QUINSTREET, INC
Form DEF 14A
September 13, 2010

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
SCHEDULE 14A
(Rule 14a-101)
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 þ
Filed by a Party other than the Registrant o
Check the appropriate box:
o Preliminary Proxy Statement
o Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
þ Definitive Proxy Statement
o Definitive Additional Materials
o Soliciting Material Pursuant to Rule 14a-12

QuinStreet, 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):
þ No fee required.
o 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:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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(1) Amount previously paid:

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

(3) Filing Party:

(4) Date Filed:

Table of Contents

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD October 22, 2010

To our stockholders:

We will hold our annual meeting of stockholders at the Crowne Plaza Hotel, 1221 Chess Drive, Foster City, CA 94404 on Friday, October 22, 2010, at 2:30 p.m. local time. We are holding this meeting for the purpose of considering and voting on:

(1) Election of two directors to the Board of Directors to serve until the 2013 annual meeting of stockholders or until their successors have been duly elected and qualified;

(2) Ratification of the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the current year; and

(3) The transaction of any other business that properly comes before the meeting.

The stockholders of record at the close of business on September 3, 2010 will be entitled to vote at the meeting or any postponements or adjournments of the meeting.

Whether or not you expect to attend, we urge you to sign, date and promptly return the enclosed proxy card in the enclosed postage prepaid envelope or vote via telephone or the Internet in accordance with the instructions on the enclosed proxy card. If you attend the meeting, you may vote your shares in person, which will revoke any prior vote.

Important Notice Regarding the Availability of Proxy Materials for the Shareholder Meeting To Be Held on October 22, 2010: This Proxy Statement, along with the 2010 Annual Report to Stockholders, are available on the following website: ***http://investor.quinstreet.com/governance.cfm.***

By order of the Board of Directors,

/s/ Daniel Caul
Daniel Caul
General Counsel

September 13, 2010
Foster City, California

TABLE OF CONTENTS

1051 East Hillsdale Blvd., Suite 800
Foster City, California 94404

PROXY STATEMENT

This proxy statement is furnished to you by the Board of Directors of QuinStreet, Inc. (the Board) and contains information related to the 2010 annual meeting of our stockholders to be held on Friday, October 22, 2010, beginning at 2:30 p.m., local time, at the Crowne Plaza Hotel, 1221 Chess Drive, Foster City, CA 94404, and at any postponements or adjournments thereof. The enclosed form of proxy is solicited by our Board. The date of this proxy statement is September 13, 2010. It is first being mailed to our stockholders on or about September 20, 2010.

References in this proxy statement to we, us, our, the Company and QuinStreet refer to QuinStreet, Inc.

ABOUT THE MEETING

Purpose of the 2010 Annual Meeting of Stockholders

The purpose of the 2010 annual meeting of stockholders is:

(1) To elect two Board nominees to serve as Class I directors for a three-year term expiring on the date of the 2013 annual meeting of stockholders or until their respective successors have been duly elected and qualified;

(2) To ratify the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the current year; and

(3) To transact any other business that properly comes before the meeting.

Quorum

A quorum is the minimum number of shares required to hold and transact business at a meeting. The presence in person or by proxy of the holders of a majority of the outstanding shares of common stock will constitute a quorum for the transaction of business at the meeting. Votes cast by proxy or in person at the meeting will be counted by the persons appointed by the Company to act as election inspectors for the meeting. The election inspectors will treat shares represented by proxies that reflect abstentions as shares that are present and entitled to vote for purposes of determining the presence of a quorum.

The election inspectors will treat shares referred to as broker nonvotes (i.e., shares held by brokers or nominees over which the broker or nominee lacks discretionary power to vote and for which the broker or nominee has not received specific voting instructions from the beneficial owner) as shares that are present and entitled to vote for purposes of determining the presence of a quorum.

Who May Vote

Holders of record of our common stock at the close of business on September 3, 2010 (Record Date) may vote at the annual meeting of stockholders. As of the Record Date, the Company had 45,085,057 issued and outstanding shares of common stock. Each share of QuinStreet common stock that you own entitles you to one vote.

How to Vote

You may vote in person at the meeting or by proxy. We recommend that you vote by proxy even if you plan to attend the meeting. You can always change your vote at the meeting.

Table of Contents

If you are a registered stockholder (meaning your name is included on the stockholder file maintained by our transfer agent, BNY Mellon Shareowner Services), you can vote by proxy in any of the following ways:

By Internet. If you have Internet access, you may submit your proxy from any location in the world by following the Internet instructions on the proxy card. The deadline for voting electronically is 11:59 p.m. (Eastern Time) on October 21, 2010.

By Telephone. You may submit your proxy by following the Telephone instructions on the proxy card. The deadline for voting by telephone is 11:59 p.m. (Eastern Time) on October 21, 2010.

In Writing. You may do this by signing your proxy card, or for shares held in street name, the voting instruction card included by your broker, bank or other nominee, and mailing it in the accompanying enclosed, pre-addressed envelope. If you provide specific voting instructions, your shares will be voted as you instruct. If you sign, but do not provide instructions, we will vote your shares in favor of the director candidates. If you return your signed proxy card to us before the annual meeting of stockholders, we will vote your shares as you direct.

If your shares are held in the name of a bank, broker or other nominee, you will receive instructions from such nominee that you must follow in order for your shares to be voted.

How Proxies Work

Our Board of Directors is asking for your proxy. Giving us your proxy means you authorize us to vote your shares at the meeting in the manner you direct. You may abstain from voting from any of the proposals. With respect to the nominees proposed to be elected at the meeting, you may vote for all, some or none of our director candidates. However, if you sign your proxy card but do not provide instructions, we will vote your shares in favor of the director candidates.

Proposals You Are Asked To Vote On and the Board s Voting Recommendation

If you properly fill in your proxy card and send it to us in time to vote, or vote by the Internet or telephone, one of the individuals named on your proxy card will vote your shares as your proxy and as you have directed. If you sign the proxy card but do not make specific choices, your proxy will follow the Board s recommendations and vote your shares:

FOR the election of two Board nominees to serve as Class I directors for a three-year term expiring on the date of the 2013 annual meeting of stockholders or until their respective successors have been duly elected and qualified (see Proposal 1 Election of Class I Directors).

FOR ratification of the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the current year (see Proposal 2 Ratification of the Selection of PricewaterhouseCoopers LLP as Our Independent Registered Public Accounting Firm).

If any other matter is properly presented at the meeting, your proxy will vote in accordance with the best judgment of the individual voting your shares as your proxy. At the time this proxy statement went to press, we knew of no other matters to be acted on at the meeting.

Vote Necessary to Approve Proposals

Directors are elected by a plurality, and the nominees who receive the most votes will be elected. The two Class I director nominees with the most votes will be elected as Class I directors to serve terms ending at our 2013 annual meeting of stockholders. Abstentions and broker nonvotes will not be taken into account in determining the outcome of the election. We did not receive any nominations from any stockholders.

