ADCARE HEALTH SYSTEMS INC
Form 10KSB
April 02, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-KSB

(Mark One)

þ **ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT**

For the transition period from __________ to __________

Commission file number 333-131542

AdCare Health Systems, Inc.

(Exact name of small business issuer in its charter)

Ohio	**31-1332119**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
5057 Troy Rd, Springfield, OH	**45502-9032**
(Address of principal executive offices)	*(Zip Code)*

Issuer s telephone number (937) 964-8974

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock, no par value	**American Stock Exchange**

Securities registered under Section 12(g) of the Exchange Act: None

Check whether the issue is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. o

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes þ No

State issuer s revenues for its most recent fiscal year: $22,549,485

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was sold, or the average bid and asked price of such common equity, as of a specified date within the past 60 days. (See definition of affiliate in Rule 12b-2 of the Exchange Act.)

As of March 9, 2007, the issuer had 3,789,129 common shares outstanding. The aggregate market value of the common shares held by non-affiliates of the issuer (3,258,217 shares) was approximately $7,298,406 based upon the average bid and asked prices ($2.24) on such date.

The number of shares of Common Stock, no par value, of AdCare Health Systems, Inc. outstanding as of December 31, 2006 was 3,786,129.

Transitional Small Business Disclosure Format (Check one): o Yes þ No

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SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

Certain statements in this report constitute forward-looking statements. These forward-looking statements involve known or unknown risks, uncertainties and other factors that may cause the actual results, performance, or achievements of AdCare to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Specifically, the actions of competitors and customers and our ability to execute our business plan, and our ability to increase revenues is dependent upon our ability to continue to expand our current business and to expand into new markets, general economic conditions, and other factors. You can identify forward-looking statements by terminology such as may, will, should, expects, intends, plans, anticipate estimates, predicts, potential, continues, or the negative of these terms or other comparable terminology. Althoug believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We undertake no obligation to publicly update or review any forward-looking statements, whether as a result of new information, future developments or otherwise.

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PART I

Item 1. Description of Business

Business Development

We are a Springfield, Ohio based developer, owner and manager of retirement communities, assisted living facilities, nursing homes, and provide home health care services in the state of Ohio. We currently manage fifteen facilities, comprised of six skilled nursing centers, seven assisted living residences and two independent living/senior housing facilities, totaling over 800 beds.

We were organized in 1989 by Gary Wade and Michael Williams, who remain active in the management of the business, as President and CEO and Executive Vice President and COO. Passport Retirement, founded by David A. Tenwick, our Chairman, acquired AdCare Health Systems in 1995. We have a seasoned senior management team with substantial senior living, healthcare and real estate industry experience. Our senior management team is incentivized to continue to grow our business through their combined ownership of approximately 16% of our common stock.

Description of Business

We have an ownership interest in seven of the facilities we manage, comprised of 100% ownership of two of the skilled nursing centers and one assisted living facility, as well as a 50% ownership of four of the assisted living residences. The assisted living facilities that we own, operate under the name Hearth & Home, with the tag line Home is where the hearth is... We also maintain a development/consulting initiative which is strategic in providing potential management opportunities to our core long-term care business. AdCare Health Systems, Inc. and Hearth & Home are registered trademarks. All of our properties are located within the State of Ohio.

Our business operates in two segments: (1) management and facility-based care and (2) home-based care. In our management and facility-based care segment, we derive revenues from three primary sources. We operate and have ownership interests in seven facilities for which we collect fees from the residents of those facilities. Profits/losses are generated to the extent that the monthly patient fees exceed the costs associated with operating those facilities. We also manage assisted living facilities and nursing homes owned by third parties. With respect to these facilities, we receive a management fee based on the revenue generated by the facilities. Within our management facility-based care segment, we provide development, consulting and accounting services to third parties. In these instances, we receive a fee for providing those services. These fees vary from project to project, with the development fee in most cases being based on a percentage of the total cost to develop the project.

Our home-based care segment provides home health care services to patients while they are living in their own homes. We use our own employees and independent contractors to provide the in-home health care and home care services at a fixed rate. Our profits/losses are based upon the spread between the amount we receive for providing the services and the cost incurred by us in providing those services. Our costs to provide services include the personnel cost which we have paid to the employees and independent contractors as well as our overhead and management expenses. Our management and support staff are more than adequate to support the number of employees and independent contractors in the field. Therefore, to the extent that we can increase the number of independent contractors and employees in the field, the profitability of our home-based care segment will improve.

