the strike price of the option as of a measurement date. This measurement date is generally when both the number of shares and the strike price of the options are determined.

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Had we recorded compensation expense using the fair value method under SFAS No. 123, "Accounting for Stock-Based Compensation," pro forma net income and diluted net income per share for the periods indicated would have been as follows:

June 30, (amounts in thousands, except per share data)	Three Months Ended		Six Months Ended	
	2004	2003	2004	2003
Net income, as reported	\$ 2,256	\$ 1,403	\$ 3,414	\$ 2,978
Compensation expense, net of taxes, under SFAS No. 123	256	764	504	1,233
Net income, under SFAS No. 123	2,000	639	2,910	1,745
Basic net income per share, as reported	.09	.06	.14	.12
Basic net income per share, under SFAS No. 123	.08	.03	.12	.07
Diluted net income per share, as reported	.09	.06	.14	.12
Diluted net income per share, under SFAS No. 123	.08	.03	.12	.07

The Black-Scholes model was used to value options granted subsequent to the Company's initial public offering. For the period ended June 30, 2004, a volatility factor of 96.8%, estimated option lives of four years, and a risk-free interest rate of 3.0% were used. For the period ended June 30, 2003, a volatility factor of 96.8%, estimated option lives of four years, and a risk-free interest rate of 2.4% were used.

We believe that the assumptions used and the models applied to value the awards yield a reasonable estimate of the fair value of the grants made under the circumstances, given the alternatives under SFAS No. 123.

### Note 2—Earnings Per Share

Basic earnings per common share is computed using the weighted average number of shares outstanding. Diluted earnings per common share is computed using the weighted average number of shares outstanding adjusted for the incremental shares attributed to options outstanding to purchase common stock, if dilutive.

The following table sets forth the computation of basic and diluted earnings per share:

June 30, (amounts in thousands, except per share data)	Three Months Ended		Six Months Ended	
	2004	2003	2004	2003
<b>Numerator:</b>				
Net income	\$ 2,256	\$ 1,403	\$ 3,414	\$ 2,978
<b>Denominator:</b>				
Denominator for basic earnings per share	25,008	24,665	25,003	24,658
Dilutive effect of unexercised employee stock options	217	348	292	302
Denominator for diluted earnings per share	25,225	25,013	25,295	24,960
<b>Earnings per share:</b>				
Basic	\$ .09	\$ .06	\$ .14	\$ .12
Diluted	\$ .09	\$ .06	\$ .14	\$ .12

The following unexercised stock options were excluded from the computation of diluted earnings per share for the three and six months ended June 30, 2004 and 2003 because the exercise prices of these options were generally greater than the average market price of common shares during the respective periods:

June 30, (amounts in thousands)	Three Months Ended		Six Months Ended	
	2004	2003	2004	2003
Anti-dilutive stock options	1,482	1,551	1,471	1,722

[Table of Contents](#)**Note 3—Reporting Comprehensive Income**

We have no other comprehensive income in any of the periods presented. Accordingly, a separate statement of comprehensive income is not presented.

**Note 4—Segment and Related Disclosures**

SFAS No. 131, “Disclosures About Segments of an Enterprise and Related Information,” requires that public companies report profits and losses and certain other information on its “reportable operating segments” in its annual and interim financial statements.

We operate in three reportable operating segments—the “SMB” segment, which contains small- and medium-sized businesses, as well as consumers; the “Public Sector” segment, which contains federal, state, and local governmental organizations and educational institutions; and the “Large Corporate Accounts” segment which serves medium-to-large corporations.

Segment information applicable to the Company’s reportable operating segments for the three and six months ended June 30, 2004 and 2003 is shown below:

<u>Three Months Ended June 30, 2004</u>	<u>SMB Segment</u>	<u>Public Sector Segment</u>	<u>Large Corp. Accts. Segment</u>	<u>Eliminations</u>	<u>Consolidated</u>
Sales to external customers	\$ 194,058	\$ 63,335	\$ 77,942	\$ —	\$ 335,335
Transfers between segments	58,781	—	—	(58,781)	—
Net sales	<u>\$ 252,839</u>	<u>\$ 63,335</u>	<u>\$ 77,942</u>	<u>\$ (58,781)</u>	<u>\$ 335,335</u>
Operating income (loss) before allocations	\$ 14,624	\$ 1,187	\$ 4,056	\$ (15,941)	\$ 3,926
Allocations	11,814	3,666	461	(15,941)	—
Operating income (loss)	<u>2,810</u>	<u>(2,479)</u>	<u>3,595</u>	<u>—</u>	<u>3,926</u>
Interest and other—net	(235)	(62)	10	—	(287)
Income (loss) before taxes	<u>\$ 2,575</u>	<u>\$ (2,541)</u>	<u>\$ 3,605</u>	<u>\$ —</u>	<u>\$ 3,639</u>
<u>Three Months Ended June 30, 2003</u>	<u>SMB Segment</u>	<u>Public Sector Segment</u>	<u>Large Corp. Accts. Segment</u>	<u>Eliminations</u>	<u>Consolidated</u>
Sales to external customers	\$ 186,576	\$ 75,023	\$ 59,969	\$ —	\$ 321,568
Transfers between segments	58,639	—	—	(58,639)	—
Net sales	<u>\$ 245,215</u>	<u>\$ 75,023</u>	<u>\$ 59,969</u>	<u>\$ (58,639)</u>	<u>\$ 321,568</u>
Operating income (loss) before allocations	\$ 12,460	\$ 1,806	\$ 3,766	\$ (15,490)	\$ 2,542
Allocations	11,904	3,174	412	(15,490)	—
Operating income (loss)	<u>556</u>	<u>(1,368)</u>	<u>3,354</u>	<u>—</u>	<u>2,542</u>
Interest and other—net	(197)	(32)	7	—	(222)
Income (loss) before taxes	<u>\$ 359</u>	<u>\$ (1,400)</u>	<u>\$ 3,361</u>	<u>\$ —</u>	<u>\$ 2,320</u>

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Six Months Ended June 30, 2004	SMB Segment	Public Sector Segment	Large Corp. Accts. Segment	Eliminations	Consolidated
Sales to external customers	\$401,482	\$ 117,187	\$ 144,301	\$ —	\$ 662,970
Transfers between segments	105,629	—	—	(105,629)	—
<b>Net sales</b>	<b>\$ 507,111</b>	<b>\$ 117,187</b>	<b>\$ 144,301</b>	<b>\$(105,629)</b>	<b>\$ 662,970</b>
Operating income (loss) before allocations	\$ 29,420	\$ 1,044	\$ 7,337	\$ (31,670)	\$ 6,131
Allocations	23,784	7,078	808	(31,670)	—
Operating income (loss)	5,636	(6,034)	6,529	—	6,131
Interest and other—net	(511)	(130)	17	—	(624)
<b>Income (loss) before taxes</b>	<b>\$ 5,125</b>	<b>\$ (6,164)</b>	<b>\$ 6,546</b>	<b>\$ —</b>	<b>\$ 5,507</b>
<b>Total assets</b>	<b>\$200,759</b>	<b>\$ 67,148</b>	<b>\$ 95,891</b>	<b>\$ (89,021)</b>	<b>\$ 274,777</b>
<b>Goodwill, net</b>	<b>\$ 1,173</b>	<b>\$ 7,634</b>	<b>\$ 35,959</b>	<b>\$ —</b>	<b>\$ 44,766</b>
<b>Six Months Ended June 30, 2003</b>	<b>SMB Segment</b>	<b>Public Sector Segment</b>	<b>Large Corp. Accts. Segment</b>	<b>Eliminations</b>	<b>Consolidated</b>
Sales to external customers	\$365,216	\$ 127,655	\$ 112,224	\$ —	\$ 605,095
Transfers between segments	98,159	—	—	(98,159)	—
<b>Net sales</b>	<b>\$463,375</b>	<b>\$ 127,655</b>	<b>\$ 112,224</b>	<b>\$ (98,159)</b>	<b>\$ 605,095</b>
Operating income (loss) before allocations	\$ 25,578	\$ 3,542	\$ 7,222	\$ (30,964)	\$ 5,378
Allocations	24,432	5,959	573	(30,964)	—
Operating income (loss)	1,146	(2,417)	6,649	—	5,378
Interest and other—net	(419)	(73)	11	—	(481)
<b>Income (loss) before taxes</b>	<b>\$ 727</b>	<b>\$ (2,490)</b>	<b>\$ 6,660</b>	<b>\$ —</b>	<b>\$ 4,897</b>
<b>Total assets</b>	<b>\$196,330</b>	<b>\$ 76,606</b>	<b>\$ 80,521</b>	<b>\$ (86,875)</b>	<b>\$ 266,582</b>
<b>Goodwill, net</b>	<b>\$ 1,173</b>	<b>\$ 7,634</b>	<b>\$ 24,897</b>	<b>\$ —</b>	<b>\$ 33,704</b>

General and administrative expenses were charged to the reportable operating segments, based on their estimated usage of the underlying functions. Interest and other expense was charged to the segments, based on the actual costs incurred by each segment, net of interest and other income generated. The amount shown above representing total assets eliminated consists of inter-segment receivables, resulting primarily from inter-segment sales transfers reported above and from inter-segment service charges.