Approval of the ratification of the selection of our independent registered public accounting firm requires the affirmative vote of the majority of the shares of common stock present or represented by proxy with respect to such proposal. For the proposal ratifying the selection of our independent registered public accounting firm, abstentions are treated as shares present or represented and voting, so abstaining has the same effect as a negative vote.

If you hold your shares through a broker and do not provide your broker with specific voting instructions, under the rules that govern brokers in such circumstances, your broker will have the discretion to vote such shares on routine matters but not on non-routine matters. Even though we are a NASDAQ-listed company, the New York

Stock Exchange (NYSE) rules govern how a broker licensed by the NYSE can vote shares it holds on behalf of stockholders of NASDAQ-listed companies. As a result:

Your broker will not have the authority to exercise discretion to vote your shares with respect to the election of directors because NYSE rules treat those matters as non-routine.

Your broker will have the authority to exercise discretion to vote your shares with respect to the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ended June 30, 2010, because that matter is treated as routine under NYSE rules.

Because the proposals to be acted upon at the annual meeting of stockholders include both routine and non-routine matters, if you do not give voting instructions to your broker, trustee or nominee, your broker, trustee or nominee may either (1) vote your shares on routine matters or (2) leave your shares unvoted.

Revoking Your Proxy

You may revoke your proxy by: (1) sending in another signed proxy card with a later date; (2) providing subsequent Internet or telephone voting instructions; (3) notifying our Secretary in writing before the meeting that you have revoked your proxy; or (4) voting in person at the meeting.

Proxy Solicitation Costs

The Company will bear the costs of soliciting proxies.

PROPOSAL 1

ELECTION OF CLASS I DIRECTORS

Recommendation of the Board of Directors

The Board of Directors recommends that you vote FOR the election of each of the nominees for election as directors described below, which proposal is designated as Proposal 1 on the enclosed proxy card.

Our Certificate of Incorporation currently provides for a classified Board of Directors. Each person elected as a Class I director at the annual meeting of stockholders will serve a three-year term expiring on the date of the 2013 annual meeting of stockholders or until their respective successors have been duly elected and qualified. Our Board has nominated James Simons and Dana Stalder for election at the annual meeting of stockholders. We did not receive any nominations from any stockholders.

Unless authority to vote for any of these nominees is withheld, the shares represented by the enclosed proxy will be voted **FOR** the election of James Simons and Dana Stalder as Class I directors. In the event that any nominee becomes unable or unwilling to serve, the shares represented by the enclosed proxy will be voted for the election of such other person as the Board may recommend in his or her place. We have no reason to believe that any nominee will be unable or unwilling to serve as a director.

Directors are elected by a plurality, and the two nominees who receive the most votes will be elected. Abstentions and broker nonvotes will not be taken into account in determining the outcome of the election.

Nominees for Election as Class I Directors (Terms Expiring on the Date of the 2013 Annual Meeting of Stockholders if Elected)

James Simons	Director since July 1999
Dana Stalder	Director since May 2003

Continuing Class II Directors (Terms Expiring on the Date of the 2011 Annual Meeting of Stockholders)

John G. McDonald	Director since September 2004
Gregory Sands	Director since July 1999

Continuing Class III Directors (Terms Expiring on the Date of the 2012 Annual Meeting of Stockholders)

William Bradley	Director since August 2004
Glenn Solomon	Director since May 2007
Douglas Valenti	Director since July 1999

Set forth below are each Director s and each Board Nominee s name and age as of the date of the annual meeting of stockholders and his or her principal occupation, business history and public company directorships held during the past five years. Each of our nominees has been chosen to stand for election in part because of his ability and willingness to ask relevant questions, understand QuinStreet s challenges, and evaluate the strategies proposed by management, as well as the implementation of such strategies. Each of the nominees has a long record of professional integrity, a dedication to his profession, a strong work ethic that includes coming fully prepared to meetings and being willing to spend the time and effort needed to fulfill his professional obligations, the ability to maintain a collegial environment, and the experience of having served as a board member of several privately-held companies and, in some cases, of several public companies. Specific experience, qualifications, attributes, and skills of each nominee are described in each nominee s biography below.

Douglas Valenti

Mr. Valenti, age 51, has served as our Chief Executive Officer and member of our board of directors since July 1999 and as our Chairman and Chief Executive Officer since March 2004. Prior to QuinStreet, Mr. Valenti served as a partner at Rosewood Capital, a venture capital firm, for five years; at McKinsey & Company as a strategy consultant and engagement manager for three years; at Procter & Gamble in various management roles for three years; and for the U.S. Navy as a nuclear submarine officer for five years. He holds a Bachelors degree in Industrial Engineering from the Georgia Institute of Technology, where he graduated with highest honors and was named the Georgia Tech Outstanding Senior in 1982, and an M.B.A. from the Stanford Graduate School of Business, where he was an Arjay Miller Scholar. As a seasoned executive and chief executive officer of QuinStreet, Mr. Valenti brings in-depth knowledge of QuinStreet s operations and strategy that is important to the Board s oversight of long-term strategy, enterprise risk management, compensation, and corporate governance practices for the Company.

William Bradley

Former Senator Bradley, age 67, has served as a member of our board of directors since August 2004. Former Senator Bradley is a Managing Director of Allen & Company LLC, an investment bank, which he joined in November 2000. From April 2001 to June 2004, Former Senator Bradley also served as chief outside advisor to the nonprofit practice of McKinsey & Company. Former Senator Bradley served in the U.S. Senate from 1979 to 1997, representing the state of New Jersey, and previously was a professional basketball player with the New York Knicks from 1967 to 1977. Former Senator Bradley also serves on the boards of directors of Seagate Technology, Starbucks Coffee Company and Willis Group Holdings. Former Senator Bradley received a B.A. in American History from Princeton University and an M.A. in American History from Oxford University, where he was a Rhodes Scholar. Former Senator Bradley brings insight into governmental affairs which can assist the Company and the Board in evaluating regulatory matters. In addition, with his experience in the investment banking industry and as a director on several public-company boards, Former Senator Bradley brings valuable insight important to the Board in overseeing risk management, strategy and corporate governance practices.

John G. McDonald

Professor McDonald, age 73, has served as a member of our board of directors since September 2004. Professor McDonald is the Stanford Investors Professor in the Stanford Graduate School of Business, where he has been a faculty member since 1968, specializing in investment management, entrepreneurial finance, principal investing, venture capital, and private equity investing. Professor McDonald also serves on the board of directors of Plum Creek Timber Company, Scholastic Corporation, iStar Financial, Inc., and twelve mutual funds managed by Capital Research and Management Company, and he served on the Board of Varian Inc. from 1999 until May 2010, when Varian was acquired by Agilent Technologies. He holds a B.A. in Engineering, an M.B.A., and a Ph.D. from Stanford University. He is a retired officer in the U.S. Army and was a Fulbright Scholar. Professor McDonald s deep knowledge of finance and investing and his experience as a director bring valuable insight to the Board regarding oversight of our financial reporting, risk management and corporate finance matters, as well as compensation and other corporate governance practices.