Because our overhead costs are relatively fixed, our management team believes that the keys to profitable operations of our business are achieving higher occupancy in the long-term care facilities that we own and/or manage, and increasing the number of home health care providers that we have in the field. We decided in 1995 to start developing assisted living properties for our own account and with partners who would provide 50% of the start-up capital. The development, construction and marketing of new facilities take time and we learned that the start-up costs and losses can be significant. Historically, it took us up to 18 months to stabilize occupancy in the facilities that we developed. As a result, in 2003 we changed our philosophy from developing new facilities for our own account, and began to focus on developing and managing new facilities for independent third parties. However, the occupancy rates among all our properties have not been consistent enough to generate over-all operating profits. Our management team believes that our facilities are very competitive in the areas of price and quality of care and that our inconsistent occupancy levels are a result of deficiencies in our marketing efforts. Accordingly, a new position of Vice President of Marketing and Business Development was created to evaluate and address these issues in early 2006. In addition, our new Vice President is responsible for finding additional

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long-term care facilities for us to manage.

While we only entered the home healthcare field with the acquisition of Assured Health Care in January, 2005, our management team believes that we have an infrastructure in place to support more offices and a larger number of home health care professionals. Our management also believes that the key to sustained profitability in this area is having a greater number of home healthcare professionals in the field. In the process of assimilating the employees and independent contractors of Assured into our organization, we lost a number of revenue producing home health care professionals in late 2005. Those professionals were replaced in 2006 and 2007. As a result, our management team believes that with our increased marketing efforts and expansion of Assured, our existing operations will become profitable. However, if we are unable to increase our occupancy levels or we are unable to increase the staffing visits of our home healthcare business, we may continue to sustain operating losses.

In addition to improving our existing operations, our management team believes that there are significant opportunities to continue the growth of our business. Our nursing homes, assisted living facilities and independent living facilitates operate in the senior living facilities market. Our management believes that this market is one of the most dynamic and rapidly growing sectors within the healthcare space. We believe the trends are encouraging as a result of two key industry drivers: positive demographics, due to the aging of America, coupled with the limited supply of senior living facilities. Our strategy is to be opportunistic by exploiting these trends and growing both internally and through strategic acquisitions.

Our principal executive offices are located at 5057 Troy Road, Springfield, Ohio 45502, and our telephone number is (937) 964-8974. We maintain a website at www.adcarehealth.com.

Employees

As of December 31, 2006, we had approximately 934 total employees of which 537 were full time employees.

Risk Factors

The following are certain risk factors that could affect our business, operations and financial condition. These risk factors should be considered in connection with evaluating the forward-looking statements contained in this Annual Report of Form 10-KSB because these factors could cause the actual results and conditions to differ materially from those projected in forward-looking statements. This section does not describe all risks applicable to our business, and we intend it only as a summary of certain material factors. If any of the following risks actually occur, our business, financial condition or results of operations could be negatively affected. In that case, the trading price of our stock could decline.

We have a history of operating losses and may incur losses in the future as we expand.

We incurred net losses from our inception until 2003, when we earned net income of $14,667 for the year. Net income increased to $64,753 for the year ended December 31, 2004. However, our net income in 2003 and 2004 was due to the gain recognized on the sales of real property owned by us. For the year ended December 31, 2005, we had a loss of $884,051 and had a loss of $2,441,217 for the year ended December 31, 2006. Therefore, we have not had profitable operations and there can be no assurance that we will be able to achieve and/or maintain profitable operations as we expand. As of December 31, 2006, we have negative working capital of approximately $482,000. Our losses in 2005 included non cash expenses related to our bridge loan of approximately $378,000. Our losses in 2006 included non cash expenses of $1,134,000 also related to our bridge loan.

We intend to expand our business into new areas of operation.

Our business model calls for seeking to acquire existing cash flowing operations and to expand our operations into other areas of business. While we intend to retain our focus on the health care industry, our success will largely depend on our ability to expand into new areas of business within our general industry. As a result, we expect to experience all of the risks that generally occur with expansion into new areas. Many of these risks are out of our control, including risks such as:

- adapting our management systems and personnel into new areas of business;
- integrating new businesses into our structure;

- obtaining adequate financing under acceptable terms;
- where applicable, securing joint venture arrangements with local hospitals, churches, universities, and other entities;
- retention of key personnel, customers and vendors of the acquired business;
- impairments of goodwill and other intangible assets; and
- contingent and latent risks associated with the past operations of, and other unanticipated costs and problems arising in, an acquired business.

If we are unable to successfully integrate the operations of an acquired business into our operations, we could be required to undertake unanticipated changes. These changes could have a material adverse effect on our business.

We may need additional financing to complete our long-term acquisition and expansion plans, and we do not have commitments for additional financing.

To achieve our growth objectives, we will need to obtain sufficient financial resources to fund our expansion, development and acquisition activities. We believe that in addition to the funds from our recent initial public offering, we may need to secure debt financing in order to help us leverage our equity resources and make further acquisitions. As of December 31, 2006 we had an accumulated deficit of $8,950,426 and negative working capital of approximately $482,000. Our cumulative losses have, in the past, made it difficult for us to borrow adequate funds on what management believed to be commercially reasonable terms. To date, we do not have any commitments for such financing and there can be no assurance that adequate financing will be available on terms that are acceptable to us, if at all. In addition, our Board of Directors may elect to use our stock as currency in acquiring additional businesses. If so, our stockholders may experience dilution.