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Net sales by business segment, sales channel, and product mix are presented below:

June 30, (amounts in thousands)	Three Months Ended		Six Months Ended	
	2004	2003	2004	2003
<b>Segment (excludes transfers between segments)</b>				
SMB	\$ 194,058	\$ 186,576	\$ 401,482	\$ 365,216
Public Sector	63,335	75,023	117,187	127,655
Large Accounts	77,942	59,969	144,301	112,224
<b>Total</b>	<b>\$ 335,335</b>	<b>\$ 321,568</b>	<b>\$ 662,970</b>	<b>\$ 605,095</b>
<b>Sales Channel</b>				
Outbound & Telemarketing Field Sales	\$ 244,859	\$ 251,130	\$ 492,682	\$ 466,716
Inbound Telesales	20,752	20,106	42,924	38,796
Online Internet	69,724	50,332	127,364	99,583
<b>Total</b>	<b>\$ 335,335</b>	<b>\$ 321,568</b>	<b>\$ 662,970</b>	<b>\$ 605,095</b>
<b>Product Mix</b>				
Notebooks & PDAs	\$ 67,413	\$ 66,269	\$ 136,150	\$ 120,527
Desktop/Servers	46,228	45,364	92,493	87,284
Storage Devices	26,710	28,582	53,213	56,517
Software	39,435	30,370	80,725	61,816
Net/Com Products	23,680	26,129	47,958	48,950
Printers & Printer Supplies	39,737	39,341	76,623	72,446
Video, Imaging & Sound	42,157	38,242	81,261	69,014
Memory & System Enhancements	17,593	18,248	34,460	34,658
Accessories/Other	32,382	29,023	60,087	53,883
<b>Total</b>	<b>\$ 335,335</b>	<b>\$ 321,568</b>	<b>\$ 662,970</b>	<b>\$ 605,095</b>

Substantially all of our net sales for the three and six months ended June 30, 2004 and 2003 were made to customers located in the United States. Shipments to customers located in foreign countries aggregated less than 2% in each of those respective periods. All of our assets at June 30, 2004 and December 31, 2003 were located in the United States. Our primary target customers are small- to medium-sized businesses comprised of 20 to 1,000 employees, federal, state, and local governmental agencies, educational institutions, and medium-to-large corporate accounts. Except for the federal government, no single customer accounted for more than 4% of total net sales in the three and six months ended June 30, 2004 and 2003. Net sales to the federal government accounted for \$11.0 million, or 3.3% of total net sales for the three months ended June 30, 2004, and \$31.5 million, or 9.8% of total net sales for the three months ended June 30, 2003. Net sales to the federal government accounted for \$25.5 million, or 3.8% of total net sales for the six months ended June 30, 2004, and \$54.0 million, or 8.9% of total net sales for the six months ended June 30, 2003. The decrease in federal government sales was due to the late 2003 cancellation of a contract by the General Services Administration (“GSA”), as discussed elsewhere in this quarterly report.

### **Note 5—Restructuring Costs and Other Special Charges**

In the three months ended June 30, 2004 and 2003, we recorded charges of \$26 and \$397, respectively, related to staff reductions, charges of \$688 and \$0, respectively, related to our investigation concerning the 2003 GSA contract cancellation and costs related to securing a new GSA schedule, and charges of \$39 and \$0, respectively, related to additional costs incurred as a result of a 2003 employee defalcation.

In the six months ended June 30, 2004 and 2003, we recorded charges of \$575 and \$397, respectively, related to staff reductions, charges of \$1,127 and \$0, respectively, related to our investigation concerning the

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2003 GSA contract cancellation and costs related to securing a new GSA schedule, and charges of \$81 and \$0, respectively, related to additional costs incurred as a result of a 2003 employee defalcation.

A rollforward of restructuring reserves is shown below.

	<u>Workforce Reductions</u>	<u>GSA Review</u>	<u>Other</u>	<u>Total</u>
Balance December 31, 2003	\$ 113	\$ 237	\$—	\$ 350
Charges	549	439	42	1,033
Cash payments	(503)	(412)	(42)	(957)
Liabilities at March 31, 2004	159	264	—	423
Charges	26	688	39	753
Cash payments	(170)	(780)	(39)	(989)
Liabilities at June 30, 2004	\$ 15	\$ 172	\$—	\$ 187

Liabilities at June 30, 2004 and December 31, 2003 are included in accrued expenses and other liabilities on the balance sheet.

### **Note 6—Acquisition of MoreDirect, Inc.**

On April 5, 2002, we completed the acquisition of MoreDirect, Inc. (“MoreDirect”). Our annual report on Form 10-K for the year ended December 31, 2003 details this transaction. Under the terms of the agreement, MoreDirect’s shareholder continues to be eligible to earn additional consideration based upon MoreDirect achieving targeted levels of annual earnings before income taxes through December 31, 2004. For the year ended December 31, 2003, we paid \$11,095 in earn-out consideration. For the period ended December 31, 2002, we paid \$10,800 in earn-out consideration. We also escrowed \$10,000 in cash in April 2002 to fund a portion of these contingent payments, of which \$5,000 was used to satisfy a portion of the 2002 liability paid by us in the first quarter of 2003. We used the remaining \$5,000 in the first quarter of 2004 to satisfy a portion of the 2003 liability paid by us.

### **Note 7—Commitments and Contingencies**

We are subject to various legal proceedings and claims which have arisen during the ordinary course of business. In the opinion of management, the outcome of such matters is not expected to have a material effect on our financial position, results of operations, and cash flows.

We are also subject to audit by various government agencies relating to sales under certain government contracts. As noted in our Annual Report on Form 10-K for the year ended December 31, 2003, the GSA, in the fourth quarter of 2003, canceled the contract that our subsidiary, GovConnection, had with that agency. We have not received an audit report or received a claim from the GSA concerning amounts that might be owed pursuant to this audit. We believe that we have provided adequate reserves to cover any claims as they relate to payment of fees required under the contract. We have reserved \$1.0 million for such fees. However, we will continue to evaluate such reserves in light of additional information that comes to our attention.

We have been informally advised that audit matters related to GovConnection have been referred to the Department of Justice for its review. Such a referral exposes us to possible civil damages for non-compliance with the GSA contract. Such damages can be substantial. No reserves have been provided for such a claim because of the preliminary nature of this matter. We will continue to evaluate our reserves—as they relate both to the GSA audit and the Department of Justice investigation—in light of additional information that comes to our attention. The ultimate outcome of these matters cannot be determined. Future events may result in conclusions that could have a material impact, either positively or negatively, on our results of operations or financial

condition. We have no indication of intentional wrongdoing by GovConnection regarding the GSA contract. In order to assist in this evaluation, we have engaged outside counsel and an independent accounting firm to review the Company's systems, policies, and procedures relative to its federal, state, and local government contracts.

**Note 8—Bank Borrowing and Trade Credit Arrangements**

We have a \$45,000 credit facility secured by substantially all of our business assets. This facility was amended as of October 1, 2003 to give us the option, which we may exercise at anytime prior to the credit facility's maturity date, of increasing the borrowing up to \$65,000. Amounts outstanding under this facility bear interest at the prime rate (4.0% at June 30, 2004). The credit facility includes various customary financial and operating covenants, including minimum net worth and maximum funded debt ratio requirements, and restrictions on the payment of dividends, and default acceleration provisions, none of which we believe significantly restricts our operations. The maximum allowable funded debt ratio under the agreement is 2.0 to 1.0; our actual funded debt ratio at June 30, 2004 was only 0.4 to 1.0. Funded debt ratio is the ratio of average outstanding advances under the facility to EBITDA (Earnings Before Interest Expense, Taxes, Depreciation, and Amortization). Borrowing availability under the agreement was \$45,000 at June 30, 2004.

No borrowings were outstanding under this credit facility at June 30, 2004. The credit facility matures on December 31, 2005, at which time amounts outstanding, if any, become due.

At June 30, 2004 and December 31, 2003, we had security agreements with two financial institutions to facilitate the purchase of inventory from various suppliers under certain terms and conditions. The agreements allow a collateralized position in inventory financed by the financial institutions up to an aggregated amount of \$45,000. The cost of such financing under these agreements is borne by the suppliers by discounting their invoices to the financial institutions as an incentive for us to purchase their products. We do not pay any interest or discount fees on such inventory financing. At June 30, 2004 and December 31, 2003, accounts payable included \$4,950 and \$6,397, respectively, owed to these financial institutions.

