SCANSOURCE INC
Form DEF 14A
October 23, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

INFORMATION REQUIRED IN PROXY STATEMENT

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the

Securities Exchange Act of 1934

Filed by the Registrant x Filed by a Party other than the Registrant ¨

Check the appropriate box:

¨ Preliminary Proxy Statement

¨ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**

x Definitive Proxy Statement

¨ Definitive Additional Materials

¨ Soliciting Material Pursuant to §240.14a-12

SCANSOURCE, INC.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

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(4) Proposed maximum aggregate value of transaction:

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¨ Fee paid previously with preliminary materials:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

ScanSource, Inc.

6 Logue Court

Greenville, South Carolina 29615

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

To Be Held December 6, 2012

The Annual Meeting of Shareholders of ScanSource, Inc. will be held at the Marriott Hotel, One Parkway East, Greenville, South Carolina 29615 on Thursday, December 6, 2012, at 10:30 a.m., local time, for the following purposes:

(1) To elect six members to the Board of Directors;

(2) To hold an advisory vote on the compensation of our named executive officers (as defined in the proxy statement);

(3) To ratify the appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending June 30, 2013; and

(4) To transact such other business as may properly come before the Annual Meeting or any adjournments thereof.

Only shareholders whose names appear of record on our books at the close of business on October 19, 2012 will be entitled to notice of and to vote at the Annual Meeting or at any adjournments thereof.

You are cordially invited to attend the Annual Meeting in person, but if you are unable to do so, please vote by proxy over the Internet or by telephone, or, if you received paper copies of the proxy materials by mail, you can also vote by mail by following the instructions on the voting instruction card. Voting over the Internet, by telephone or by written proxy or voting instruction card will ensure your representation at the Annual Meeting regardless of whether you attend in person. If you attend the Annual Meeting and desire to revoke your proxy and vote in person, you may do so. In any event, you are entitled to revoke your proxy at any time before it is exercised.

Steven R. Fischer

Chairman of the Board

October 23, 2012

2012 Proxy Statement Summary

This summary highlights information contained elsewhere in this proxy statement. This summary does not contain all of the information that you should consider, and you should read the entire proxy statement carefully before voting.

Annual Meeting of Shareholders

Time and Date	10:30 a.m., December 6, 2012
Place	Marriott Hotel One Parkway East Greenville, South Carolina 29615
Record Date	October 19, 2012
Voting	Shareholders as of the record date are entitled to vote. Each share of common stock is entitled to one vote for each director nominee and one vote for each of the proposals to be voted on.

Meeting Agenda

Election of 6 directors

Advisory vote on the compensation of our named executive officers

Ratification of Ernst & Young LLP as our independent registered public accounting firm for fiscal 2013

Voting Matters

Proposal	Board Vote Recommendation	Page Reference (for more detail)
1. Election of 6 directors	FOR	7
2. Advisory vote on the compensation of our named executive officers	FOR	7
3. Ratification of Ernst & Young LLP as our independent registered public accounting firm for fiscal 2013	FOR	9

Board Nominees

The following table provides summary information about each director nominee. The nominees receiving a plurality of the votes cast at the meeting will be elected as directors.

Name	Age	Director Since	Occupation	Experience/ Qualification	Independent	AC	CC	GC	NC
Steven R. Fischer	67	1995	Financial consultant; former President of North Fork Business Capital Corporation	Leadership Finance	X	X	X	X	X
Michael L. Baur	55	1995						X	

			CEO of ScanSource and Founder	Leadership Industry					
Michael J. Grainger	60	2004	Former President and COO of Ingram Micro, Inc.	Leadership Finance Industry	X	X	C	X	X

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Name	Age	Director Since	Occupation	Experience/ Qualification	Independent	AC	CC	GC	NC
Steven H. Owings	59	2011	Former Chairman/ CEO of ScanSource and Founder	Leadership Industry				X	
John P. Reilly	64	2001	President and CEO of Keltic Financial Services, LLC	Leadership Finance	X	X	X	C	C
Charles R. Whitchurch	66	2009	Former CFO of Zebra Technologies Corporation	Leadership Finance	X	C	X	X	X

AC Audit Committee
CC Compensation Committee
GC Governance Committee
NC Nominating Committee
C Committee Chairman
X Member of Committee or Independent

Independent Auditor

We are asking shareholders to ratify the selection of Ernst & Young LLP as our independent registered public accounting firm for fiscal 2013. Set forth below is summary information with respect to Ernst & Young LLP s fees for services provided in fiscal 2012 and fiscal 2011.