Gregory Sands

Mr. Sands, age 44, has served as a member of our board of directors since July 1999. Since September 1998, Mr. Sands has been a Managing Director at Sutter Hill Ventures, a venture capital firm. Previously, Mr. Sands held various operational roles at Netscape Communications Corporation and was a management consultant with Mercer Management Consulting. Mr. Sands also serves on the boards of several privately-held companies. He holds a B.A. in Government from Harvard College and an M.B.A. from the Stanford Graduate School of Business. Mr. Sands is a seasoned Internet executive and investor with an in-depth knowledge of our business. His business experience and history as a director on our Board bring knowledge that is important to the Board s oversight of our business and operations, strategy and risk management.

James Simons

Mr. Simons, age 47, has served as a member of our board of directors since July 1999. Mr. Simons is a Managing Director of Split Rock Partners, a venture capital firm, which he founded in June 2004. Prior to founding Split Rock Partners, Mr. Simons served as General Partner of St. Paul Venture Capital, a venture capital firm, from November 1996 to June 2004. Previously, Mr. Simons was a partner at Marquette Venture Partners and held banking positions at Trammell Crow Company and First Boston Corporation. Mr. Simons also serves on the boards of several privately-held companies. He holds a B.A. in Economics and History from Stanford University and an M.S. in Management from the J.L. Kellogg Graduate School of Management, Northwestern University. Mr. Simons has deep expertise in marketing and customer acquisition on the Internet and has many years of experience as an investor in Internet marketing and other companies. He has been a Quinstreet director since 1999 and has an in-depth knowledge of our business. His business experience and history as a director on our Board bring knowledge that is important to the Board s oversight of our business and operations, strategy and risk management.

Glenn Solomon

Mr. Solomon, age 41, has served as a member of our board of directors since May 2007. Since March 2006, Mr. Solomon has been a Managing Director of GGV Capital (formerly Granite Global Ventures), a venture capital firm. Prior to joining GGV Capital, Mr. Solomon served as a General Partner at Partech International, a venture capital firm, from September 1997. Previously, Mr. Solomon served in various financial roles at Goldman Sachs and at SPO Partners. Mr. Solomon also serves on the boards of two privately-held companies. He earned a B.A. in Public Policy from Stanford University, where he graduated with Distinction, and an M.B.A. from the Stanford Graduate School of Business, where he was an Arjay Miller Scholar. Mr. Solomon s business and investing experience and his knowledge of finance are important to the Board s oversight of our business and operations, strategy and risk management.

Dana Stalder

Mr. Stalder, age 42, has served as a member of our board of directors since May 2003. Since August 2008, Mr. Stalder has been a General Partner of Matrix Partners, a venture capital firm. Prior to joining Matrix Partners, Mr. Stalder served in various executive roles, including Senior Vice President at eBay, Inc., an online marketplace company, from December 2001 to August 2008. Previously, he was the Chief Financial Officer and Vice President of Business Development of Respond.com, Vice President of Finance and Operations at Netscape Communication Corporation and an associate and manager at Ernst & Young LLP. Mr. Stalder also serves on the boards of several privately-held companies. He holds a B.A. in Commerce from Santa Clara University. Mr. Stalder has significant operational experience as an executive, as well as deep knowledge of finance and financial reporting. His experience is important to the Board s oversight of strategy, operations, risk management and financial reporting.

Table of Contents

BOARD OF DIRECTORS

The Board of Directors held six meetings during fiscal year 2010. All directors attended more than 75% of the total number of meetings of the Board and the committees on which he served in fiscal year 2010. The Board and its committees regularly hold executive sessions of non-management directors without management present. As a matter of policy, directors are encouraged, but not required, to attend the annual meeting of stockholders.

Compensation of Board of Directors

In January 2010, our Compensation Committee adopted a compensation policy that is applicable to all of our non-employee directors. This compensation policy provides that each such non-employee director will receive the following compensation for board services:

- $25,000 per year for service as a board member;
- $15,000 per year for service as a chairperson of the Audit Committee, Compensation Committee or Nominating and Corporate Governance Committee;
- $2,000 for each in-person board meeting and $1,000 for each telephonic board meeting;
- $1,500 for each in-person committee meeting; and
- $1,000 for each telephonic committee meeting.

In addition, our non-employee director compensation plan provides that non-employee directors will be granted an option to purchase 20,000 shares of our common stock under the Non-Employee Directors Stock Award Plan in connection with their initial election or appointment to our board of directors. These initial grants will vest monthly over a period of four years. The plan also provides that non-employee directors will receive an annual grant of an option to purchase 20,000 shares of our common stock. These grants will vest monthly over a period of one year.

We have reimbursed and will continue to reimburse our non-employee directors for their travel, lodging and other reasonable expenses incurred in attending meetings of our board of directors and committees of the board of directors.

Additionally, under our policies prior to January 2010, certain of our non-employee directors were granted an option to purchase 50,000 shares of our common stock under our stock option plans in connection with their initial election to serve on our board of directors. We have also awarded certain existing non-employee directors an option to purchase 25,000 shares of our common stock annually.

Fiscal Year 2010 Compensation of Non-Management Directors. The following table sets forth information regarding compensation earned by or paid to our non-employee directors during the fiscal year ended June 30, 2010.

DIRECTOR COMPENSATION

(for fiscal year 2010)

	Option Awards	Total

Name	Fees Earned or Paid in Cash ($)	($)(1)	($)
William Bradley	54,150	532,415	586,565
John McDonald	62,650	532,415	595,065
Gregory Sands	15,625	234,988	250,613
James Simons	15,625	234,988	250,613
Glenn Solomon	15,625	234,988	250,613
Dana Stalder	62,650	471,200	533,850

(1) The amounts in this column do not reflect actual value realized by the director. Instead, as required by SEC rules, these amounts represent the aggregate grant date fair value for grants made in fiscal year 2010, computed in accordance with FASB ASC Topic 718 (Compensation Stock Compensation). The calculations of these values are determined by accounting requirements and include vested as well as unvested awards (since

Table of Contents

the options vest over four years following the grant date), and so they do not necessarily correspond to the actual value that may be realized by the directors with respect to the awards. The assumptions used in the valuation of these awards are set forth in the notes to our consolidated financial statements, which are included in our Annual Report on Form 10-K for the year ended June 30, 2010, filed with the SEC on September 13, 2010.