PC CONNECTION, INC. AND SUBSIDIARIES

Part I—Financial Information

Item 2—MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS

*The following Management’s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements based on management’s current expectations, estimates, and projections about the Company’s industry, management’s beliefs, and certain assumptions made by management. All statements, trends, analyses, and other information contained in this report relative to trends in net sales, gross margin, and anticipated expense levels, as well as other statements, including words such as “anticipate,” “believe,” “plan,” “estimate,” “expect,” “may,” “project,” “will,” “would,” and “intend” and other similar expressions, constitute forward-looking statements. These forward-looking statements involve risks and uncertainties, and actual results may differ materially from those anticipated or expressed in such statements. Potential risks and uncertainties include, among others, those set forth under the caption “Factors That May Affect Future Results and Financial Condition” included within this section. Particular attention should be paid to the cautionary statements involving the industry’s rapid technological change and exposure to inventory obsolescence, availability and allocations of goods, reliance on vendor support and relationships, competitive risks, pricing risks, and the overall level of economic activity and the investment in information technology products. Except as required by law, the Company undertakes no obligation to update any forward-looking statement, whether as a result of new information, future events, or otherwise. Readers, however, should carefully review the factors set forth in other reports or documents that the Company files from time to time with the Securities and Exchange Commission.*

**OVERVIEW**

PC Connection is a national direct marketing organization, offering a wide range of information technology products and services—including computer systems, software and peripheral equipment, networking communications, and other products and accessories that we purchase from manufacturers, distributors, and other suppliers. We also offer a growing range of repair, installation, and other services performed by third-party providers. We operate through three primary business segments: (a) consumers and small- to medium-sized businesses (“SMB”) through our PC Connection Sales subsidiary, (b) federal, state, and local government and educational institutions (“Public Sector”) through our GovConnection subsidiary, and (c) large corporate accounts (“Large Accounts”) through our MoreDirect subsidiary.

We generate sales through (i) outbound telemarketing and field sales contacts by account managers focused on the business, education, and government markets, (ii) inbound calls from customers responding to our catalogs and other advertising media, and (iii) our Internet Web sites.

***Opportunities, Challenges, and Risks***

With our sales representing less than 1% of the overall \$200 billion U.S. Information Technology (“IT”) market, we believe that we have an excellent opportunity to grow and gain a larger share of this market. As experienced in the last half of 2003, we continued to experience an improvement in sales productivity in the first half of 2004. We also implemented a number of sales and gross profit improvement initiatives, including tighter management of discounting, more extensive and focused sales training on costs and margins, and targeted improvements in sales pricing, sales incentives, and account management. With these initiatives, we expect our sales personnel to continue to generate more add-on sales, thereby further increasing sales per transaction as well as improving over-all gross profit margins during the remainder of 2004.

As noted in our 2003 Annual Report on Form 10-K, the General Services Administration (“GSA”) cancelled its contract with GovConnection, following its review of our subsidiary’s contract management system and procedures and the possibility of the sale of unqualified items and underpayment of required fees. We have



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applied for a new contract with the GSA. The pre-award audit by the GSA began in March 2004 with our submission of records and was completed in June 2004. We are in negotiations with the GSA in finalizing the new contract. However, the timing of the awarding of a new contract is beyond our control. Accordingly, our 2004 sales will continue to be adversely impacted if the new contract is not approved. This matter is further discussed below in the section entitled "Factors That May Affect Future Results and Financial Condition."

The primary challenges we continue to face in effectively managing our business are: (1) continuing our sales growth while stabilizing the downward trend of gross profit margins in our large account segment and ultimately improving our gross profit margins in all three segments of our business, (2) continuing to improve the productivity of our sales personnel, and (3) effectively managing and leveraging our selling, general, and administrative expenses over a higher sales base. We expect competition to be even more intense in the future, which could put additional pressure on our gross profit margins.

### RESULTS OF OPERATIONS

The following table sets forth for the periods indicated information derived from our statements of operations expressed as a percentage of net sales.

<u>June 30,</u>	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Net sales (in millions)	<b>\$ 335.3</b>	\$ 321.6	<b>\$ 663.0</b>	\$ 605.1
Net sales	<b>100.0%</b>	100.0%	<b>100.0%</b>	100.0%
Gross profit	<b>10.8</b>	10.3	<b>10.6</b>	10.8
Selling, general, and administrative expenses	<b>9.4</b>	9.3	<b>9.4</b>	9.9
Restructuring costs and other special charges	<b>0.2</b>	0.1	<b>0.3</b>	0.1
Income from operations	<b>1.2</b>	0.8	<b>0.9</b>	0.9

The increase in gross profit as a percentage of sales for the second quarter of 2004 nearly offset the decrease in the first quarter and resulted from increased focus on gross margins and product mix. The 2004 decrease in selling, general, and administrative expenses as a percentage of net sales for the six-month periods is the result of higher sales volumes spread over relatively fixed expenses, together with various cost improvement initiatives, including the consolidation of our sales support staff.

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### **Sales Distribution**

The following table sets forth our percentage of net sales by business segment, sales channel, and product mix:

June 30,	Three Months Ended		Six Months Ended	
	2004	2003	2004	2003
<b>Segment (excludes transfers between segments)</b>				
SMB	58%	58%	60%	60%
Public Sector	19	23	18	21
Large Accounts	23	19	22	19
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>Sales Channel</b>				
Outbound Telemarketing & Field Sales	73%	78%	74%	77%
Inbound Telesales	6	6	7	6
Online Internet	21	16	19	17
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>Product Mix</b>				
Notebooks & PDAs	20%	21%	21%	21%
Desktop/Servers	14	14	14	14
Storage Devices	8	9	8	9
Software	12	9	12	10
Net/Com Products	7	8	7	8
Printers & Printer Supplies	12	12	12	12
Videos, Imaging & Sound	12	12	12	11
Memory & System Enhancements	5	6	5	6
Accessories/Other	10	9	9	9
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Sales of enterprise server and networking products (included in the above product mix) were 25% and 26% of net sales for the three months ended June 30, 2004 and 2003, respectively, and 25% and 27% of net sales for the six months ended June 30, 2004 and 2003, respectively.

### **Gross Profit Margins**

The following table summarizes our overall gross profit margins, as a percentage of net sales, over the periods indicated:

June 30,	Three Months Ended		Six Months Ended	
	2004	2003	2004	2003
<b>Segment</b>				
SMB	11.7%	10.7%	11.3%	11.3%
Public Sector	9.1	7.9	8.9	8.5
Large Account	9.8	11.7	9.8	12.0
<b>Total</b>	<b>10.8%</b>	<b>10.3%</b>	<b>10.6%</b>	<b>10.8%</b>

Gross margins on a consolidated basis increased year over year for the three-month periods and also increased sequentially from 10.4% in the first quarter of 2004. Consolidated gross margin for the six months ended June 30, 2004 was slightly lower than the comparable period in 2003, primarily due to higher vendor rebates in the first quarter of 2003. Gross margins also vary by product mix. Sales of notebooks and PDAs continued to account for a high percentage of our overall sales in the second quarter of 2004, although they

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generally yield a low gross margin percentage. Our on-going efforts to improve product margins continue to focus on increasing add-on sales of accessories and other companion products to our system sales and increasing the level of enterprise product sales and sales of third-party warranty, installation, and other services. We also implemented a number of sales and gross profit improvement initiatives, including tighter management of discounting, more extensive and focused sales training on costs and margins, and targeted improvements in sales pricing, sales incentives, and account management.

### **Operating Expenses**

The following table breaks out our more significant operating expenses for the periods indicated (in millions of dollars):

June 30,	Three Months Ended		Six Months Ended	
	2004	2003	2004	2003
Personnel costs	\$ 23.5	\$ 21.9	\$ 46.0	\$ 43.8
Facilities operations	2.4	2.5	4.8	4.7
Credit card fees	1.8	1.9	3.6	3.6
Depreciation and amortization	1.8	2.2	3.5	4.4
Bad debts	0.7	0.8	1.1	1.6
Other – net, including advertising	1.3	0.7	3.2	1.6
<b>Total</b>	<b>\$ 31.5</b>	<b>\$ 30.0</b>	<b>\$ 62.2</b>	<b>\$ 59.7</b>
Percentage of net sales	9.4%	9.3%	9.4%	9.9%

Personnel costs continue to represent the majority of our operating expenses, with sales personnel representing the largest portion of these costs. Our other operating costs, except for credit card fees and bad debts, tend to be relatively fixed over changing sales levels. The increases in other operating costs for the three-month and six-month periods in 2004 are attributable primarily to increased business insurance costs, legal and accounting fees, and net advertising costs.