	Year Ended June 30, 2012	Year Ended June 30, 2011
Audit Fees	$ 1,815,125	$ 1,483,905
Audit-Related Fees	102,711	255,947
Tax Fees	189,987	487,423
All Other Fees		
Total	$ 2,107,823	$ 2,227,275

Advisory Votes on the Compensation of our Named Executive Officers

We are asking our shareholders to approve, on a non-binding, advisory basis, the compensation of our named executive officers. The Board believes that our executive compensation philosophy and practices have resulted in executive compensation decisions that are aligned with shareholder interests and that have benefitted the Company over time.

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Executive Compensation Elements

Type	Form	Terms
Cash	Salary	Based on employment agreements; increases, if any, determined through subjective assessment of performance
	Cash Incentives	Earned based on attainment of pre-determined performance metrics
Equity	Service-Based Restricted Stock Awards	Generally vest ratably over three years
	Service-Based Restricted Stock Units	Generally vest ratably over three years
	Performance-Based Restricted Stock Awards	Generally have one year performance periods with 50% vesting after one year and the remaining 50% vesting after year two
	Performance-Based Restricted Stock Units	Generally have one year performance periods with 50% vesting after one year and the remaining 50% vesting after year two
	Stock Options	Generally vest ratably over three years
Other Employee Benefits	401(k)	On the same terms as all employees
	Profit-Sharing Contributions	On the same terms as all employees
	Deferred Compensation Plan	Matching contributions vest over five-year period

Fiscal 2012 Compensation Decisions

There have been no changes in named executive compensation philosophy, plans or agreements since our shareholders overwhelmingly approved our compensation for our named executive officers at our 2011 annual meeting. During the fiscal year ending June 30, 2012, the Company achieved solid financial performance, but not as strong as the prior fiscal year, and accordingly the named executive officer compensation attained was lower than the prior year.

In evaluating and monitoring the Company s financial condition and operating performance, the Company s management places a significant emphasis on operating income and return on invested capital (ROIC[1],) which impacts shareholder value. Management uses ROIC, a non-GAAP measure, to assess its efficiency at allocating the capital under its control to generate returns. Operating income and ROIC for the fiscal year ending June 30, 2012 demonstrated the successful performance of our Company and our named executive officers:

- The Company posted operating income of $113.5 million during fiscal 2012, which represents a slight increase over the previous fiscal year s operating income of $113.1 million. Operating income for each of fiscal 2012 and fiscal 2011 increased sharply, as compared to fiscal 2010, when operating income was $75.8 million.

- The Company s ROIC for fiscal 2012 was 17.2%. This percentage is higher than ROIC achieved by the Company during fiscal 2010 of 16.7%, but it is lower than the Company s fiscal 2011 ROIC of 20.6%.

Because of the emphasis in our executive compensation program on performance-based pay, the Company s financial performance during fiscal 2012 is reflected in the compensation of each of our named executive officers, particularly with respect to payouts pursuant to our cash incentive program. For the fiscal year ended

[1] We provide a reconciliation of the differences between this non-GAAP financial measure and its most directly comparable GAAP financial measure in Appendix A to this proxy statement.

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June 30, 2012, the cash incentives paid to our named executive officers under each of the cash incentive plans set forth in their respective employment agreements aggregated to $2,261,735, or 2.0% of operating income, compared to the cash incentives paid for the prior fiscal year ended June 30, 2011 of $2,549,954, or 2.3% of operating income. For fiscal 2012, this is an 11.3% decrease from the cash incentives in fiscal 2011.