The following table sets forth information regarding the individual options granted during fiscal 2010 to the non-employee directors, including the exercise price (which was the fair market value of the stock on the grant date) and the per-share grant date fair value for each option used in calculating the amounts in the table above:

Name	Grant Date	Securities Underlying Options (#)	Per Share Exercise Price of Option ($)	Per Share Grant Date Fair Value of Option ($)	Grant Date Fair Value of Option ($)(a)	Current Per Share Intrinsic Value of Option ($)(b)	Current Total Intrinsic Value of Option ($)(c)
William Bradley	November 17, 2009	25,000	19.00	9.40	234,988		
	October 6, 2009	25,000	11.08	11.90	297,428	1.34	33,500
John McDonald	November 17, 2009	25,000	19.00	9.40	234,988		
	October 6, 2009	25,000	11.08	11.90	297,428	1.34	33,500
Gregory Sands	November 17, 2009	25,000	19.00	9.40	234,988		
James Simons	November 17, 2009	25,000	19.00	9.40	234,988		
Glenn Solomon	November 17, 2009	25,000	19.00	9.40	234,988		
Dana Stalder	November 17, 2009	25,000	19.00	9.40	234,988		
	August 7, 2009	25,000	9.01	9.45	236,213	3.41	85,250

(a) See note (1) above.

(b) The intrinsic value represents the difference between the stock price of $12.42 per closing of the market as of September 3, 2010 and the exercise price of the option award, if the exercise price is less than $12.42.

(c) As of fiscal year-end 2010, each of Messrs. Bradley and McDonald held an aggregate of 200,000 options, Mr. Stalder held an aggregate of 225,000 options, and each of Messrs. Sands, Simons and Solomon held 25,000 options, in each case including both vested and unvested options and the options granted during fiscal year 2010.

Committees of the Board of Directors

Our Board of Directors has standing Audit, Compensation and Nominating and Corporate Governance Committees. The Board Committees meet in executive session with no members of management present. Copies of the charters for each of these Committees are available by using the Investor Relations and then Corporate Governance links on the Company s website at *www.quinstreet.com.* The following table lists members of the Committees as of the date of the Proxy Statement.

Name	Audit Committee	Compensation Committee	Governance Committee
William Bradley			Chair
John McDonald	Member	Chair	
Gregory Sands		Member	Member
James Simons			Member
Glenn Solomon	Member		
Dana Stalder	Chair	Member	

Audit Committee four meetings in fiscal year 2010. Our Audit Committee, which has been established in accordance with Section 3(a)(58)(A) of the Exchange Act, currently consists of Messrs. Stalder, Solomon and McDonald. The chair of our Audit Committee is Mr. Stalder. The functions of this committee include:

- reviewing and pre-approving the engagement of our independent registered public accounting firm to perform audit services and any permissible non-audit services;

evaluating the performance of our independent registered public accounting firm and deciding whether to retain their services;

reviewing our annual and quarterly financial statements and reports and discussing the statements and reports with our independent registered public accounting firm and management;

providing oversight with respect to related party transactions;

reviewing, with our independent registered public accounting firm and management, significant issues that may arise regarding accounting principles and financial statement presentation, as well as matters concerning the scope, adequacy and effectiveness of our financial controls;

reviewing reports from management and auditors regarding our procedures to monitor and ensure compliance with our legal and regulatory responsibilities, our code of business conduct and ethics and our compliance with legal and regulatory requirements; and

Table of Contents

Had compensation expense been determined consistent with SFAS 123, the Company s net income and earnings per share would have been changed to the following pro forma amounts:

	Three Months Ended August 31,		Six Months Ended August 31,	
	2004	2003	2004	2003
		(Restated)		(Restated)
Net income applicable to common shareholders as reported	$ 2,065	$ 1,538	$ 3,194	$ 2,046
Total stock-based employee compensation expense under fair value method for all awards, net of tax	38		76	1
Pro forma income applicable to common Shareholders	$ 2,027	$ 1,538	$ 3,118	$ 2,045
Basic earnings per share:				
As reported	$ .19	$ .14	$ .30	$ .19
Pro forma	$ .19	$ .14	$ .29	$ .19
Diluted earnings per share:				
As reported	$ .19	$ .14	$ .30	$ .19
Pro forma	$ .19	$ .14	$ .29	$ .19

3 - Restatement

The Company filed a restated annual report on Form 10-K/A on October 15, 2004. Prior quarterly results were restated in Note 10, Quarterly Results, of the Form 10-K/A. The Company had concluded that it improperly accounted for certain interest rate derivative instruments that were originally entered into in September 2000 and April 2001. The Company did not properly record the fair value of the derivative and the change to the fair value of the derivative as an unrealized gain or loss in the statements of operations for the periods affected.

In connection with the restatement, the Company has reclassified payments made on derivative instruments from interest expense to interest derivative gain or loss; recorded changes in the fair value of such instruments as interest derivative gain or loss; and the related effect of such changes in fair value. The net effect of all the restatement adjustments is as follows:

	Three Months Ended August 31,	Six Months Ended August 31,
	2003	2003

Increase to net income due to restatement to record unrealized derivative gain	$ 110	$ 130
Increase to earnings per share:		
Basic	$ .01	$ .01
Diluted	$ .01	$ .01

8

Table of Contents

4 - Contingent Liabilities

The Company has an arrangement with an HVACR equipment manufacturer and a bonded warehouse agent whereby HVACR equipment is held for sale in bonded warehouses located at the premises of certain of the Company s operations, with payment due only when products are sold. The supplier retains legal title and substantial management control with respect to the consigned inventory. The Company is responsible for damage to and loss of inventory that may occur at its premises. The Company has the ability to return consigned inventory, at its sole discretion, to the supplier for a specified period of time after receipt of the inventory. Such inventory is accounted for as consigned merchandise and is not recorded on the Company s balance sheet. As of August 31, 2004, the cost of such inventory held in the bonded warehouses was approximately $4,655,000.

The terms of the consignment agreement further provide that the Company may be required to purchase inventory not sold within a specified period of time. Historically, most consigned inventory is sold before the specified purchase date, and prior to August 31, 2004, the supplier had never enforced its right to demand payment, instead permitting such inventory to remain on consignment. At August 31, 2004, the Company agreed to purchase approximately $300,000 of inventory that had been on consignment more than one year. The Company expects that most of this equipment will be sold before the end of fiscal 2005.

5 - Goodwill

Goodwill represents the excess cost of companies acquired over the fair value of their tangible net assets. The Company accounts for goodwill in accordance with SFAS No. 142. Goodwill attributable to each of the Company s reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. These impairment tests are performed at least annually. On an ongoing basis (absent any impairment indicators), the Company performs the annual impairment test as of the end of its fiscal year.

6 - Interest Rate Derivative Instruments

The Company has an interest rate derivative that does not qualify as a hedge, in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The fair value of the derivative instrument is reflected on the Company s balance sheets, and changes in the fair value of such derivatives are recorded as unrealized gains or losses, as applicable, in the Company s statements of operations as interest derivative loss or gain. Payments received or paid by the Company during the term of the derivative contract as a result of differences between the fixed interest rate of the derivative and the market interest rate are also recorded as interest derivative loss or gain.