### **YEAR-OVER-YEAR COMPARISONS**

#### *Three Months Ended June 30, 2004 Compared to Three Months Ended June 30, 2003*

Changes in net sales and gross profit by business segment are shown in the following table (dollars in millions):

	Three Months Ended June 30,				
	2004		2003		% Change
	Amount	% of Net Sales	Amount	% of Net Sales	
<b>Sales:</b>					
SMB	\$ 194.1	57.9%	\$ 186.6	58.0%	4.0%
Public Sector	63.3	18.9	75.0	23.3	(15.6)
Large Account	77.9	23.2	60.0	18.7	29.8
<b>Total</b>	<b>\$ 335.3</b>	<b>100.0%</b>	<b>\$ 321.6</b>	<b>100.0%</b>	<b>4.3%</b>
<b>Gross Profit:</b>					
SMB	\$ 22.8	11.7%	\$ 20.1	10.7%	13.4%
Public Sector	5.8	9.1	5.9	7.9	(1.7)
Large Account	7.6	9.8	7.0	11.7	8.6
<b>Total</b>	<b>\$ 36.2</b>	<b>10.8%</b>	<b>\$ 33.0</b>	<b>10.3%</b>	<b>9.7%</b>

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*Net sales* for the quarter increased year over year due primarily to increases of our SMB and Large Account segments, as explained in the following:

- Net sales for our SMB segment increased because we increased the number of sales representatives in the year by 8.2% while incurring only a 3.8% decline in annualized sales productivity, quarter to quarter. Sales representatives for the SMB segment totaled 384 at June 30, 2004, up from 355 at June 30, 2003.
- Net sales for our Public Sector segment decreased due to a 65.0% decline in sales to the federal government. Sales to the federal government decreased as a result of the cancellation of our GSA contract in late 2003. Sales to state and local government units and educational institutions, however, increased 20.2% from the second quarter of 2003. Sales account managers for the Public Sector segment totaled 110 at June 30, 2004, down from 114 at June 30, 2003.
- Net sales for our Large Account segment increased due to a year-over-year improvement in average annualized sales productivity per account manager by 31.7%. Sales representatives for this segment totaled 76 at June 30, 2004, down from 77 at June 30, 2003.

*Gross profit* and the corresponding gross margin percentage of net sales increased as shown by the above table. These increases are explained by the following:

- Gross profit for the SMB segment increased year over year, as did its gross margin rate. These increases are attributable to our increased focus on margins and a shift in product mix to more profitable products. We also implemented a number of sales and gross profit improvement initiatives, including tighter management of discounting, more extensive and focused sales training on costs and margins, and targeted improvements in sales pricing, sales incentives, and account management.
- Gross profit for the Public Sector segment was substantially flat in 2004 compared to the 2003 quarter. The decrease attributable to the decline in federal government sales discussed above was largely offset by the increase in margin rate.
- Gross profit for the Large Account segment increased by 8.6% due to the increase in sales discussed above, partially offset by the decline in the gross margin rate. Changes in customer mix and continuing competitive pressures caused gross margin rates to decrease on a year-over-year basis.

*Selling, general, and administrative* expenses increased modestly year over year in the three months ended June 30, 2004 and also increased modestly as a percentage of sales over the comparable period in 2003. The dollar increase is related largely to increased variable costs, primarily sales personnel expense associated with higher sales levels referred to above.

We have concentrated our efforts on managing our overall operating costs. Personnel costs generally account for over two-thirds of our selling, general, and administrative (“SG&A”) expenses, as shown earlier in the table of SG&A expenses. In the first half of 2004, we restructured our sales support staff to provide more efficiency and effectiveness. While we plan to continue our focus on controlling discretionary expenditures, we expect that our SG&A expense may vary depending on changes in sales volume, as well as the levels of continued investments in key growth initiatives such as hiring more experienced outbound sales account managers, improving marketing programs, and deploying next generation Internet Web technology to support our sales organization.

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SG&A expenses attributable to our operating segments are summarized below (dollars in millions):

	Three Months Ended June 30,				
	2004		2003		% Change
	Amount	% of Net Sales	Amount	% of Net Sales	
SMB	\$ 20.0	10.3%	\$ 19.1	10.2%	4.7%
Public Sector	7.5	11.8	7.3	9.7	2.7
Large Account	4.0	5.1	3.6	6.0	11.1
<b>Total</b>	<b>\$ 31.5</b>	<b>9.4%</b>	<b>\$ 30.0</b>	<b>9.3%</b>	<b>5.0%</b>

- SG&A expenses for the SMB segment increased in the three months ended June 30, 2004 compared to the same period in 2003, and also increased modestly as a percentage of net sales from 2003. Professional fees and business insurance costs for this segment were slightly higher in 2004 compared to the comparable quarter in 2003.
- The Public Sector segment's expenses increased slightly in the second quarter of 2004 but increased significantly as a percentage of net sales from the comparable period in 2003. The significant decrease in our federal government sales described above increased this segment's SG&A as a percentage of sales despite the small increase in actual expense. We have retained experienced sales personnel in anticipation of a new GSA contract.
- SG&A expenses for the Large Account segment increased by 11.1% but decreased as a percentage of net sales. SG&A expenses for this segment represent the lowest of the three segments as a percentage of net sales, reflecting the nature and efficiency of this segment's variable cost field sales and drop-shipping operating model.

*Restructuring costs and other special charges* totaled \$0.8 million for the three months ended June 30, 2004 and \$0.4 million for the three months ended June 30, 2003. A roll forward of restructuring costs and other special charges for the period presented is shown below (in thousands). There were no changes in estimates in any of the periods presented.

	Workforce Reductions	GSA Review	Other	Total
Balance March 31, 2004	\$ 159	\$ 264	\$ —	\$ 423
Charges	26	688	39	753
Cash payments	(170)	(780)	(39)	(989)
<b>Balance June 30, 2004</b>	<b>\$ 15</b>	<b>\$ 172</b>	<b>\$ —</b>	<b>\$ 187</b>

The legal and other professional charges for the GSA contract review represent costs of our ongoing investigations relating to the GSA's cancellation in late 2003 of its contract with our subsidiary, GovConnection, and costs related to securing a new GSA schedule. The other charges represent additional expenses incurred in investigating and settling an employee defalcation loss sustained in 2003 by one of our commercial subsidiaries in excess of the amount covered by insurance.

*Income from operations* increased by \$1.4 million, or 56.0%, to \$3.9 million for the three months ended June 30, 2004 from \$2.5 million for the comparable period in 2003. Income from operations as a percentage of net sales increased from 0.8% in the three months ended June 30, 2003 to 1.2% in the same period in 2004. This increase was attributable to the changes in net sales, gross margin, and SG&A expenses as discussed above.

*Interest expense* increased slightly due to higher average borrowings outstanding in 2004 as compared to 2003.

Our effective tax rate was 38% for the second quarter of 2004 and 39.5% for the same period in 2003.

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Net income increased by \$0.9 million, or 64.3%, to \$2.3 million in the three months ended June 30, 2004 from \$1.4 million in the three months ended June 30, 2003, principally as a result of the increase in income from operations.

### Six Months Ended June 30, 2004 Compared to Six Months Ended June 30, 2003

Changes in net sales and gross profit by business segment are shown in the following table (dollars in millions):

	Six Months Ended June 30,				
	2004		2003		% Change
	Amount	% of Net Sales	Amount	% of Net Sales	
<b>Sales:</b>					
SMB	\$ 401.5	60.5%	\$ 365.2	60.4%	9.9%
Public Sector	117.2	17.7	127.7	21.1	(8.2)
Large Account	144.3	21.8	112.2	18.5	28.6
<b>Total</b>	<b>\$ 663.0</b>	<b>100.0%</b>	<b>\$ 605.1</b>	<b>100.0%</b>	<b>9.6%</b>
<b>Gross Profit:</b>					
SMB	\$ 45.5	11.3%	\$ 41.1	11.3%	10.7%
Public Sector	10.4	8.9	10.9	8.5	(4.6)
Large Account	14.2	9.8	13.4	12.0	6.0
<b>Total</b>	<b>\$ 70.1</b>	<b>10.6%</b>	<b>\$ 65.4</b>	<b>10.8%</b>	<b>7.2%</b>

Net sales for the quarter increased year over year due primarily to increases of our SMB and Large Account segments, as explained in the following:

- Net sales for our SMB segment increased primarily because of our increase in sales representatives. We increased the number of sales representatives in the year to 384 at June 30, 2004, up from 355 at June 30, 2003.
- Net sales for our Public Sector segment decreased due to a 52.8% decline in sales to the federal government. Sales to the federal government decreased from 2003 as a result of the cancellation of the GSA contract in late 2003. Sales to state and local government units and educational organizations, however, increased 24.5% for the six months ended June 30, 2004 compared to the six months ended June 30, 2003. Sales account managers for the Public Sector segment totaled 110 at June 30, 2004, down from 114 at June 30, 2003.
- Net sales for our Large Account segment increased due to a year-over-year improvement in annualized sales productivity per account manager as discussed earlier. Sales representatives for this segment totaled 76 at June 30, 2004, down from 77 at June 30, 2003.

Gross profit and the corresponding gross margin percentage of net sales increased as shown by the above table. These increases are explained by the following:

- Gross profit for the SMB segment increased year over year, and its gross margin rate increased slightly over the same period. The margin rate improvement in the second quarter of 2004 fully offset the decline in the first quarter, due to the increased focus on margins and product mix to more profitable products. We also implemented a number of sales and gross profit improvement initiatives, including tighter management of discounting, more extensive and focused sales training on costs and margins, and targeted improvements in sales pricing, sales incentives, and account management.
- Gross profit for the Public Sector segment decreased due to the decline in the federal government sales discussed above, partially offset by an increase in the year-over-year gross margin rate, particularly in the second quarter of 2004. The first quarter margins were impacted by the aggressive sales growth promotions to state and local government and educational institutions, which produced positive sales results, as observed above.

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- Gross profit for the Large Account segment increased by 6.0% due to the increase in sales discussed above, partially offset by the decline in gross margin rate. Changes in customer mix and continuing competitive pressures caused gross margin rates to decrease on a year-over-year basis.