As of December 31, 2006, we were in violation of certain loan covenants, which required us to obtain waivers to cure.

As of December 31, 2006, we were in violation of certain financial covenants with respect to loans with WesBanco Bank. As of December 31, 2006, the aggregate amount of indebtedness owed on these loans was $5,699,504. In March, 2007, we received a waiver of the violations with respect to the loans. Without the existence of the waiver, we would still be in violation of these loan covenants. There is no assurance that we will not violate these covenants in the future, which may trigger cross defaults in a material amount of our outstanding loans.

We currently do not have any lines of credit in place which creates additional risks of not being able to satisfy short-term cash needs.

At the present time, we do not have any lines of credit available to us. Businesses typically use lines of credit to finance short-term and unexpected cash needs. Since we do not have a line of credit currently in place, we are more susceptible to an acute cash deficit. We intend to secure a line of credit and an acquisition credit facility, but we can provide no assurance that a line of credit will be available on acceptable terms, if at all, or that the amount of any line of credit obtained will be sufficient to handle future cash needs as they arise.

Our business is concentrated in Ohio, making it subject to increased risks as a result of potential declines in the Ohio economy.

To date, all of our properties are located within the State of Ohio. In recent years, the economy in the State of Ohio has lagged behind the economic growth in other areas of the country. While we intend to explore expansion into other geographic areas, we are, to some extent, dependent upon the economy of the State of Ohio and the surrounding region. To date, we do not believe that the slow growth of the Ohio economy has negatively impacted our business. However, a substantial downturn in Ohio s economy, could negatively impact our ability to expand operations and may impair our ability to develop, acquire, and operate our residences.

We are engaged in an evolving and highly-regulated industry, which increases the cost of doing business and may require us to change the way our business is conducted.

Health care is an area of extensive and frequent regulatory change. Changes in the laws or new interpretations of existing laws can have a significant effect on methods of doing business, cost of doing business, and amounts of

reimbursements from the government and other payers. Our assisted living residences and nursing homes are subject to regulation and

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licensing by state and local health and social service agencies and other regulatory authorities. We are and will continue to be subject to varying degrees of regulation and licensing by health or social service agencies. A failure to comply with applicable requirements could cause us to be fined or could cause the cessation of our business, which would have a material adverse effect on our company.

The assisted living model for long-term care is relatively new and, accordingly, the manner and the extent to which it is regulated at the federal and state level is evolving. Changes in the laws or new interpretations of existing laws may have a significant effect on our methods and costs of doing business. Our success will depend partially on our ability to satisfy the applicable regulations and requirements and to procure and maintain required licenses. Our operations could also be adversely affected by, among other things, regulatory developments such as mandatory increases in the scope and quality of care given to the residents and revisions in licensing and certification standards. We believe that our operations do not presently violate any existing federal or state laws. But there can be no assurance that federal, state, or local laws or regulatory procedures which might adversely affect our business, financial condition, and results of operations for prospects will not be expanded or imposed.

Changes in the reimbursement rate from methods of payment from Medicare and Medicaid may adversely affect our revenues and operating margins.

For the years ended December 31, 2006 and 2005, Medicare and Medicaid constituted 27% and 51%, respectively, of our total patient care revenues. The health care industry is experiencing a strong trend towards cost containment. In general, the government has sought to impose lower reimbursement and resource utilization group rates, limit the scope of covered services, and negotiate reduced payment schedules with providers. These cost containment measures have generally resulted in reduced rates of reimbursement for the services provided by companies such as ours. Changes to Medicare and Medicaid reimbursement programs have limited, and are expected to continue to limit, payment increases under these programs. Also, the timing of Medicare and Medicaid program payments is subject to regulatory action and governmental budgetary constraints. For example, Medicaid increased the look-back for transferring assets from three years to five years. That is, Medicaid formerly looked back three years to determine whether or not an applicant had transferred assets out of their possession in order to qualify for Medicaid reimbursement. Assets improperly transferred during this three year period would be deemed to be returned to the applicant for purposes of determining eligibility. The net result would be that the applicant would be required to cover more of their healthcare costs before Medicaid would begin reimbursement. Unfortunately, in most instances, the applicant no longer has the assets and therefore the applicant becomes a private pay resident and, in most cases, because they no longer have the assets, it becomes very difficult to collect fees owed to us. The extension of this period from three years to five years will only exacerbate this situation, as it means that participant eligibility will take longer to establish. In addition to extending the look-back, Medicare is progressively reducing the amount of coverage provided for bad debt. In addition, federal and state government agencies may reduce the funds available under those programs in the future or require more stringent utilization and quality review of service providers such as us.

State regulatory changes also affect our business.