The derivative instrument is an interest rate swap whereby the Company has agreed to exchange, at specified intervals, the difference between a fixed rate of 6.33% and a variable rate based upon LIBOR, amounts as calculated by reference to a notional principal amount of $8 million. The interest rate swap was scheduled to mature in April 2005. However, the Company elected to terminate the agreement early and settle the remaining outstanding liability with a payment of $238,000 in September 2004 as part of the refinancing arrangement discussed in Note 8. The fair value of the derivative is represented by a liability of $233,000 and $464,000, at August 31, 2004 and February 29, 2004, respectively.

Table of Contents

7 - Stock Option Agreements and Equity Transactions

Effective March 1, 2004, both the Chief Financial Officer and the General Counsel of the Company entered into employment contracts that each provide for the contingent issuance of 500,000 shares of restricted stock upon both continuation of employment and attainment of specified financial performance objectives by the Company. After the end of the first quarter, it was recognized that certain provisions of the agreements led to differing interpretations of the timing and number of shares that could vest under certain financial performance conditions. A process commenced at that time to amend the agreements to clarify the terms. In September 2004, the agreements were revised to extend the vesting period and eliminate the performance criteria. Under the revised agreements, the restricted stock will vest ratably over six years beginning March 1, 2004, subject only to continuation of employment of the officers. As a result of this revision, September 27, 2004 established a new measurement date for valuing the restricted stock. On that date the Company s share price was $2.15, and accordingly, the Company has recorded $2,150,000 as deferred compensation, which will be amortized on a straight-line basis as compensation expense over the six-year vesting period of the grants. As the amendment clarified provisions identified at the end of the first quarter, and adjustment was made in the second quarter to reflect year-to-date compensation expense based on the new terms. For the three and six-month periods ended August 31, 2004, compensation expense recognized under the agreements was $70,000 and $179,000, respectively.

Effective March 1, 2004, the two outside directors of the Company each received restricted stock grants of 42,000 shares, subject to continuation of service as a director for four years. Such shares will vest annually pro-rata over such period. The Company will recognize $122,000 as compensation expense ratably over the four-year period for the restricted stock grants. For the three and six-month periods ended August 31, 2004, the Company recognized $8,000 and $15,000, respectively, as compensation expense related to the directors restricted stock grants.

The Company has a stock option plan for key employees and directors of the Company and its subsidiaries. The plan provides for the granting of up to 500,000 non-qualified and/or incentive stock options. The options expire after five years and can be extended for a period of up to five years. On March 23, 2004, the expiration date of 93,500 options granted under the plan in March 1999 was extended until March 23, 2006. The extension created a new measurement date for valuing the options. No compensation expense has been recognized since, at the date of grant, the market price of the stock was equal to the option price on the date of extension.

8- Debt

The Company has a revolving line of credit arrangement with a commercial bank. The maximum amount that may be borrowed under the revolving line of credit was increased from $25 million to $30 million during the quarter ended August 31, 2004, and an additional $1 million may be borrowed for capital expenditures. At August 31, 2004, the Company had available credit of $2.2 and $0.2 million under the revolving credit line and the capital expenditure term loan facility, respectively. The terms of the agreement allow the line of credit to be extended for one year unless either party gives notification. In June 2004, the Company notified the bank of its intention to terminate the arrangement.

On September 7, 2004, the Company entered into a direct financing agreement (Agreement) with another commercial bank. The Agreement provides to the Company a $30 million revolving line of credit and a $5 million credit line that may be used for capital expenditures or to purchase real estate. The Agreement replaces the Company s previous financing arrangement noted above.

Table of Contents

The amount that may be borrowed under the new revolving credit line is limited to a borrowing base consisting of 85% of eligible accounts receivable, and from 50% to 65% of eligible inventory, depending on the time of year. As of September 7, 2004, the Company s borrowing base exceeded $30 million. The Company initially borrowed $26.5 million under the revolving credit line and $0.8 million under the credit line for capital expenditures and real estate to repay its obligations to the former lender.

The interest rate under the Agreement is initially LIBOR plus 1.625%, which is 0.625% less than under the Company s previous borrowing arrangement, or the Prime Rate less 0.125%. The Company has initially elected to use the LIBOR rate option for substantially all of its borrowings. The incremental percentage above LIBOR may vary depending on the Company s leverage and financial performance. The Agreement also requires the Company to pay monthly a fee of 0.25% per annum on the average unused portion of the revolving credit line. All of the Company s assets are pledged as collateral for borrowings under the Agreement.

The Agreement contains customary loan covenants with respect to the Company s net worth, fixed charge coverage, leverage ratio, and ratio of funded debt to earnings before interest, income tax, depreciation, amortization and non-cash compensation expense. At the inception of the Agreement, the Company is in compliance with all such covenants. The Agreement also contains various affirmative and negative covenants unrelated to the Company s financial performance, including a prohibition on payment of dividends. Failure to comply with any financial or non-financial covenant, if not promptly cured, constitutes an Event of Default under the Agreement. Certain other specified events and any Material Adverse Change, as determined by the bank, also constitute an Event of Default. The existence of an Event of Default gives the bank a right to accelerate all outstanding indebtedness under the Agreement.

The Agreement does not require the Company to use lockbox or similar arrangements pursuant to which the bank would exercise control over collection proceeds and the discretion to reduce indebtedness under the Agreement. If an Event of Default exists, the bank may offset against the Company s indebtedness all funds of the Company that are held in accounts at the bank. The Company is not required to maintain deposit balances at the bank, although the Company has initially elected to utilize the bank s treasury management services.

9 - New Accounting Pronouncements

In January 2003, the Emerging Issues Task Force (EITF) reached a final consensus on EITF Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor . EITF 02-16 clarifies certain aspects for accounting and recording of consideration received from vendors. Certain provisions of the EITF are effective for fiscal years beginning after December 15, 2002, and other provisions of the EITF are effective for arrangements entered into after November 21, 2003. The Company s accounting for consideration received from vendors is consistent with the provisions of EITF 02-16 as of August 31, 2004.

In January 2003, the FASB issued Interpretation 46, Consolidation of Variable Interest Entities. In general, a Variable Interest Entity is a corporation, partnership, trust, or other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s activities or entitled to receive a majority of the entity s residual returns or both. The Interpretation is effective for all Variable Interest Entities created after January 31, 2003, and is effective for special purpose entities created before

Table of Contents

February 1, 2003 for the first reporting period after December 15, 2003 and for non-special purpose entities for the first reporting period beginning after March 15, 2004. The adoption of the Interpretation did not have nor is expected to have a material impact on the Company s financial statements.