Fiscal 2012 Compensation Summary

The following table summarizes the compensation of our Chief Executive Officer, Chief Financial Officer and our next three most highly compensated executive officers, to whom we refer collectively as the named executive officers, for the fiscal year ended June 30, 2012, as determined by the rules of the Securities and Exchange Commission, or the SEC.

Name	Salary ($) (1)	Bonus ($)	Stock Awards ($)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)	All Other Compensation ($)	Total ($)
Michael L. Baur, Chief Executive Officer	803,077			1,021,931	1,475,708	284,954	3,585,670
Richard P. Cleys, Vice President and Chief Financial Officer	308,984		200,776		73,041	107,102	689,903
R. Scott Benbenek, President of Worldwide Operations	379,454		214,001	207,101	357,575	161,240	1,319,371
Andrea D. Meade, Executive Vice President of Operations and Corporate Development	271,842		248,316		255,411	60,016	835,585
John J. Ellsworth, Vice President, General Counsel and Corporate Secretary	243,935		201,481		100,000	65,159	610,575

(1) Salary paid includes one additional business day (261 business days, as opposed to a standard 260-day year).

2013 Annual Meeting

Shareholder proposals submitted pursuant to SEC Rule 14a-8 must be received by us by June 25, 2013.

Notice of shareholder proposals outside of SEC Rule 14a-8 must be delivered to us no earlier than September 7, 2013 and no later than October 7, 2013.

SCANSOURCE, INC.

6 Logue Court

Greenville, South Carolina 29615

PROXY STATEMENT

General

This proxy statement is furnished in connection with the solicitation of proxies by the Board of Directors (the Board) of ScanSource, Inc. (the Company) to be used in voting at the Annual Meeting of Shareholders of the Company to be held at the Marriott Hotel, One Parkway East, Greenville, South Carolina 29615 on Thursday, December 6, 2012, at 10:30 a.m., local time, and at any adjournments thereof (the Annual Meeting).

Important Notice Regarding the Availability of Proxy Materials for the Annual Meeting to Be

Held on December 6, 2012:

The Notice of Annual Meeting of Shareholders, proxy statement, form of proxy, and 2012 Annual Report

are available at *www.proxyvote.com*.

Pursuant to rules promulgated by the SEC, we are providing access to our proxy materials over the Internet. On or about October 23, 2012, we first began mailing to our shareholders a Notice of Internet Availability of Proxy Materials (the Notice). The Notice contains instructions on how to access this proxy statement and the Annual Report and vote online. The Notice also contains instructions on how shareholders can receive a paper copy of our proxy materials, including this proxy statement, the Annual Report and a form of proxy card or voting instruction card. The Notice is not a ballot or other form for voting. Shareholders who receive a paper copy of our proxy materials, including a proxy statement, the Annual Report and a form of proxy card or voting instruction card, may vote by mail by returning the accompanying proxy card, by telephone, or via the Internet. By furnishing our proxy materials over the Internet, we are lowering the costs and reducing the environmental impact of the Annual Meeting.

Any shareholder who executes the form of proxy referred to in this proxy statement may revoke it at any time before it is exercised. The proxy may be revoked by giving written notice to our Secretary of such revocation, by executing and delivering to our Secretary a proxy bearing a later date, or by attending the Annual Meeting and voting in person. Whether or not you plan to attend, please vote electronically via the Internet or by telephone, or, if you request paper copies of the proxy materials, please complete, sign, date and return the accompanying proxy card in the enclosed postage-paid envelope.

The cost of preparing, assembling and mailing this proxy statement and the form of proxy will be borne by us. Our directors, officers and employees may also solicit proxies personally or by mail, telephone or facsimile. No compensation will be paid for such solicitations. In addition, we will bear the reasonable expenses of brokerage houses and other custodians, nominees and fiduciaries who, at our request, may send proxies and proxy solicitation material to their clients and principals. This proxy statement is first being made available to our shareholders on October 23, 2012.