The Ohio General Assembly passed a new budget effective July 1, 2005 which, among other things, institutes significant changes in the Medicaid reimbursement formula for nursing homes. Under this new law, the cost reimbursement system, which has been in place since the early 1990 s, will be phased out and replaced with a pricing system that will reward both quality of care and efficiency in management operations. In July 2006, Medicaid began the transition to the new reimbursement system. The transition is expected to take a number of years. Additionally, the State of Ohio has stopped paying co-pays on dually eligible residents. For the time being, the Federal Government has picked up the costs of the co-pays no longer provided by the State of Ohio. We are not certain whether the Federal Government will continue this program in the long run. As a result, should Ohio continue to refuse co-pays on dually eligible residents and the Federal Government should stop such payments; a substantial amount of our co-pays could become uncollectible.

State Certificate of Need laws and other regulations could negatively impact our ability to grow our nursing home business.

The State of Ohio, and other states in which we could expand, have adopted Certificate of Need or similar laws that generally require that a state agency approve certain nursing home acquisitions and determine the need for certain

nursing home bed additions, new services, capital expenditures, or other changes prior to the acquisition or addition of beds or

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services, the implementation of other changes, or expenditure of capital. State approvals are generally issued for specified maximum expenditures and require implementation of the proposal within a specified period of time. Failure to obtain the necessary state approval can result in the inability to provide the service, to operate the centers, to complete the acquisition, addition, or other change, and can also result in sanctions or adverse action on the center s license and adverse reimbursement action. There can be no assurance that we will be able to obtain Certificate of Need approval for all future projects requiring the approval, or that approvals will be timely.

Due to the high-risk circumstances in which we conduct business, we may encounter liability claims in excess of insurance coverage.

The provision of health care services entails an inherent risk of liability. In recent years, participants in the long-term care industry have become subject to an increasing number of lawsuits alleging malpractice or related legal theories, many of which involve large claims and significant defense costs. We currently maintain $1,000,000 in liability insurance for any one exposure. This insurance is intended to cover malpractice and other lawsuits. Although we believe that it is in keeping with industry standards, there can be no assurance that claims in excess of our limits will not arise. Any such successful claims could have a material adverse effect upon our financial condition and results of operations. Claims against us, regardless of their merit or eventual outcome, may also have a material adverse effect upon our ability to attract and retain business. In addition, our insurance policies must be renewed annually and there can be no assurance that we will be able to retain coverage in the future or, if coverage is available, that it will be available on acceptable terms.

We encounter intense competition from competitors, many of whom have greater resources than AdCare.

The long-term care industry is highly competitive and we believe that it will become even more competitive in the future. Our assisted living facilities and nursing homes compete with numerous companies providing similar long-term care alternatives, such as home health care agencies, community-based service programs, retirement communities and convalescent centers, and other assisted living providers. We compete with national companies such as HCR Manor Care, Alterra and Extended Care with respect to both our nursing home and assisted living facilities. We also compete with locally owned entities as well as Health Care Facilities-HCF on a regional basis. Historically, we have found that the entry of one or more of these competitors into one of our established markets can reduce both our occupancy and the rates we were able to charge to our customers. In the past, we have found national publicly traded competitors who are willing to enter into a market already served by us. When these competitors experienced lower than expected occupancies, they relied on their greater financial resources to reduce their rates in order to increase occupancy. This resulted in our occupancies decreasing below expected levels. Eventually, demographics improved and rates stabilized. However, there can be no assurance that similar events will not occur in the future which could limit our ability to attract residents or expand our business and that could have a negative effect on our financial condition, results of operations, and prospects. We can provide no assurance that competitive pressures will not have a material adverse effect on us.

The home health care business is also highly competitive. Since we first acquired Assured Health Care in 2005, its operations remain relatively centralized in the Dayton, Ohio area. However, in that area, Assured faces competition from several sources including, without limitation, Fidelity Nursing Home Systems, Kettering Network Home Care, GEM City Home Care, Greene Memorial Hospital Home Care, and Community Springfield.

Our business is very labor intensive, we operate in smaller markets with limited personnel resources, and our success is tied to our ability to attract and retain qualified employees.

We compete with other providers of home health care, nursing home care, and assisted living with respect to attracting and retaining qualified personnel. We depend on the availability of Registered Nurses and Licensed Practical Nurses to provide skilled care to our nursing home residents. According to the Ohio Hospital Association, the supply of nurses nationwide is predicted to be 800,000 short of demand by 2020. Because of the small markets in which we operate, shortages of nurses and/or trained personnel may require us to enhance our wage and benefit package in order to compete and lure qualified employees from more metropolitan areas. To date, we have been able to adequately staff all of our operations. However, we can provide no assurance that our labor costs will not increase, or that, if they do increase, they can be matched by corresponding increases in revenues.

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We are dependent on our management team and the loss of any of these individuals would harm our business.