*Selling, general, and administrative* expenses increased modestly year over year in the six months ended June 30, 2004 but decreased as a percentage of sales from the comparable period in 2003. As shown above, the dollar increase is largely related to increased variable costs associated with higher sales levels. These include greater sales personnel expense, higher credit card fees, and increased net advertising expense.

We have concentrated our efforts on managing our overall operating costs. Personnel costs generally account for over two-thirds of our SG&A expenses, as shown earlier in the table of SG&A expenses. In the first quarter of 2004, we restructured our sales support staff to provide more efficiency and effectiveness. While we plan to continue our focus on controlling discretionary expenditures, we expect that our SG&A expense may vary depending on changes in sales volume, as well as the levels of continued investments in key growth initiatives such as hiring more experienced outbound sales account managers, improving marketing programs, and deploying next generation Internet Web technology to support our sales organization.

SG&A expenses attributable to our operating segments are summarized below (dollars in millions):

	Six Months Ended June 30,				
	2004		2003		%
	Amount	% of Net Sales	Amount	% of Net Sales	
SMB	\$ 39.5	9.8%	\$ 39.6	10.8%	(0.3)%
Public Sector	15.3	13.1	13.3	10.4	15.0
Large Account	7.4	5.1	6.8	6.1	8.8
Total	\$ 62.2	9.4%	\$ 59.7	9.9%	4.2%

- SG&A expenses for the SMB segment were substantially flat in the six months ended June 30, 2004 compared to the same period in 2003, and decreased as a percentage of net sales from 2003. This segment has a relatively fixed cost structure, and the significant increase in its 2004 net sales, particularly in the first quarter, resulted in a correspondingly lower expense rate for that quarter. Additionally, the restructuring of our sales support staff in the first quarter of 2004 improved our efficiency and effectiveness.
- The Public Sector segment's expenses increased in the six months ended June 30, 2004 and also increased significantly as a percentage of net sales from the comparable period in 2003. Expenses increased year over year partly due to the opening of a new GovConnection sales office in April 2003. The significant decrease in our federal government sales described above accounted for the significant increase in this segment's SG&A as a percentage of net sales.
- SG&A expenses for the Large Account segment increased slightly but decreased as a percentage of net sales. SG&A expenses for this segment represent the lowest of the three segments as a percentage of net sales, reflecting the nature and efficiency of this segment's variable cost field sales and drop-shipping operating model.

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*Restructuring costs and other special charges* totaled \$1.8 million for the six months ended June 30, 2004 and \$0.4 million in the comparable period in 2003. A roll forward of restructuring costs and other special charges for the 2004 period presented is shown below (in thousands). There were no changes in estimates in any of the periods presented.

	<u>Workforce Reductions</u>	<u>GSA Review</u>	<u>Other</u>	<u>Total</u>
Balance December 31, 2003	\$ 113	\$ 237	\$—	\$ 350
Charges	575	1,127	81	1,783
Cash payments	(673)	(1,192)	(81)	(1,946)
Balance June 30, 2004	\$ 15	\$ 172	\$—	\$ 187

We recognized \$0.6 million in charges related to continued staff reductions in the six months ended June 30, 2004 as we continued to stabilize our workforce. The legal and other professional charges for the GSA contract review represent costs of our ongoing investigations relating to the GSA's cancellation in late 2003 of its contract with our subsidiary, GovConnection, and costs related to securing a new GSA schedule. The other charges represent additional expenses incurred in investigating and settling an employee defalcation loss sustained in 2003 by one of our commercial subsidiaries in excess of the amount covered by insurance.

*Income from operations* increased by \$0.7 million, or 13.0%, to \$6.1 million for the six months ended June 30, 2004 from \$5.4 million for the comparable period in 2003. Income from operations as a percentage of net sales was flat at 0.9% in both the 2004 and 2003 periods.

*Interest expense* increased slightly due to higher average borrowings in 2004 as compared to 2003.

Our effective tax rate was 38% for the six months ended June 30, 2004 and 39.2% for the same period in 2003.

*Net income* increased by \$0.4 million, or 13.3%, to \$3.4 million in the six months ended June 30, 2004 from \$3.0 million in the six months ended June 30, 2003, principally as a result of the increase in income from operations.

## LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity have historically been internally generated funds from operations and borrowings under our bank line of credit. We have used those funds to meet our capital requirements, which consist primarily of operational needs, capital expenditures for computer equipment and software used in our business, and more recently, earn-out payments required under our 2002 acquisition of MoreDirect.

We believe that funds generated from operations, together with available credit under our bank line of credit, will be sufficient to finance our working capital, capital expenditure, and other requirements at least for the next twelve calendar months. We expect our capital needs for the next twelve months to consist primarily of capital expenditures of between \$3 and \$4 million, payments on capital and operating lease obligations of approximately \$5.3 million, and an additional payment under our MoreDirect merger agreement, the amount of which we cannot estimate at this time. We expect to meet our cash requirements for 2004 through a combination of cash on hand, cash generated from operations, and, if necessary, additional borrowings on our bank line of credit.

Our ability to continue funding our planned growth, both internally and externally, is dependent upon our ability to generate sufficient cash flow from operations or to obtain additional funds through equity or debt financing, or from other sources of financing, as may be required. While at this time we do not anticipate needing any additional sources of financing to fund our operations, if demand for information technology products declines, our cash flows from operations may be substantially affected. See also related risks listed below under "Factors That May Affect Future Results and Financial Condition."



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### **Summary Sources and Uses of Cash**

The following table summarizes our sources and uses of cash over the periods indicated (in millions):

June 30,	Six Months Ended	
	2004	2003
Net cash provided by operating activities	\$ 11.1	\$ 13.5
Net cash used for investing activities	(7.1)	(7.1)
Net cash provided by (used for) financing activities	(5.5)	0.2
Increase (decrease) in cash and cash equivalents	\$ (1.5)	\$ 6.6

*Cash provided by operations* decreased year over year for the six months ended June 30, 2004, compared to the same period in 2003 primarily due to a decrease in payables partially offset by a decrease in receivables. Our receivables decreased due to improved collection efforts, particularly in our GovConnection subsidiary. Our overall Days Sales Outstanding, calculated on a quarterly basis, improved to 41 days at June 30, 2004, down from 44 days at March 31, 2004 and from 45 days at June 30, 2003.

At June 30, 2004, we had \$89.0 million in outstanding accounts payable. Such accounts are generally paid within 30 days of incurrence and will be financed by cash flows from operations or short-term borrowings under the line of credit. This amount includes \$5.0 million payable to two financial institutions under security agreements to facilitate the purchase of inventory. We believe we will be able to meet our obligations under our accounts payable with cash flows from operations and our existing line of credit.

*Cash used for investing activities* consisted primarily of our required payments for our most recent acquisition. According to the terms of our 2002 acquisition of MoreDirect, we continue to use cash to fund earn-out payments due to the former shareholder of MoreDirect. These payments totaled \$11.1 million and \$10.8 million for the six months ended June 30, 2004 and 2003, respectively. Additionally, such cash used includes our capital expenditures in periods presented, primarily for computer equipment and capitalization of internally developed software.

*Cash used by financing activities* in the six months ended June 30, 2004 related primarily to a reduction in our net borrowings by \$5.6 million under our bank line of credit, whereas there was no such decrease in the comparable period of 2003.

### **Debt Instruments, Contractual Agreements, and Related Covenants**

Below is a summary of certain provisions of our credit facilities and other contractual obligations. It is qualified in its entirety by the terms of the actual agreements, which are on file with the Securities and Exchange Commission. For more information about the restrictive covenants in our debt instruments and inventory financing agreements, see "Factors Affecting Sources of Liquidity." For more information about our obligations, commitments, and contingencies, see our consolidated financial statements and the accompanying notes included in this quarterly report.

**Bank Line of Credit.** Our bank line of credit provides us with a borrowing capacity of up to \$45 million, based on sufficient levels of trade receivables to meet borrowing base requirements, and depending on meeting minimum EBITDA (earnings before interest, taxes, depreciation, and amortization) and equity requirements, described below under "Factors Affecting Sources of Liquidity." Amounts outstanding under this facility bear interest at the prime rate (4.0% at June 30, 2004). No borrowings were outstanding under this credit facility at June 30, 2004. Substantially all of our assets are collateralized as security for this facility, and all of our subsidiaries are guarantors under the line of credit. Borrowing availability under the line was \$45.0 million at June 30, 2004. In late 2003, we negotiated an extension of this credit facility to December 31, 2005 and an option to increase the facility up to \$65 million at any time prior to its maturity date.

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This facility operates under an automatic cash management program whereby disbursements in excess of available cash are added as borrowings at the time disbursement checks clear the bank, and available cash receipts are first applied against any outstanding borrowings and then invested in short-term qualified cash investments. Accordingly, borrowings under the line are classified as current.