10 - Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. The Company uses the liability method in accounting for income taxes. Under the liability method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

11 - Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share for the six months and the three months ended August 31, 2004 and 2003 (in thousands except per share data):

	Three Months Ended August 31,		**Six Months Ended August 31,**	
	2004	**2003**	**2004**	**2003**
		(Restated)		**(Restated)**
Numerator for basic and diluted earnings per share				
Net income	$ 2,065	$ 1,538	$ 3,194	$ 2,046
Denominator:				
Denominator for basic earnings per share weighted average shares	10,681	10,681	10,681	10,681
Effect of dilutive securities:				
Stock options	105		75	
Restricted stock grants	72		39	
Denominator for diluted earnings per share adjusted weighted average shares and assumed conversions	10,847	10,681	10,789	10,681
Basic earnings per share	$ .19	$ .14	$ .30	$ .19
Diluted earnings per share	$ .19	$ .14	$ .30	$ .19

12

Table of Contents

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

INTRODUCTION

ACR Group, Inc. and its subsidiaries (collectively, the Company) is an independent distributor of heating, air conditioning and refrigeration (HVACR) equipment and related parts and supplies. The Company is among the ten largest such distributors in the United States. Substantially all of the Company s sales are to contractor dealers and institutional end-users. Generally accepted accounting principles allow the aggregation of an enterprise s segments if they are similar. Although the Company operates in different geographic areas, we have reviewed the aggregation criteria and determined that the Company operates as a single segment based on the high degree of similarity of the Company s operations.

This report on Form 10-Q includes certain statements that may be deemed to be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements, which are other than statements of historical facts. Forward-looking statements involve risks and uncertainties that could cause actual results or outcomes to differ materially. Such risks and uncertainties may include the availability of debt or equity capital to fund the Company s working capital requirements, unusual weather conditions, the effects of competitive pricing, the strength of construction markets and general economic conditions. Our expectations and beliefs are expressed in good faith and we believe there is a reasonable basis for them, but there can be no assurance that our expectations, beliefs or projections will be achieved or accomplished. The forward-looking statements in this document are intended to be subject to the safe harbor protection provided under the securities laws.

RESULTS OF OPERATIONS FOR THE SIX MONTHS ENDED AUGUST 31, 2004 COMPARED TO THE SIX MONTHS ENDED AUGUST 31, 2003

The Company recognized net income of $3,194,000 for the six months ended August 31, 2004 (fiscal 2005) compared to $2,046,000 for the six months ended August 31, 2003 (fiscal 2004) an increase of 56%. The Company s financial improvement was broad-based, as each of the Company s six business units, except for the Texas-based unit, generated operating income at least 40% greater than the preceding year. The Texas-based unit was adversely affected by unusually high rainfall and relatively mild temperatures throughout the summer, which reduced demand for the Company s products. Business units based in Colorado and California generated the highest rate of growth in net income over the previous year. A resurgence in economic development in Colorado enabled that business unit to earn its highest six-month income since fiscal 2002. The California business unit sustained the momentum it developed in fiscal 2004.

Consolidated sales increased 17% during the six months ended August 31, 2004 compared to the six months ended August 31, 2003. Same-store sales increased 15% over the same fiscal periods. For the first eight months of calendar 2004, same-store sales growth was also 15%, compared to a 6% increase in industry-wide product shipments during the same period based on data compiled by a leading industry trade association. Same-store comparisons exclude two non-core business units that were sold in fiscal 2004, a branch closed in fiscal 2004 and four new branches opened since June 2003. Growth was strongest in California and Florida, which benefited from the growth curve usually associated with recently opened branches. Other than in Texas, summer weather patterns were close to normal and the Company s business units experienced the customary seasonal increase in sales. Sales under a contract with a customer that commenced in the second quarter of fiscal 2004 represented 3 percentage points of the increase in consolidated and same-store sales in the first six months of fiscal 2005.

Table of Contents

The Company s consolidated gross margin percentage on sales was 22.6% for the six months ended August 31, 2004, compared to 22.0% for the six months ended August 31, 2003. The increase in gross margin percentage resulted from continuous improvement in purchasing and payment terms with suppliers and customer pricing disciplines across all business units. The Company earns a relatively low gross margin percentage on the large volume contract described in the preceding paragraph; sales under this contract decreased consolidated gross margin percentage for the six-month period ended August 31, 2004 by 0.6 percentage points.

Selling, general and administrative (SG&A) expenses increased by 14% in the six months ended August 31, 2004, compared to the same period of 2003. Same-store SG&A expenses increased 12% over the same periods, generally because of the much higher sales volumes in fiscal 2005. Expressed as a percentage of sales, SG&A expenses decreased in the six months ended August 31, 2004 to 17.7% from 18.1% in 2003.

Interest expense decreased 1% in the six-month period ended August 31, 2004 from the same period ended August 31, 2003 as a result of a decrease in the average interest rate on the Company s variable rate indebtedness. Average funded indebtedness increased 7% in the six months ended August 31, 2004, compared to the preceding year, as the Company used its revolving credit line for working capital requirements associated with the increase in sales over the preceding year and, upon increasing the credit line in July 2004, to access more favorable payment terms with suppliers.

The Company has an effective combined federal and state income tax rate of 38.9% for the six months ended August 31, 2004, compared to 37.8% for the six months ended August 31, 2003. In fiscal 2004, slightly less than half of the provision for income taxes was charged to deferred taxes because of federal income tax loss carryforwards. The Company has no loss carryforwards to utilize in fiscal 2005.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED AUGUST 31, 2004 COMPARED TO THE THREE MONTHS ENDED AUGUST 31, 2003

The Company recognized net income of $2,065,000 for the quarter ended August 31, 2004 (fiscal 2005) compared to $1,538,000 for the quarter ended August 31, 2003 (fiscal 2004), an increase of 34%. Each of the Company s six business units generated operating income at least 15% greater than the preceding year.

Consolidated and same-store sales increased 15% and 16%, respectively, during the quarter ended August 31, 2004 compared to the quarter ended August 31, 2003. Consistent with the six-month period ended August 31, sales growth was greatest in California and Florida. All business units generated increases in sales over fiscal 2004, although sales in Texas were generally flat because of the weather conditions described above. The hurricanes that hit Florida in August and September 2004 somewhat impacted business at the end of the second quarter. Although the Company s facilities in Florida suffered no physical damage, the evacuations that preceded the storms and the subsequent utility disruptions effectively halted business for several days. However, the forthcoming repairs to, and replacement of, HVAC systems as a result of hurricane damage are likely to generate additional business for the Company over the next several months.

The Company s consolidated gross margin percentage on sales increased to 22.9% for the quarter ended August 31, 2004, compared to 22.0% for the quarter ended August 31, 2003, as a result of the

Table of Contents

initiatives described in the analysis of six-month results above. Excluding sales under the large volume contract described above, gross margin percentage for the quarter ended August 31, 2004 was 23.3%.

Selling, general and administrative (SG&A) expenses increased by 15% in the quarter ended August 31, 2004 compared to the same quarter of 2003. Same-store SG&A expenses increased 13% over the same periods, generally because of the much higher sales volumes in fiscal 2005. Expressed as a percentage of sales, SG&A expenses decreased in the second quarter from 17.1% in 2003 to 17.0% in 2004.