Our future success depends largely upon the management experience, skill, and contacts of our officers and directors, in particular, David A. Tenwick, our Chairman, Gary L. Wade, our President and CEO, and J. Michael Williams, our Executive Vice President and COO. Mr. Wade, Mr. Williams, and Mr. Tenwick have each signed employment contracts that are effective through April 2008. Loss of the services of any or all of these officers could be materially detrimental to our operations. In addition, due to the location of our corporate headquarters in a smaller urban region, we may experience difficulty attracting senior managers in the future. At the present time, we do not have any key man life insurance on any of these officers.

Our business is largely dependent on short-term management contracts that may not be renewed from year to year.

For the years ended December 31, 2006, and December 31, 2005, approximately 7.5% of our total revenues were generated from management contracts to manage senior living and long-term care facilities. These contracts generally have terms of three years with options to renew at the end of the term. Each contract can be terminated without cause by either party on nine months notice and may be terminated earlier for cause. While we had 100% renewal of the contracts which were up for renewal in 2005 and 2006, there can be no assurance that the contracts will be renewed at the end of the present terms, or that our customers will not exercise their ability to terminate the contracts earlier. Our home healthcare business enters into one year contracts with various agencies to provide home care services to clients and members of those agencies. These contracts are renewable annually and, while 100% of the contracts were renewed for the years ended December 31, 2006 and 2005, there can be no assurance that existing contracts will be renewed in 2007 or later.

We own multiple parcels of real estate and could be subject to environmental liability for hazardous substances found on any of those parcels, whether or not we caused the contamination.

While we are not aware of any potential problems at this time, we own multiple parcels of real estate, each of which is subject to various federal, state, and local environmental laws, ordinances, and regulations. Many of these laws and regulations provide that a current or previous owner of real property may be held liable for the cost of removing hazardous or toxic substances, including materials containing asbestos that would be located on, in, or under the property. These laws and regulations often impose liability whether or not the owner or operator knew, or was responsible for, the presence of the hazardous or toxic substances. The cost of the removal is generally not limited under the laws and regulations and could exceed the property s value and the aggregate assets of the owner or operator. The presence of these substances or failure to remediate such substances properly may also adversely affect the owner s ability to sell or rent the property or to borrow using the property as collateral. If any of our properties were found to have environmental issues, we may be required to expend significant amounts to rehabilitate the property and we may be subject to significant liability.

The price of our securities may be subject to fluctuation.

The market price of our common stock and warrants will likely be highly volatile and subject to wide fluctuations in response to various factors, many of which are beyond our control. These factors include:

- variations in our operating results;
- changes in the general economy, and more specifically the Ohio economy or in the local economies in which we operate;
- the departure of any of our key executive officers and directors;
- the level and quality of securities analysts coverage for our common stock;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- changes in the federal, state, and local health-care regulations to which we are subject; and

future sales of our common stock.

For these reasons, comparing our operating results on a period-to-period basis may not be meaningful, and you should not rely on past results as an indication of future performance.

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Our management substantially controls all major decisions.

Our directors and officers beneficially own approximately 18% of our outstanding common shares. Therefore, our directors and officers will be able to influence major corporate actions required to be voted on by stockholders, such as the election of directors, the amendment of our charter documents, and the approval of significant corporate transactions such as mergers, reorganizations, sales of substantially all of our assets, and liquidation. Furthermore, our directors will be able to make decisions affecting our capital structure, including decisions to issue additional capital stock, implement stock repurchase programs and incur indebtedness. This control may have the effect of deterring hostile takeovers, delaying or preventing changes in control or changes in management, or limiting the ability of our other stockholders to approve transactions that they may deem to be in their best interest.

As we expand our operations, we may open or manage facilities that are geographically near other facilities that we operate or manage.

While the facilities that we own and manage are sufficiently well-spaced so that they do not currently compete for business, there can be no assurance in the future, as we grow, that circumstances will not arise where facilities which we own and/or manage will compete with each other for patients. If this were to occur, it may damage our relationships with facilities that we manage that could result in the termination of our management agreements.

The requirements of being a public company may strain our resources and distract our management.

As a public company, we are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and the Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act. These requirements may place a strain on our systems and resources. The Exchange Act requires that we file annual, quarterly and current reports with respect to our business and financial condition. The Sarbanes-Oxley Act requires that we maintain effective disclosure controls and procedures and internal controls for financial reporting. We will be required to document and test our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires annual management assessments of the effectiveness of our internal controls over financial reporting and a report by our independent registered public accountants addressing these assessments. During the course of our testing, we may identify deficiencies which we may not be able to remediate in time to meet the deadline imposed by the Sarbanes-Oxley Act for compliance with the requirements of Section 404. We will be required to comply with the requirements of Section 404 for our fiscal year ended December 31, 2007. In addition, if we fail to achieve and maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act.

In order to maintain and improve the effectiveness of our disclosure controls and procedures and internal control over financial reporting, significant resources and management oversight will be required. This may divert management s attention from other business concerns, which could have a material adverse effect on our business, financial condition, results of operations and cash flows. In addition, we may need to hire additional accounting and financial staff with appropriate public company experience and technical accounting knowledge, and we cannot assure you that we will be able to do so in a timely fashion.