**Inventory Trade Credit Arrangements.** We have security agreements with two financial institutions to facilitate the purchase of inventory from various suppliers under certain terms and conditions. These agreements allow a collateralized first position in certain branded products inventory financed by these financial institutions. Although the agreements provide for financing up to an aggregate of \$45 million, any outstanding financing must be fully secured by available inventory. We do not pay any interest or discount fees on such inventory financing; such costs are borne by the suppliers as an incentive for us to purchase their products.

**Capital Lease.** We have a fifteen-year lease for our corporate headquarters with an affiliated company related through common ownership. We are required to make lease payments aggregating from \$0.9 million to \$1.1 million per year, plus real estate taxes, insurance, and common area maintenance charges.

**Operating Leases.** We also lease facilities from our principal stockholders and facilities and equipment from third parties under non-cancelable operating leases. See the Liquidity Table below for lease commitments under these leases.

**Earn-out Provisions of MoreDirect Merger Agreement.** We completed the acquisition of MoreDirect in April 2002. Under the terms of this agreement, we are required to make additional payments to the MoreDirect shareholder if certain earnings levels are achieved through December 31, 2004. In 2004, we paid \$11.1 million in earn-out consideration for the year ending December 31, 2003. Final payment will be due in 2005 if MoreDirect achieves its earnings target in 2004 and is expected to be funded from cash provided by operating activities. We escrowed \$10.0 million in 2002 in connection with this acquisition to be available for these additional payments to the MoreDirect shareholder. This amount has been used to make such additional payments.

**Liquidity Table for Contractual Obligations.** The following table sets forth information with respect to our long-term obligations payable in cash as of June 30, 2004 (in thousands):

	Payments Due By Period				
	Total	Less Than 1 Year	1 – 3 Years	3 – 5 Years	More Than 5 Years
<b>Contractual Obligations:</b>					
Capital lease obligation <sup>(1)</sup>	\$ 10,225	\$ 1,025	\$ 2,051	\$ 2,117	\$ 5,032
Operating lease obligations	5,605	3,780	1,684	141	—
<b>Total</b>	<b>\$ 15,830</b>	<b>\$ 4,805</b>	<b>\$ 3,735</b>	<b>\$ 2,258</b>	<b>\$ 5,032</b>

<sup>(1)</sup> Including interest, excluding taxes, insurance, and common area maintenance charges.

We do not have any other off-balance sheet arrangements that have or are reasonably likely to have, a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.

### **Factors Affecting Sources of Liquidity**

**Internally-Generated Funds.** The key factors affecting our internally generated funds are our ability to minimize costs and fully achieve our operating efficiencies, timely collection of our customer receivables, and management of our inventory levels.

**Bank Line of Credit.** Our credit facility contains certain financial ratios and operational covenants and other restrictions (including restrictions on additional debt, guarantees, dividends and other distributions,

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investments, and liens) with which the Company and all of its subsidiaries must comply. Any failure to comply with these covenants would not only prevent us from borrowing additional funds under this line of credit, but would also constitute a default. This credit facility contains two financial tests:

- The funded debt ratio (defined as the average outstanding advances under the line for the quarter, divided by the consolidated EBITDA for the trailing four quarters) must not be more than 2.0 to 1.0. Our actual funded debt ratio at June 30, 2004 was 0.4 to 1.0.
- Minimum Consolidated Net Worth must be at least \$125.0 million, plus 50% of consolidated net income for each quarter since December 31, 2001 (loss quarters not counted). Such amount was calculated at June 30, 2004 as \$132.3 million, whereas our actual consolidated stockholders' equity at this date was \$161.0 million.

The borrowing base under this facility is set at 80% of qualified commercial receivables, plus 50% of qualified government receivables, less \$24 million of the formula availability which must be held in reserves. As of June 30, 2004, the full amount of the facility was available for additional borrowings.

*Inventory Trade Credit Agreements.* These agreements contain similar financial ratios and operational covenants and restrictions as those contained in our bank line of credit described above. Such agreements also contain cross-default provisions whereby a default under the bank agreement would also constitute a default under these agreements. Financing under these agreements is limited to the purchase of specific branded products from authorized suppliers, and amounts outstanding must be fully collateralized by inventories of those products on hand.

*MoreDirect Merger Agreement.* The merger agreement with MoreDirect contemplates an earn-out period of three years following the closing whereby if MoreDirect maintains certain earnings before income tax, or EBIT, levels, additional payments will be made to MoreDirect's shareholder. Under the merger agreement, earn-out payments are tied to EBIT levels targeted to grow at a 15% rate per year. The maximum payment we would make for 2004 under the earn-out provisions of the merger agreement is \$21.7 million, assuming MoreDirect maintains 200% of the targeted EBIT level for that year. If MoreDirect maintains less than 60% of the targeted EBIT level for 2004, no payment would be required under the earn-out provisions of the merger agreement. We believe we will be able to meet our obligations to MoreDirect and its stockholder under the merger agreement.

*Capital Markets.* Our ability to raise additional funds in the capital market depends upon, among other things, general economic conditions, the condition of the Information Technology industry, our financial performance and stock price, and the state of the capital markets.

## **INFLATION**

We have historically offset any inflation in operating costs by a combination of increased productivity and price increases, where appropriate. We do not expect inflation to have a significant impact on our business in the future.

## **FACTORS THAT MAY AFFECT FUTURE RESULTS AND FINANCIAL CONDITION**

Our future results and financial condition are dependent on our ability to continue to successfully market, sell, and distribute information technology products and services, including computers, hardware, and software. Inherent in this process are a number of factors that we must successfully manage in order to achieve a favorable financial condition and favorable operating results. Potential risks and uncertainties that could affect our future financial condition and operating results include, without limitation, the following factors:

### **We experienced a decline in sales in 2002 and 2001, and there is no assurance that we will be able to avoid further decreases in revenues.**

Our net sales declined to \$1.19 billion in 2002 from \$1.44 billion in 2000. In 2003 our net sales increased to \$1.31 billion, largely due to the April 2002 acquisition of MoreDirect. We believe we would have experienced a greater decline in our net sales for 2002 if it had not been for that acquisition. If our revenues decline again in the future, we may not be able to reduce our staffing levels and operating expenses in a timely manner to avoid significant losses from operations.

### **We may also experience quarterly fluctuations and seasonality which could impact our business.**

Several factors have caused our sales and results of operations to fluctuate and we expect these fluctuations to continue on a quarterly basis. Causes of these fluctuations include:

- changes in the overall level of economic activity;
- changes in the level of business investment in information technology products;
- the condition of the personal computer industry in general;
- shifts in customer demand for hardware and software products;
- industry shipments of new products or upgrades;
- the timing of new merchandise and catalog offerings;
- fluctuations in response rates;
- fluctuations in postage, paper, shipping, and printing costs and in merchandise returns;
- adverse weather conditions that affect response, distribution, or shipping;
- shifts in the timing of holidays;
- changes in our product offerings;
- changes in consumer demand for information technology products; and
- changes in vendor distribution of products.

We base our operating expenditures on sales forecasts. If revenues do not meet expectations in any given quarter, our operating results could suffer.

In addition, customer response rates for our catalogs and other marketing vehicles are subject to variations. The first and last quarters of the year generally have higher response rates while the two middle quarters typically have lower response rates.

### **We experienced a loss of a major federal government contract in 2003, which could significantly reduce our sales to that organization and negatively impact our business.**

In November 2003 we were advised that the GSA cancelled its contract with our subsidiary, GovConnection, following a review of its contract management system and procedures that may have resulted in

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the sale of unqualified items or underpayment of required fees. The matter has been referred to the Department of Justice for review, and we are cooperating in that review. We have applied with the GSA to obtain a new contract. The pre-award audit by the GSA began in March 2004 with our submission of records and was completed in June 2004. We are currently in negotiations with the GSA in finalizing the new contract. However, the timing of the awarding of a new contract is beyond our control. Accordingly, our 2004 sales will continue to be adversely impacted if a new contract is not approved. Revenues for 2003 under the GSA contract were approximately \$79 million. We believe the GSA contract, if it had remained in effect, would have provided us with 2004 revenues generally comparable to the 2003 levels reported.

### **We are exposed to inventory obsolescence due to the rapid technological changes occurring in the personal computer industry.**

The market for personal computer products is characterized by rapid technological change and the frequent introduction of new products and product enhancements. Our success depends in large part on our ability to identify and market products that meet the needs of customers in that marketplace. In order to satisfy customer demand and to obtain favorable purchasing discounts, we have and may continue to carry increased inventory levels of certain products. By so doing, we are subject to the increased risk of inventory obsolescence. Also, in order to implement our business strategy, we intend to continue, among other things, to place larger than typical inventory stocking orders, and increase our participation in first-to-market purchase opportunities. We may also participate in end-of-life-cycle purchase opportunities and market products on a private-label basis, which would increase the risk of inventory obsolescence. In addition, we sometimes acquire special purchase products without return privileges. There can be no assurance that we will be able to avoid losses related to obsolete inventory. In addition, manufacturers are limiting return rights and are also taking steps to reduce their inventory exposure by supporting "build-to-order" programs authorizing distributors and resellers to assemble computer hardware under the manufacturers' brands. These trends reduce the costs to manufacturers and shift the burden of inventory risk to resellers like us which could negatively impact our business.