Voting Securities Outstanding; Vote Required for Each Proposal

The Board has fixed the close of business on October 19, 2012 as the record date and time for the determination of shareholders entitled to notice of, and to vote at, the Annual Meeting and at any adjournments thereof. As of such date, 27,769,945 shares of our common stock, no par value, were outstanding. All of such shares are eligible to be voted on each matter currently scheduled to come before the Annual Meeting, and no other outstanding shares of our capital stock are eligible to be voted at the Annual Meeting. All shares of our common stock represented by valid proxies received pursuant to this solicitation, and not revoked before they are exercised, will be voted in the manner specified. If no specification is made, properly executed and returned proxies will be voted FOR all director nominees, FOR approval, on an advisory basis, of the compensation of our named executive officers (as defined in Executive Compensation Compensation Discussion and Analysis Executive Summary), and FOR the ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm. Management is not aware of any matters, other than those specified herein, that will be presented for action at the Annual Meeting. If other matters are properly presented at the Annual Meeting for consideration, the agents named on the proxy card will have the discretion to vote on those matters for you.

Our Bylaws provide that the presence in person or by proxy of the holders of a majority of the outstanding shares of common stock entitled to vote at the Annual Meeting is necessary to constitute a quorum at the Annual Meeting and at any adjournments thereof. Signed proxies that withhold authority to vote for directors or reflect abstentions or broker non-votes (as described below) will be counted for purposes of determining if a quorum is present at the Annual Meeting. If a quorum is not present or represented at the Annual Meeting, the chairman of the meeting or the shareholders holding a majority of the shares of common stock entitled to vote, present in person or represented by proxy, have the power to adjourn the meeting from time to time without notice, other than an announcement at the meeting, until a quorum is present or represented. Our directors, officers and employees may solicit proxies for the reconvened meeting in person or by mail or telephone. At any such reconvened meeting at which a quorum is present or represented, any business may be transacted that might have been transacted at the meeting as originally scheduled.

Brokers that are members of certain securities exchanges and who hold shares of our common stock in street name on behalf of beneficial owners have authority to vote on certain items when they have not received instructions from beneficial owners. Under applicable securities exchange rules, only the proposal to ratify the appointment of the independent registered public accounting firm is considered a discretionary item. This means that brokers may vote in their discretion on this proposal on behalf of beneficial owners who have not furnished voting instructions. In contrast, all of the other proposals in this proxy statement are considered non-discretionary items, and a broker non-vote occurs when brokers do not receive voting instructions from beneficial owners with respect to these proposals.

Assuming the existence of a quorum at the Annual Meeting:

The nominees receiving the greatest number of the votes cast at the Annual Meeting will be elected as directors. Withheld votes and broker non-votes, if any, are not treated as votes cast, and therefore will have no effect on the outcome of the vote on this proposal.

The compensation of our named executive officers will be approved, on an advisory basis, if the votes cast in favor of the proposal exceed the votes cast against the proposal. Abstentions and broker non-votes, if any, are not treated as votes cast, and therefore will have no effect on the outcome of the vote on this proposal. Because your vote is advisory, it will not be binding on the Company, our Board of Directors or our Compensation Committee. However, the Board of Directors and the Compensation Committee will consider the outcome of the vote when making future compensation decisions for our executive officers.

The ratification of the appointment of Ernst & Young LLP will be approved if the votes cast in favor of the proposal exceed the votes cast against the proposal. Abstentions will not be treated as votes cast, and therefore will have no effect on the outcome of the vote on this proposal. If your shares are held in street name and you do not provide voting instructions to your broker, your broker has discretionary authority to vote your shares with respect to the proposal.

PROPOSAL ONE

ELECTION OF DIRECTORS

Six directors are to be elected at the Annual Meeting. The size of the Board is set at six members and may be increased or decreased by resolution of the Board.

The Board has recommended the six existing members of the Board as the six nominees for election as directors at the Annual Meeting to serve until the next annual meeting of shareholders or until their respective successors shall have been elected and qualified. The following are our nominees for election as directors at the Annual Meeting: Michael L. Baur, Steven R. Fischer, Michael J. Grainger, Steven H. Owings, John P. Reilly and Charles R. Whitchurch.