Takeover defense provisions may adversely affect the market price of our common stock.

Various provisions of Ohio corporation law and of our corporate governance documents may inhibit changes in control not approved by our Board of Directors and may have the effect of depriving you of an opportunity to receive a premium over the prevailing market price of our common stock in the event of an attempted hostile takeover. In addition, the existence of these provisions may adversely affect the market price of our units, warrants, and common stock. These provisions include:

- a requirement that special meetings of stockholders be called by our Board of Directors, the Chairman, the President, or the holders of shares with voting power of at least 25%;
- staggered terms among our directors with these classes of directors and only one class to be elected each year;
- advance notice requirements for stockholder proposals and nominations; and

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availability of blank check preferred stock.

Provisions in our bylaws provide for indemnification of officers and directors, which could require us to direct funds away from our business and future products.

Our Articles of Incorporation and Code of Regulations provide for the indemnification of our officers and directors. We may be required to advance costs incurred by an officer or director and to pay judgments, fines and expenses incurred by an officer or director, including reasonable attorneys fees, as a result of actions or proceedings in which our officers and directors are involved by reason of being or having been an officer or director of our company. Funds paid in satisfaction of judgments, fines and expenses may be funds we need for the operation of our business and the development of our product candidates, thereby affecting our ability to attain or maintain profitability.

Item 2. Properties

Our corporate office is located in Springfield, Ohio. We own the office building, which contains approximately 7,200 square feet of office space. We believe that we will need additional office space in the near future and that suitable office space is available in the Springfield area. We own additional land on which we could expand our office facilities. This property is subject to debt in the amount of $221,071 (as of December 31, 2006) which matures on June 1, 2013.

Community s Hearth & Home, Ltd., is an Ohio limited liability company that owns three assisted living properties. We own 50% of this entity and our partner, Community Mercy Health Partners, a hospital group, owns the remaining 50%. The three properties owned by this entity are each subject to a mortgage of $3,725,000 (as of December 31, 2006) which matures December 22, 2022.

Hearth & Home at Harding is a free standing, single story assisted living facility, comprised of 11,711 square feet of space. The central core of common living area of the home includes a living room, family room, dining room, kitchen, activity room, and laundry room with 10 separate bedrooms with baths on each side of the central core for a total of 20 bedrooms (including 8 one bedroom units). The facility is located on 1.25 acres in Springfield, Ohio. Springfield is a community in southwestern Ohio.

Hearth & Home at El Camino is a duplicate copy of Hearth & Home at Harding also located in Springfield, Ohio. The facility is dedicated to providing Alzheimer s care for its residents.

Hearth & Home at Urbana was a duplicated copy of Hearth & Home at Harding and El Camino. However, the facility was expanded in 2003 to add 12 more bed rooms, public area and parking spaces now totaling 20,180 square feet of space. The assisted living facility is located on 2 acres in Urbana, Ohio. Urbana is a community located in southwestern Ohio.

Hearth & Home at Van Wert is a free standing single story assisted living facility, comprised of 25,571 square feet of space and is owned by Hearth & Home of Van Wert, Ltd., an Ohio limited liability company. The facility is designed with 15 residential bedrooms (30 total bedrooms) grouped into two clusters around community living spaces, including family kitchen, dining, laundry and a hearth room. There is a main kitchen and the living clusters are connected by a large interior atrium. The assisted living facility is located on 3 acres in Van Wert, Ohio. Van Wert is a community in northwestern Ohio. We own 48.5% of the limited liability company with the remaining 51.5% owned by individual investors, located primarily in Van Wert. This property is subject to a mortgage in the amount of $1,975,504 (as of December 31, 2006) which matures on January, 2026.

Hearth & Home at Vandalia is a free standing single story assisted living facility, comprised of 29,431 square feet of space. The facility is designed with 15 residential bedrooms (45 total bedrooms) grouped into three clusters around community living spaces, including family kitchen, dining, laundry and hearth room. There is a main kitchen and the living clusters are connected by a large interior atrium. The assisted living facility is located on 4 acres in Vandalia, Ohio. Vandalia is a community located on the north side of the city of Dayton, Ohio. This property is subject to a mortgage in the amount of $3,646,490 (as of December 31, 2006) which matures on May, 2041.

The Pavilion is a 62-bed nursing home located on 4 acres of land in Sidney, Ohio. The nursing home is a single story building that is licensed for 62 beds and has a gross building area of 16,151 square feet. The building is constructed in the form of a cross, with resident rooms in three of the wings and the nurses station at the center of the cross. The

fourth wing

of the building contains the dining room and activity area, kitchen, laundry and other staff operations areas. The 62 resident beds are dually certified for Medicaid and Medicare. Sidney is a community located in northwestern Ohio. This property is subject to a mortgage in the amount of $2,017,677 (as of December 31, 2006) which matures on June, 2022.