### **We acquire products for resale from a limited number of vendors; the loss of any one of these vendors could have a material adverse effect on our business.**

We acquire products for resale both directly from manufacturers and indirectly through distributors and other sources. The five vendors supplying the greatest amount of goods to us constituted 63% and 65% of our total product purchases in the six months ended June 30, 2004 and 2003, respectively. Among these five vendors, purchases from Ingram Micro, Inc. represented 27% and 23% of our total product purchases in the six months ended June 30, 2004 and 2003, respectively. Purchases from Tech Data Corporation comprised 14% and 15% of our total product purchases in the six months ended June 30, 2004 and 2003, respectively. Purchases from Hewlett-Packard Company ("HP") represented 11% and 16% of our total product purchases in the six months ended June 30, 2004 and 2003, respectively. No other vendor supplied more than 10% of our total product purchases in the six months ended June 30, 2004 and 2003, respectively. If we were unable to acquire products from Ingram, HP, or Tech Data, we could experience a short-term disruption in the availability of products and such disruption could have a material adverse effect on our results of operations and cash flows.

Substantially all of our contracts and arrangements with our vendors that supply significant quantities of products are terminable by such vendors or us without notice or upon short notice. Most of our product vendors provide us with trade credit, of which the net amount outstanding at June 30, 2004 was \$89.0 million. Termination, interruption, or contraction of relationships with our vendors, including a reduction in the level of trade credit provided to us, could have a material adverse effect on our financial position.

Some product manufacturers either do not permit us to sell the full line of their products or limit the number of product units available to direct marketers such as us. An element of our business strategy is to continue to increase our participation in first-to-market purchase opportunities. The availability of certain desired products, especially in the direct marketing channel, has been constrained in the past. We could experience a material

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adverse effect to our business if we are unable to source first-to-market purchase or similar opportunities, or if we face the reemergence of significant availability constraints.

### **We may experience a reduction in the incentive programs offered to us by our vendors.**

Some product manufacturers and distributors provide us with incentives such as supplier reimbursements, payment discounts, price protection, rebates, and other similar arrangements. The increasingly competitive computer hardware market has already resulted in the following:

- reduction or elimination of some of these incentive programs;
- more restrictive price protection and other terms; and
- reduced advertising allowances and incentives, in some cases.

Many product suppliers provide us with co-op advertising support and in exchange we feature their products in our catalogs. This support significantly defrays our catalog production expense. In the past, we have experienced a decrease in the level of co-op advertising support available to us from certain manufacturers. The level of co-op advertising support we receive from some manufacturers may further decline in the future. Such a decline could increase our selling, general, and administrative expenses as a percentage of sales and have a material adverse effect on our cash flows.

### **We face many competitive risks.**

The direct marketing industry and the computer products retail business, in particular, are highly competitive. We compete with consumer electronics and computer retail stores, including superstores. We also compete with other direct marketers of hardware and software and computer-related products, including an increasing number of Internet retailers. Certain hardware and software vendors, such as HP, IBM, and Apple, who provide products to us, are also selling their products directly to end users through their own catalogs, stores, and over the Internet. We compete not only for customers, but also for co-op advertising support from personal computer product manufacturers. Some of our competitors have larger catalog circulations and customer bases and greater financial, marketing, and other resources than we do. In addition, some of our competitors offer a wider range of products and services than we do and may be able to respond more quickly to new or changing opportunities, technologies, and customer requirements. Many current and potential competitors also have greater name recognition, engage in more extensive promotional activities, and adopt more aggressive pricing policies than us. We expect competition to increase as retailers and direct marketers who have not traditionally sold computers and related products enter the industry.

We cannot assure you that we can continue to compete effectively against our current or future competitors. In addition, price is an important competitive factor in the personal computer hardware and software market and we cannot assure you that we will not face increased price competition. If we encounter new competition or fail to compete effectively against our competitors, our business may be harmed.

In addition, product resellers and direct marketers are combining operations or acquiring or merging with other resellers and direct marketers to increase efficiency. Moreover, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to enhance their products and services. Accordingly, it is possible that new competitors or alliances among competitors may emerge and acquire significant market share.

### **We face and will continue to face significant price competition.**

Generally, pricing is very aggressive in the personal computer industry and we expect pricing pressures to continue. An increase in price competition could result in a reduction of our profit margins. There can be no

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assurance that we will be able to offset the effects of price reductions with an increase in the number of customers, higher sales, cost reductions, or otherwise. Also, our sales of personal computer hardware products are generally producing lower profit margins than those associated with software products. Such pricing pressures could result in an erosion of our market share, reduced sales, and reduced operating margins, any of which could have a material adverse effect on our business.

### **The methods of distributing personal computers and related products are changing and such changes may negatively impact us and our business.**

The manner in which personal computers and related products are distributed and sold is changing, and new methods of distribution and sale, such as online shopping services, have emerged. Hardware and software manufacturers have sold, and may intensify their efforts to sell, their products directly to end users. From time to time, certain manufacturers have instituted programs for the direct sales of large order quantities of hardware and software to certain major corporate accounts. These types of programs may continue to be developed and used by various manufacturers. Some of our vendors, including Apple, Hewlett-Packard, and IBM, currently sell some of their products directly to end users and have stated their intentions to increase the level of such direct sales. In addition, manufacturers may attempt to increase the volume of software products distributed electronically to end users. An increase in the volume of products sold through or used by consumers of any of these competitive programs or distributed electronically to end users could have a material adverse effect on our results of operations.

### **We could experience system failures which would interfere with our ability to process orders.**

We depend on the accuracy and proper use of our management information systems including our telephone system. Many of our key functions depend on the quality and effective utilization of the information generated by our management information systems, including:

- our ability to manage inventory and accounts receivable collection;
- our ability to purchase, sell, and ship products efficiently and on a timely basis; and
- our ability to maintain operations.

### **Interruptions could result from natural disasters as well as power loss, telecommunications failure, and similar events.**

Our management information systems require continual upgrades to most effectively manage our operations and customer database. Although we maintain some redundant systems with full data backup, a substantial interruption in management information systems or in telephone communication systems would substantially hinder our ability to process customer orders and thus could have a material adverse effect on our business.

### **We rely on the continued development of electronic commerce and Internet infrastructure development.**

We have had an increasing amount of sales made over the Internet in part because of the growing use and acceptance of the Internet by end users. No one can be certain that acceptance and use of the Internet will continue to develop or that a sufficiently broad base of consumers will adopt and continue to use the Internet and other online services as a medium of commerce. Sales of computer products over the Internet do not currently represent a significant portion of overall computer product sales. Growth of our Internet sales is dependent on potential customers using the Internet in addition to traditional means of commerce to purchase products. We cannot accurately predict the rate at which they will do so.

Our success in growing our Internet business will depend in large part upon the development of an infrastructure for providing Internet access and services. If the number of Internet users or their use of Internet resources continues to grow rapidly, such growth may overwhelm the existing Internet infrastructure. Our ability

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to increase the speed with which we provide services to customers and to increase the scope of such services ultimately is limited by and reliant upon the speed and reliability of the networks operated by third parties and these networks may not continue to be developed.

### **We depend heavily on third-party shippers to deliver our products to customers.**

We ship approximately 64% of our products to customers by DHL Worldwide Express D/B/A "DHL," with the remainder being shipped by United Parcel Service, Inc. and other overnight delivery and surface services. A strike or other interruption in service by these shippers could adversely affect our ability to market or deliver products to customers on a timely basis.

### **We may experience potential increases in shipping, paper, and postage costs, which may adversely affect our business if we are not able to pass such increases on to our customers.**

Shipping costs are a significant expense in the operation of our business. Increases in postal or shipping rates and paper costs could significantly impact the cost of producing and mailing our catalogs and shipping customer orders. Postage prices and shipping rates increase periodically and we have no control over future increases. We have a long-term contract with DHL whereby DHL ships products to our customers. We believe that we have negotiated favorable shipping rates with DHL. We generally invoice customers for shipping and handling charges. There can be no assurance that we will be able to pass on to our customers the full cost, including any future increases in the cost, of commercial delivery services such as DHL.

We also incur substantial paper and postage costs related to our marketing activities, including producing and mailing our catalogs. Paper prices historically have been cyclical and we have experienced substantial increases in the past. Significant increases in postal or shipping rates and paper costs could adversely impact our business, financial condition, and results of operations, particularly if we cannot pass on such increases to our customers or offset such increases by reducing other costs.

### **Privacy concerns with respect to list development and maintenance may materially adversely affect our business.**

We mail catalogs and send electronic messages to names in our proprietary customer database and to potential customers whose names we obtain from rented or exchanged mailing lists. Worldwide public concern regarding personal privacy has subjected the rental and use of customer mailing lists and other customer information to increased scrutiny. Any domestic or foreign legislation enacted limiting or prohibiting these practices could negatively affect our business.