Interest expense increased 4% in the quarter ended August 31, 2004, compared to same quarter in 2003. Higher average borrowings offset lower average interest rates. Average funded indebtedness increased 11% in the quarter ended August 31, 2004, compared to the preceding year, as the Company utilized funds available from an increase in its revolving credit line to negotiate and take advantage of favorable payment terms with certain suppliers.

The Company has an effective a combined federal and state income tax rate of 39.2% for the quarter ended August 31, 2004, compared to 37.7% for the quarter ended August 31, 2003, with the difference attributable to additional state income taxes.

LIQUIDITY AND CAPITAL RESOURCES

In the six months ended August 31, 2004, the Company used cash flow in operations of $2,791,000, compared to $224,000 in the same period of 2003, as cash was utilized for working capital needed to support new branches and higher sales volumes. Gross accounts receivable represented 41 days of gross sales as of August 31, 2004, compared to 40 days at August 31, 2003. Inventory at August 31, 2004 was $7.2 million greater than at August 31, 2003. Of such increase, approximately $1.4 million was at three branches opened in the past year; $1.4 million represented product that the Company expects to sell in the third quarter and purchased in advance of an announced price increase by a supplier; $1.0 million was attributable to a new equipment product line to be distributed in California; $2.0 million represented purchases of HVAC equipment inventory pursuant to favorable terms from a supplier that otherwise would have been purchased in the third quarter; and $0.7 million represented coil steel inventory at the Company s sheet metal manufacturing plant that was purchased to ensure adequate raw material inventory in light of the volatile steel market. Management expects total inventories to decline significantly during the last two quarters of the fiscal year.

At August 31, 2004, the Company had credit facilities with a commercial bank that included a $30 million revolving line of credit, and $1 million for capital expenditures. The limit on the revolving credit line was increased from $25 million to $30 million in July 2004. At August 31, 2004, the Company had available credit of $2.2 and $0.2 million under the revolving credit line and the capital expenditure term loan facility, respectively. At August 31, 2004, the interest rate on each facility was either the prime rate or LIBOR plus 2.25%, and the Company had elected the LIBOR option on substantially all outstanding variable rate borrowings. As of August 31, 2004, the average interest rate on all borrowings was 3.71%.

On September 7, 2004, the Company entered into a direct financing agreement (Agreement) with another commercial bank. The new Agreement provides to the Company a $30 million revolving line of credit and a $5 million credit line that may be used for capital expenditures or to purchase real estate. The Agreement replaces the Company s previous financing arrangement noted above.

The amount that may be borrowed under the new revolving credit line is limited to a borrowing base consisting of 85% of eligible accounts receivable, and from 50% to 65% of eligible inventory, depending on the time of year. As of September 7, 2004, the Company s borrowing base exceeded $30

Table of Contents

million. The Company initially borrowed $26.5 million under the revolving credit line and $0.8 million under the credit line for capital expenditures and real estate to repay its obligations to the former lender.

The interest rate under the Agreement is initially LIBOR plus 1.625%, which is 0.625% less than under the Company s previous borrowing arrangement, or the Prime Rate less 0.125%. The Company has initially elected to use the LIBOR rate option for substantially all of its borrowings. The incremental percentage above LIBOR may vary depending on the Company s leverage and financial performance. The Agreement also requires the Company to pay monthly a fee of 0.25% per annum on the average unused portion of the revolving credit line. All of the Company s assets are pledged as collateral for borrowings under the Agreement.

The Agreement contains customary loan covenants with respect to the Company s net worth, fixed charge coverage, leverage ratio, and ratio of funded debt to earnings before interest, income tax, depreciation, amortization and non-cash compensation expense. At the inception of the Agreement, the Company is in compliance with all such covenants. The Agreement also contains various affirmative and negative covenants unrelated to the Company s financial performance, including a prohibition on payment of dividends. Failure to comply with any financial or non-financial covenant, if not promptly cured, constitutes an Event of Default under the Agreement. Certain other specified events and any Material Adverse Change, as determined by the bank, also constitute an Event of Default. The existence of an Event of Default gives the bank a right to accelerate all outstanding indebtedness under the Agreement.

The Agreement does not require the Company to use lockbox or similar arrangements pursuant to which the bank would exercise control over collection proceeds and the discretion to reduce indebtedness under the Agreement. If an Event of Default exists, the bank may offset against the Company s indebtedness all funds of the Company that are held in accounts at the bank. The Company is not required to maintain deposit balances at the bank, although the Company has initially elected to utilize the bank s treasury management services.

Management believes that availability under the new revolving credit facility is adequate to meet the Company s working capital requirements of its existing operations, debt service requirements and anticipated capital expenditures. In addition to reducing the average interest rate on borrowings, the new loan agreement provides funds to both finance additional growth through new branch operations or small acquisitions and enables the Company to take advantage of certain advantageous payment terms with suppliers.

SEASONALITY

The Company s sales volume and, accordingly, its operating income vary significantly during its fiscal year. The highest levels of sales occur during the times of the year when climatic conditions require the greatest use of air conditioning, since the Company s operations are concentrated in the warmer sections of the United States. Accordingly, sales will be highest in the Company s second quarter ended August 31, and will be lowest in its fourth quarter.

INFLATION

The Company does not believe that inflation has had a material effect on its results of operations in recent years. Generally, manufacturer price increases attributable to inflation uniformly affect both the Company and its competitors, and such increases are passed through to customers as an increase in sales prices.

16

Table of Contents

NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the Emerging Issues Task Force (EITF) reached a final consensus on EITF Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor . EITF 02-16 clarifies certain aspects for accounting and recording of consideration received from vendors. Certain provisions of the EITF are effective for fiscal years beginning after December 15, 2002, and other provisions of the EITF are effective for arrangements entered into after November 21, 2003. The Company s accounting for consideration received from vendors is consistent with the provisions of EITF 02-16 as of August 31, 2004.

In January 2003, the FASB issued Interpretation 46, Consolidation of Variable Interest Entities. In general, a Variable Interest Entity is a corporation, partnership, trust, or other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s activities or entitled to receive a majority of the entity s residual returns or both. The Interpretation is effective for all Variable Interest Entities created after January 31, 2003, and is effective for special purpose entities created before February 1, 2003 for the first reporting period after December 15, 2003 and for non-special purpose entities for the first reporting period beginning after March 15, 2004. The adoption of the Interpretation did not have nor is expected to have a material impact on the Company s financial statements.

CRITICAL ACCOUNTING POLICIES

The accounting policies discussed below are critical to the Company s business operations and an understanding of the Company s financial statements. The financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make assumptions and estimates that affect the reported amounts of assets, liabilities, revenues and expenses in each reporting period. Management bases its estimates on historical experience and other factors that are believed to be reasonable under the circumstances. Actual results, once known, may vary from management s estimates.