In accordance with our Bylaws, those nominees receiving the greatest number of votes cast (although not necessarily a majority of the votes cast) will be elected to the Board. Withheld votes and broker non-votes, if any, will not be included in determining the number of votes cast in the election of directors. The proxies solicited for the Annual Meeting cannot be voted for a greater number of persons than six, the number of nominees named. If any nominee shall become unavailable for any reason, the persons named in the form of proxy shall vote for a substitute nominee or vote to reduce the number of directors to be elected as directed by the Board. The Board has no reason to believe that any of the six nominees listed above will not be available for election as a director.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR THE ELECTION OF THE NOMINEES SET FORTH ABOVE.

PROPOSAL TWO

ADVISORY VOTE ON THE COMPENSATION OF OUR NAMED EXECUTIVE OFFICERS

Background of the Proposal

There have been no changes in named executive compensation philosophy, plans or agreements since our shareholders overwhelmingly approved our compensation for our named executive officers at our 2011 annual meeting. However, Section 14A of the Securities Exchange Act of 1934, as amended (the Exchange Act), which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires all public companies to hold a separate non-binding advisory shareholder vote to approve the compensation of named executive officers as described in the Compensation Discussion and Analysis and the executive compensation tables and related information in public filings. We are providing our shareholders with the opportunity at the Annual Meeting to vote on a non-binding advisory resolution, commonly known as a Say on Pay proposal, considering approval of the compensation of our named executive officers. This vote is not intended to address any specific item of compensation or any specific named executive officer, but rather the overall compensation of our named executive officers and the philosophy, policies and practices described in this proxy statement. Such discussion is found on pages 18 through 35 of this proxy statement. At the 2011 annual shareholder meeting, 93.6% of shares voting voted in support of the compensation for our named executive officers, as described in our 2011 proxy statement.

Executive Compensation

The Compensation Committee has overseen the development of a compensation program designed to attract, retain and motivate executives who enable us to achieve our strategic and financial goals. The Compensation Discussion and Analysis and the tabular disclosures regarding named executive officer compensation, together with the accompanying narrative disclosure, illustrate the trends in compensation and application of our compensation philosophies and practices for the years presented. Highlights of our compensation program include the following:

- Variable cash incentives are payable to named executive officers to encourage the achievement of various pre-determined performance metrics, business growth opportunities, management goals and profitability of business units, all of which focus our named executive officers on performance goals intended to enhance shareholder value.

Awards of long-term equity incentives, in the form of stock options, restricted stock awards and restricted stock units, directly align the interests of our named executive officers and shareholders.

Linking the personal financial interests of our named executive officers to the Company s long-term performance discourages excessive risk-taking and encourages behavior that supports sustainable shareholder value creation.

The Compensation Committee believes that our executive compensation program achieves an appropriate balance between fixed compensation and variable incentive compensation, pays for performance and promotes an alignment between the interests of our named executive officers and our shareholders. Accordingly, we are asking our shareholders at the Annual Meeting to vote FOR the non-binding advisory resolution approving the compensation of our named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including Compensation Discussion and Analysis, compensation tables, and narrative discussion.

Effect of Resolution

Because your vote is advisory, it will not be binding upon the Company, the Compensation Committee or the Board of Directors. However, the Compensation Committee and the Board value the opinion of our shareholders and will take the outcome of the vote into account when considering future executive compensation arrangements.

You may vote FOR , AGAINST or ABSTAIN on this proposal. If a broker or other nominee holds your shares in its name on your behalf, the broker or nominee is not permitted to vote your shares on this proposal in the absence of voting instructions from you. Abstentions and broker non-votes will not affect the outcome of voting on this proposal. To be approved, the number of votes cast FOR the advisory resolution must exceed the votes cast AGAINST the advisory resolution.

Recommendation of Board of Directors

The Board of Directors also believes that our executive compensation program aligns our named executive officers compensation with the long-term interests of our shareholders. Our program is guided by the philosophy that total executive compensation should vary based on achievement of goals and objectives, both individual and corporate, and should be focused on long-term strategies to build shareholder value. The Board believes that our philosophy and practices have resulted in executive compensation decisions that are aligned with shareholder interests and that have benefitted and will benefit the Company over time.