Hearth & Care at Greenfield is a 50-bed single story nursing home, located on approximately one half acre, in Greenfield, Ohio. The property is a residential home that was converted and expanded into 40-nursing beds all located on the first floor. The property is in the process of again being improved with the addition of 10 private bedrooms, new kitchen, laundry, activity and therapy rooms and a new front entrance and nurses station totaling 10,550 square feet. When completed, scheduled for the second quarter of 2007, the total square footage will be approximately 29,000 square feet of space. The 50 resident beds are dually certified for Medicaid and Medicare. Greenfield is a community located in southern Ohio. This property is currently being rehabilitated and will be subject to a mortgage in the amount of $1,412,000 upon completion. This lien will mature March 2030. The outstanding principal amount as of December 31, 2006 was $1,412,000. This project is currently over budget and behind schedule for completion. Due to several change orders, weather delays and increased costs of construction, an additional $620,000 is required to complete the expansion. We are working with a bank to refinance the construction loan and provide additional funds to complete the project; however, in the meantime, the Company is providing the funds to complete the improvements scheduled for completion by July 1, 2007.

Pursuant to a ten-year lease which began March 1, 2003, we lease 100% of The Covington Care Center, a 106-bed single story nursing home located in Covington, Ohio. This is a net lease in which we lease the entire facility including the building and equipment. We also manage this facility and all revenues collected in excess of the lease costs and operating expenses represent our profits with respect to this facility. The building is a long, rectangular building containing 31,048 square feet of space. It has several nurses stations, dining, laundry, kitchen, activity, therapy, and several other rooms along with administrative offices. The 106 resident beds are dually certified for Medicaid and Medicare. The nursing home is located in Covington, Ohio, a community located in western Ohio. Our lease payments are $620,000 per year and we have an option to purchase the property after five years at the greater of $5,500,000 or the then fair market value. In the event we do not acquire the facility, the annual lease payment will increase to $650,000 per year for the remaining five years of the ten year lease beginning in March 2008.

We believe that all of our properties are well maintained and suitable for the services we provide in them and that they are adequately covered by insurance.

Portfolio of Owned and Managed Facilities

SKILLED NURSING FACILITIES (SNF)	BEDS	FACILITIES DEVELOPED BY ADCARE	% OWNED	MANAGE	2005 OCCUPANCY (3)	2006 OCCUPANCY (3)
Covington Care Center, Covington, OH (2)	106			X	85%	83%
Koester Pavilion, Troy, OH	150			X	97%	97%
The Pavilion, Sidney, OH	62		100%	X	85%	83%
The Health Center at SpringMeade, Tipp City, OH	99	X		X	98%	99%
Valley View Alzheimer s Center, Frankfort, OH	50			X	95%	98%
Hearth & Care at Greenfield, Greenfield, OH	50		100%	X	78%	89%

ASSISTED LIVING FACILITIES (ALF)	BEDS	FACILITIES DEVELOPED BY ADCARE	% OWNED	MANAGE	2005 OCCUPANCY (3)	2006 OCCUPANCY (3)
Hearth & Home at Harding, Springfield, OH	20	X	50%	X	90%	88%

Hearth & Home at Urbana, Urbana, OH	32	X	50%	X	92%	73%
Hearth & Home at Friedman Village, Tiffin OH	20	X		X	79%	95%
Hearth & Home at El Camino, Springfield, OH	20	X	50%	X	94%	77%
Hearth & Home at Van Wert, Van Wert, OH	30	X	48.5%	X	88%	77%
Hearth & Home at Vandalia, Vandalia, OH	45	X	100%	X	91%	95%
Legacy Assisted Living Xenia, OH	22	X		X	(4)	29%

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INDEPENDENT LIVING FACILITIES (ILF)	BEDS	FACILITIES DEVELOPED BY ADCARE	% OWNED	MANAGE	2005 OCCUPANCY[3]	2006 OCCUPANCY[3]
SpringMeade Residence, Tipp City, OH	83	X		X	98%	98%
Friedman Village, Tiffin, OH	34	X		X	65%	69%

(1) *These represent facilities in which we acted in the traditional capacity of a real estate developer overseeing the entire project from acquisition of the land through construction and operation of the facility.*

(2) *Net Lease in which we pay rent plus taxes, insurance and maintenance on the property.*

(3) *Average occupancy for the year ended December 31, 2005 and December 31, 2006.*

(4) *Legacy Village was not open in 2005 and began admitting residents during 2006.*

Item 3. Legal Proceedings

We are not currently involved in any material litigation. We may from time to time become a party to various legal proceedings arising in the ordinary course of our business.

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

Not applicable.

PART II

Item 5. Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities.