Revenue Recognition

The Company s revenues consist of sales of HVACR products. The Company recognizes revenue when the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the amounts recognized are fixed and determinable, and (4) collectibility is reasonably assured.

Vendor Rebates

The Company receives rebates from certain vendors based on the volume of product purchased from the vendor. The Company records rebates when they are earned, and when specified purchase volume levels are reached. Vendor rebates attributable to unsold inventory are carried as a reduction of the carrying value of inventory until such inventory is sold, at which time the related rebates are used to reduce cost of sales.

Table of Contents

Allowance for Doubtful Accounts

The Company records an allowance for doubtful accounts for estimated losses resulting from the inability to collect accounts receivable from customers. The Company establishes the allowance based on historical experience, credit risk of specific customers and transactions, and other factors. Management believes that the lack of customer concentration is a significant factor that mitigates the Company s accounts receivable credit risk. Three customers represented 2.1%, 1.7% and 1.6% of consolidated fiscal 2004 sales, respectively, and no other customer comprised as much as 1% of sales. The number of customers and their distribution across the geographic areas served by the Company help to reduce the Company s credit exposure to a single customer or to economic events that affect a particular geographic region. Although the Company believes that its allowance for doubtful accounts is adequate, any future condition that would impair the ability of a broad section of the Company s customer base to make payments on a timely basis may require the Company to record additional allowances

Inventory

Inventories consist of HVACR equipment, parts and supplies and are valued at the lower of cost or market value using the average cost method. Substantially all inventories represent finished goods held for sale; raw materials represent less than 1% of inventories. When necessary, the carrying value of obsolete or excess inventory is reduced to estimated net realizable value. The process for evaluating the value of obsolete or excess inventory requires estimates by management concerning future sales levels and the quantities and prices at which such inventory can be sold in the ordinary course of business.

The Company holds a substantial amount of HVACR equipment inventory at several branches on consignment from a supplier. The terms of this arrangement provide that the inventory is held for sale in bonded warehouses at the branch premises, with payment due only when products are sold. The supplier retains legal title and substantial management control with respect to the consigned inventory. The Company is responsible for damage to and loss of inventory that may occur at its premises. The Company has the ability to return consigned inventory, at its sole discretion, to the supplier for a specified period of time after receipt of the inventory. The terms of the arrangement further provide that the supplier may require the Company to purchase consigned inventory not sold within a specified period of time. Historically, most consigned inventory is sold before the specified purchase date, and the supplier has never enforced its right to demand payment, instead permitting such inventory to remain on consignment.

This consignment arrangement allows the Company to have inventory available for sale to customers without incurring a payment obligation for the inventory prior to a sale. Because of the control retained by the supplier and the uncertain time when a payment obligation will be incurred, the Company does not record the consigned inventory as an asset upon receipt with a corresponding liability. Rather, the Company records a liability to the supplier only upon sale of the inventory to a customer. The amount of the consigned inventory is disclosed in the Company s financial statements as a contingent obligation.

Interest Rate Derivative Instruments

The Company has an interest rate derivative that does not qualify as a hedge, in accordance with Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. The fair value of the derivative instrument is reflected on the Company s balance sheets, and changes in the fair value of such derivatives are recorded as unrealized gains or losses, as applicable, in the Company s statements of operations as interest derivative loss or gain. Payments received or paid by the Company during the term of the derivative contract as a result of

18

Table of Contents

differences between the fixed interest rate of the derivative and the market interest rate are also recorded as interest derivative loss or gain.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company was subject to market risk exposure related to changes in interest rates on its senior credit facility, which included revolving credit and term notes. These instruments bear interest at a pre-agreed upon percentage point spread from either the prime interest rate or LIBOR. Under its senior credit facility the Company may, at its option, elect the interest rate for certain borrowings to be based on a spread over LIBOR for 30 days to three months. At August 31, 2004 the Company had $24.5 million outstanding under its senior credit facility, of which $16.5 million is subject to variable interest rates. Based on this balance, an immediate change of one percent in the interest rate would cause a change in annualized interest expense of approximately $165,000, or $.02 per share, on an annual basis.

As discussed in Note 8, subsequent to the end of the second quarter, the Company entered into a direct financing agreement with another commercial bank. In connection with the refinancing of the Company s previous credit facility, the value of the Company s interest rate swap was paid in full (See Note 6, above). Under the new agreement all of the principal balance is subject to variable interest rates. Based on the outstanding balance at August 31, an immediate change of one percent in the interest rate would cause a change in interest expense of approximately $245,000, or $.02 per basic share, on an annual basis.

Item 4. Controls and Procedures

The Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act) as of the end of the period covered by this report. This evaluation was performed under the supervision and with the participation of the Company s management, including the Chief Executive Officer and Chief Financial Officer. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that these disclosure controls and procedures are effective in producing the timely recording, processing, summarizing and reporting of information and in accumulating and communicating of information to management as appropriate to allow for timely decisions with regard to required disclosure.

No changes were made to the Company s internal control over financial reporting during the last fiscal quarter that materially affected, or are reasonably likely to materially affect the Company s internal control over the financial reporting.

Table of Contents

PART II OTHER INFORMATION

Item 1. Legal Proceedings

None

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

(a) The Company s 2004 Annual Meeting was held on August 19, 2004.

(b) The Company s management solicited proxies pursuant to Regulation 14 under the Securities Exchange Act of 1934. There was no solicitation in opposition to the management s nominees as listed in the proxy statement. The following nominees were elected as indicated in the proxy statement pursuant to the vote of the shareholders; Alex Trevino, Jr., Anthony R. Maresca, A. Stephen Trevino, Alan D. Feinsilver, and Roland H. St. Cyr.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.3B	Amendment to Exhibit A of the Employment Agreement between the Company and Anthony R. Maresca effective as of March 1, 2004.
10.19A	Amendment to Exhibit A of the Employment Agreement between the Company and A. Stephen Trevino effective as of March 1, 2004.
10.20	Credit Agreement between the Company and Wells Fargo Bank, NA dated September 7, 2004.
31.1	Certificate of the Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated October 15, 2003,
31.2	Certificate of the Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated October 15, 2003,
32.1	Certification from the Chief Executive Officer of ACR Group, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification from the Chief Financial Officer of ACR Group, Inc. 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.

The Company filed an 8-K on July 6, 2004, filing its financial results for its first fiscal quarter ended May 31, 2004. A copy of the Company s press release was attached as Exhibit 99.1 to the Form 8-K.

Table of Contents

The Company filed an 8-K on September 13, 2004, under Item 2.03, Creation of a Direct Financing Agreement.

The Company filed an 8-K on October 8, 2004, under Item 4.02(a), Non- Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review, and Item 9.01, Financial Statements and Exhibits, filing a press release. A copy of the Company s press release was attached as Exhibit 99.1 to the Form 8-K.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	ACR GROUP, INC.
October 15, 2004	/s/ Anthony R. Maresca
Date	Anthony R. Maresca
	Senior Vice-President and
	Chief Financial Officer