For the reasons stated above, we recommend a vote FOR the following advisory resolution at our Annual Meeting:

RESOLVED, that the compensation paid to the Company s named executive officers, as disclosed in the Proxy Statement for our 2012 Annual Meeting of Shareholders pursuant to the compensation disclosure rules of the Securities and Exchange Commission, including the Compensation Discussion and Analysis, named executive officer compensation tables and related narrative discussion, is hereby APPROVED.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR THE APPROVAL, ON AN ADVISORY BASIS, OF THE COMPENSATION OF OUR NAMED EXECUTIVE OFFICERS AS DISCLOSED IN THIS PROXY STATEMENT.

PROPOSAL THREE

RATIFICATION OF APPOINTMENT OF INDEPENDENT AUDITORS

The Audit Committee has appointed the firm of Ernst & Young LLP, an independent registered public accounting firm, as independent auditor to make an examination of our accounts for the fiscal year ending June 30, 2013, which appointment has been ratified by the Board. See the Audit Committee Report below for more information. If the shareholders do not ratify this appointment, other independent registered public accounting firms will be considered by the Audit Committee.

THE BOARD RECOMMENDS A VOTE FOR THE RATIFICATION OF THE APPOINTMENT OF ERNST & YOUNG LLP AS OUR INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING JUNE 30, 2013.

A representative of Ernst & Young LLP is expected to be in attendance at the Annual Meeting and will have the opportunity to make a statement and be available to respond to appropriate questions.

Principal Accountant Fees and Services

As reflected in the table below, we incurred fees in fiscal 2012 and 2011 for services performed by Ernst & Young LLP related to such periods.