### **We face many uncertainties relating to the collection of state sales or use tax.**

We presently collect sales tax on sales of products to residents in many states. Taxable sales to customers were approximately 25% of our net sales during the year ended December 31, 2003 and approximately 28% of our net sales for the six months ended June 30, 2004. Various states have sought to impose on direct marketers the burden of collecting state sales taxes on the sales of products shipped to their residents. In 1992, the United States Supreme Court affirmed its position that it is unconstitutional for a state to impose sales or use tax collection obligations on an out-of-state mail-order company whose only contacts with the state are limited to the distribution of catalogs and other advertising materials through the mail and the subsequent delivery of purchased goods by United States mail or by interstate common carrier. However, legislation that would expand the ability of states to impose sales tax collection obligations on direct marketers has been introduced in Congress on many occasions. Due to its presence on various forms of electronic media and other factors, our contact with many states may exceed the contact involved in the Supreme Court case. We cannot predict the level of contact that is sufficient to permit a state to impose on us a sales tax collection obligation. If the Supreme Court changes its position or if legislation is passed to overturn the Supreme Court's decision, the imposition of a sales or use tax collection obligation on us in states to which we ship products would result in additional administrative expenses to us, could result in price increases to our customers, and could reduce demand for our product.



**We are dependent on key personnel.**

Our future performance will depend to a significant extent upon the efforts and abilities of our senior executives. The competition for qualified management personnel in the computer products industry is very intense, and the loss of service of one or more of these persons could have an adverse effect on our business. Our success and plans for future growth will also depend on our ability to hire, train, and retain skilled personnel in all areas of our business, including sales account managers and technical support personnel. There can be no assurance that we will be able to attract, train, and retain sufficient qualified personnel to achieve our business objectives.

**We are controlled by two principal stockholders.**

Patricia Gallup and David Hall, our two principal stockholders, beneficially own or control, in the aggregate, approximately 68% of the outstanding shares of our common stock. Because of their beneficial stock ownership, these stockholders can continue to elect the members of the Board of Directors and decide all matters requiring stockholder approval at a meeting or by a written consent in lieu of a meeting. Similarly, such stockholders can control decisions to adopt, amend, or repeal our charter and our bylaws, or take other actions requiring the vote or consent of our stockholders and prevent a takeover of us by one or more third parties, or sell or otherwise transfer their stock to a third party, which could deprive our stockholders of a control premium that might otherwise be realized by them in connection with an acquisition of us. Such control may result in decisions that are not in the best interest of our public stockholders. In connection with our initial public offering, the principal stockholders placed substantially all shares of common stock beneficially owned by them into a voting trust, pursuant to which they are required to agree as to the manner of voting such shares in order for the shares to be voted. Such provisions could discourage bids for our common stock at a premium as well as have a negative impact on the market price of our common stock.

**PC CONNECTION, INC. AND SUBSIDIARIES**

**Part I—Financial Information**

**Item 3—QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We invest cash balances in excess of operating requirements in short-term securities, generally with maturities of 90 days or less. In addition, our unsecured credit agreement provides for borrowings which bear interest at variable rates based on the prime rate. We had no borrowings outstanding pursuant to our credit agreement as of June 30, 2004. We believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations, and cash flows should not be material. Our credit agreement exposes earnings to changes in short-term interest rates since interest rates on the underlying obligations are variable. However, as noted above, there were no borrowings outstanding on the credit agreement at June 30, 2004. A change in earnings resulting from a hypothetical 10% increase or decrease in interest rates is not material.

**Item 4—CONTROLS AND PROCEDURES**

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a -15(e) and 15d - 15(e) under the Exchange Act) as of June 30, 2004. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 2004, our disclosure controls and procedures were (1) designed to ensure that material information relating to us, including our consolidated subsidiaries, is made known to our Chief Executive Officer and Chief Financial Officer by others within those entities, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms.

No change in our internal control over financial reporting (as defined in Rules 13a – 15(f) and 15d – 15(f) under the Exchange Act) occurred during the fiscal quarter ended June 30, 2004 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PC CONNECTION, INC. AND SUBSIDIARIES****Part II—Other Information****Item 1—Legal Proceedings**

Not applicable.

**Item 2—Changes in Securities, Use of Proceeds, and Issuer Purchases of Equity Securities**

(a) The following table provides information about purchases by the Company during the quarter ended June 30, 2004 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act:

**ISSUER PURCHASES OF EQUITY SECURITIES**

<u>Period</u>	<u>Total Number of Shares (or Units) Purchased</u>	<u>Average Price Paid per Share (or Unit)</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program (1)</u>
04/01/04-04/30/04	—	\$ —	—	\$ 12,714,000
05/01/04-05/31/04	—	—	—	\$ 12,714,000
06/01/04-06/30/04	—	—	—	\$ 12,714,000
Total:	—	\$ —	—	

(1) Our Board of Directors approved the repurchase by the Company of shares of our common stock having a value of up to \$15.0 million in the aggregate pursuant to a repurchase program announced on March 28, 2001.

**Item 3—Defaults Upon Senior Securities**

Not applicable.

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

At the 2004 Annual Meeting of Stockholders of the Company (the “Annual Meeting”) on June 8, 2004, the following matters were acted upon by the stockholders of the Company:

1. the election of six Directors;
2. the ratification of the appointment of Deloitte & Touche LLP as the Company’s independent auditors for the current fiscal year.

## Table of Contents

The number of shares of Common Stock issued, outstanding, and eligible to vote as of the record date of April 26, 2004 was 25,007,577. The results of the voting on each of the matters presented to stockholders at the Annual Meeting are set forth below:

		<u>VOTES FOR</u>	<u>VOTES AGAINST</u>	<u>VOTES ABSTAINED</u>	<u>UNVOTED</u>
1.	Election of Directors:				
	Patricia Gallup	22,079,783	793,948	N/A	N/A
	David Hall	22,079,783	793,948	N/A	N/A
	Bruce Barone	22,671,634	202,101	N/A	N/A
	David Beffa-Negrini	22,671,634	202,101	N/A	N/A
	Peter Baxter	22,671,634	202,101	N/A	N/A
	Joseph Baute	22,079,783	793,948	N/A	N/A
2.	Ratification of the Appointment of Auditors	22,856,248	13,720	3,763	

### **Item 5—Other Information**

Not applicable.

### **Item 6—Exhibits and Reports on Form 8-K**

#### **(a) Exhibits**

<u>Exhibit Number</u>	<u>Description</u>
15	Letter on unaudited interim financial information.
31.1	Certification of the Company's President and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Company's Senior Vice President of Finance and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Company's President and Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Company's Senior Vice President of Finance and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

#### **(b) Reports on Form 8-K**

- (1) On April 22, 2004, the Company furnished a Current Report on Form 8-K under Item 9, containing a copy of its earnings release for the period ended March 31, 2004, (including financial statements) pursuant to Item 12 (Results of Operation and Financial Condition).



July 21, 2004

PC Connection, Inc.  
730 Milford Road  
Merrimack, New Hampshire

We have made a review, in accordance with standards of the Public Company Accounting Oversight Board (United States), of the unaudited interim financial information of PC Connection, Inc. and subsidiaries for the periods ended June 30, 2004 and 2003, as indicated in our report dated July 21, 2004; because we did not perform an audit, we expressed no opinion on that information.

We are aware that our report referred to above, which is included in your Quarterly Report on Form 10-Q for the quarter ended June 30, 2004, is incorporated by reference in Registration Statement Nos. 333-91584, 333-66450, 333-40172, 333-83943, 333-69981, 333-50847, 333-50845, and 333-106652 on Form S-8.

We also are aware that the aforementioned report, pursuant to Rule 436(c) under the Securities Act of 1933, is not considered a part of the Registration Statement prepared or certified by an accountant or a report prepared or certified by an accountant within the meaning of Sections 7 and 11 of that Act.

/s/ Deloitte & Touche LLP  
Boston, Massachusetts

## CERTIFICATIONS

I, Patricia Gallup, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of PC Connection, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) [Paragraph omitted in accordance with SEC transition instructions contained in SEC Release 34-47986];
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 23, 2004

/s/ PATRICIA GALLUP

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**Patricia Gallup**  
**President and Chief Executive Officer**

## CERTIFICATIONS

I, Mark Gavin, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of PC Connection, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) [Paragraph omitted in accordance with SEC transition instructions contained in SEC Release 34-47986];
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 23, 2004

/s/ MARK GAVIN

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**Mark Gavin**  
**Senior Vice President of Finance and Chief Financial Officer**



CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report on Form 10-Q of PC Connection, Inc. (the "Company") for the period ended June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Patricia Gallup, President and Chief Executive Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, that:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ PATRICIA GALLUP

Dated: July 23, 2004

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**Patricia Gallup**  
**President and Chief Executive Officer**

A signed original of this written statement required by Section 906 has been provided to PC Connection, Inc. and will be retained by PC Connection, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report on Form 10-Q of PC Connection, Inc. (the "Company") for the period ended June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Mark Gavin, Senior Vice President of Finance and Chief Financial Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, that:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ MARK GAVIN

Dated: July 23, 2004

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**Mark Gavin**  
**Senior Vice President of Finance and**  
**Chief Financial Officer**

A signed original of this written statement required by Section 906 has been provided to PC Connection, Inc. and will be retained by PC Connection, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.