	Year Ended June 30, 2012	Year June 3
ees	$ 1,815,125	$ 1,48
elated		

nd 2004, respectively, and $1,295 and $1,320 for the nine months ended September 30, 2005 and 2004, respectively. Amortization of leasing commissions is included in the property operating, maintenance and real estate taxes line item in the Company's consolidated statements of operations. DISTRIBUTION POLICY Our board of directors determines the amount and timing of distributions to our stockholders. The board of directors will consider many factors prior to making any distributions, including the following: - the amount of cash available for distribution; - our financial condition; - whether to reinvest funds rather than to distribute such funds; - our committed and projected capital expenditures; - the amount of cash required for new property acquisitions, including acquisitions under existing agreements with the Berg Group; - prospects of tenant renewals and re-leases of properties subject to expiring leases; - cash required for re-leasing activities; - the annual distribution requirements under the REIT provisions of the federal income tax laws; and - such other factors as the board of directors deems relevant. We cannot assure you that we will be able to meet or maintain our cash distribution objectives. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS We do not believe recently issued accounting standards will materially impact our financial position, results of operations, or cash flows. In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment" ("SFAS No. 123R"), which addresses the accounting for employee and director stock options. Statement 123R requires that the cost of all employee and director stock options, as well as other equity-based compensation arrangements, be reflected in the financial statements based on the estimated fair value of the awards. SFAS No. 123R is an amendment to SFAS No. 123 and supersedes APB Opinion No. 25 ("APB No. 25"). SFAS No. 123R is applicable to any award that is settled or measured in stock, including stock options, restricted stock, stock appreciation rights, stock units, and employee stock purchase plans. SFAS No. 123R will be effective for public companies starting with the first interim period commencing after June 15, 2005. On April 14, 2005, the SEC announced a new rule that delays the implementation of SFAS No. 123R until the beginning of the next fiscal year that begins after December 15, 2005. We will adopt the requirements of SFAS No. 123R beginning 2006. We expect that the adoption of this standard will reduce our net income and earnings per share; however, it will have no impact on cash flow. Although we have not yet determined whether the adoption of SFAS No. 123R will result in amounts that are similar to the current pro forma disclosures under SFAS No. 123, we are evaluating the requirements under SFAS No. 123R including the valuation methods and support for the assumptions that underlie the valuation of the awards and the transition methods (modified prospective transition method or the modified retrospective transition method). In December 2004, the FASB issued SFAS No. 153, "Exchanges of Non-monetary Assets" ("SFAS No. 153"). SFAS No. 153 amends the guidance in APB Opinion No. 29, "Accounting for Non-monetary Transactions" to eliminate certain exceptions to the principle that exchanges of non-monetary assets be measured based on the fair value of the assets exchanged. SFAS No. 153 eliminates the exception - 22 - for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. This statement is effective for non-monetary asset exchanges in fiscal years beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have an impact on our consolidated results of operations, financial position or cash flows. - 23 - ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK We do not generally hold market risk sensitive instruments for trading purposes. We use fixed and variable rate debt to finance our operations. Our exposure to market risk for changes in interest rates relates primarily to our current variable rate debt and future debt obligations. We are vulnerable to significant fluctuations of interest rates on our floating rate debt and pricing on our future debt. We manage our market risk by monitoring interest rates where we try to recognize the unpredictability of the financial markets and seek to reduce potentially adverse effect on the results of our operations. This takes frequent evaluation of available lending rates and examination of opportunities to reduce interest expense through new sources of debt financing. Several factors affecting the interest rate risk include governmental monetary and tax policies, domestic and international economics and other factors that are beyond our control. The following table provides information about the principal cash flows, weighted average interest rates, and expected maturity dates for debt outstanding as of September 30, 2005. The current terms of this debt are described in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources." For variable rate debt, the table presents the assumption that the outstanding principal balance at September 30, 2005 will be paid upon maturity. There was no variable rate debt at September 30, 2005. For fixed rate debt, the table presents the assumption that the outstanding principal balance at September 30, 2005 will be paid according to scheduled principal payments and that we will not prepay any of the outstanding principal balance. Three Months Year Ending December 31, Remaining --- 2005 2006 2007 2008 2009 Thereafter Total Fair Value --- (dollars in thousands) Variable Rate Debt: Secured and unsecured debt - - - - - - - - Weighted average interest rate - - - - - - - - Fixed Rate Debt: Secured notes payable $2,504 $10,427 $11,046 $121,623 $9,598 $214,839 $370,037 $467,602 Weighted average interest rate 5.84% 5.84% 5.84% 5.84% 5.84% 5.84% The primary market risks we face are interest rate fluctuations. Principal amounts outstanding under the Berg Group line of credit and the CNB line of credit, which are tied to a LIBOR based interest rate, were $0.00, of the total $370.0 million of outstanding debt as of September 30, 2005. As a result, we pay lower rates of interest in periods of decreasing interest rates and higher rates of interest in periods of increasing interest rates. All of our debt is denominated in United States dollars. We had no interest rate caps or interest rate swap contracts at September 30, 2005. As of September 30, 2005, we had no interest rate risk since there was no variable rate debt outstanding. - 24 - ITEM 4. CONTROLS AND PROCEDURES DISCLOSURE CONTROLS AND PROCEDURES We strive to maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls. As required by SEC Rule 13a-15(b) we conducted an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer, President and Vice President of Finance, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer, President and Vice President of Finance concluded that our disclosure controls and procedures were effective in timely alerting them to material information relating to us (including our subsidiaries) required to be included in our periodic SEC filings. CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING There was no material change in our internal control over financial reporting during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting. - 25 - PART II - OTHER INFORMATION ITEM 1. LEGAL PROCEEDINGS Legal proceedings are incorporated herein by reference from Part 1 "Item 1. - Financial Statements - Note 7 - Commitments and Contingencies." ITEM 6. EXHIBITS 31.1 Section 1350 Certificate of CEO 31.2 Section 1350 Certificate of President & COO 31.3 Section 1350 Certificate of Principal Financial Officer 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - 26 - == Signatures Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereto duly authorized. Mission West Properties, Inc. (Registrant) Date: November 9, 2005 By: /s/ Carl E. Berg --------------------------------------- Carl E. Berg Chief Executive Officer Date: November 9, 2005 By: /s/ Wayne N. Pham --------------------------------------- Wayne N. Pham Vice President of Finance and Controller (Principal Accounting Officer and Duly Authorized Officer) - 27 -