Our units began trading on the American Stock Exchange on November 10, 2006, under the symbol ADK.U . Each unit consisted of two shares of common stock and two five year warrants for two shares of common stock. The units stopped trading and the common stock and the warrants began to trade separately on December 21, 2006, with the common stock under the symbol ADK and the warrants under the symbol ADK.WS .

The high, low and closing prices of our stock on the American Stock Exchange and dividends declared and paid during 2006 were as follows:

ADK	High	Low	Close	Cash Dividends
2006 Fourth Quarter	$3.75	$2.80	$2.80	None

ADK.WS	High	Low	Close	Cash Dividends
2006 Fourth Quarter	$.50	$.25	$.40	None

On December 31, 2006, we had 432 stockholders of record.

We have never paid cash dividends on our common shares. Holders of common shares are entitled to receive dividends. Our ability to pay dividends will depend upon our future earnings and net worth. We are restricted by Ohio law from paying dividends on any of our outstanding shares while insolvent or if such payment would result in a reduction of our stated capital below the required amount.

It is the intention of our Board periodically to consider the payment of dividends, based on future earnings, operating and financial condition, capital requirements and other factors deemed relevant by the Board. There is no assurance that we will be able or will desire to pay dividends in the near future or, if dividends are paid, in what amount. Our Board may decide not to pay dividends in the near future, even if funds are legally available, in order to provide us with more funds for operations.

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For the year ended December 31, 2006, there were no sales of unregistered securities. Additionally, we did not repurchase any equity securities of the Company.

Use of Proceeds

Our initial public offering was co-underwritten by Newbridge Securities Corporation and Joseph Gunnar & Co, LLC. Our offering consisted of 703,000 units. Each unit consisted of two shares of our common stock and two five-year warrants each to purchase one share of our common stock. Our net proceeds from the sale and issuance of 703,000 units was $5,742,865, based upon an initial public offering price of $9.50 per unit and after deducting the estimated underwriting discount, the non-accountable expense allowance and the estimated offering expenses payable by us. The following table contains a reasonable estimate of the expenses incurred in this offering and the subsequent use of proceeds at the conclusion of the offering:

Gross offering proceeds (703,000 units x $9.50 per unit)		$ 6,678,500
Underwriting discounts and commissions	534,280.00	
Underwriter s expenses	226,354.12	
Other expenses (1)	175,000.00	
Total Expenses		935,634.12
Net offering proceeds		5,742,865.88
Repayment of indebtedness	2,082,152.00	
Legal and accounting fees related to this offering	696,701.56	
Working capital	936,146.44	
Cash held in money market account	1,527,865.88	
Cash held in interest bearing saving account	500,000.00	
Net proceeds unaccounted for		$ 0.00

(1) Other expenses consist of $75,000 paid to Newbridge Securities Corporation for as a consulting fee in connection with their Financial Advisory Agreement. $100,000 represents our purchase of the warrants held by Newbridge Securities Corporation pursuant to the underwriting agreement.

In accordance with the terms and conditions contained in the underwriting agreement, we agreed to sell to the representatives of our initial public offering, for $100, options to purchase up to a total of 5% of the units sold. Each unit consisting of two shares of stock and two warrants for two shares of stock. Therefore, 35,150 unit options were issued at the closing of our initial public offering on November 9, 2006. These options are exercisable at an exercise price of $11.875 (125% of the offering price) per unit commencing on November 9, 2007 and ending on November 9, 2011. We have valued the unit options, using the Black-Scholes option pricing model, at approximately $102,000. The issuance of the options and the related expense, which was treated as a cost of the offering, were both offsetting adjustments to additional paid in capital. The warrants are exercisable commencing on November 9, 2007 and ending on November 9, 2011 at an exercise price equal to 125% of exercise price of the warrants in the units in the offering or $6.75 per warrant.

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Equity Compensation Plan Information

The following table sets forth additional information as of December 31, 2006, concerning shares of our common stock that may be issued upon the exercise of options and other rights under our existing equity compensation plans and arrangements, divided between plans approved by our shareholders and plans or arrangements not submitted to the shareholders for approval. The information includes the number of shares covered by, and the weighted average exercise price of, outstanding options and other rights and the number of shares remaining available for future grants excluding the shares to be issued upon exercise of outstanding options, warrants, and other rights.

	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity compensation plans approved by security holders (1)	80,640	$ 2.50	5,800
Equity compensation plan not approved by security holders (2)	0	$ 0.00	200,000

(1) The total number of shares available under the option plan is 120,000. The options were granted in August 2004 and vest over a five year period contingent on continued employment. At December 31, 2006, 80,640 options had vested with an additional 18,780 remaining to

vest. Due to separation of employment, 14,800 options have been forfeited during the five year vesting period.

(2) We have a stock option plan effective September, 2005. To date, no options have been granted under this plan.

Item 6. Management s Discussion and Analysis or Plan of Operation

Overview

We are a Springfield, Ohio, based developer, owner and operator of nursing homes, assisted living facilities and retirement communities. We also provide development, consulting and accounting services to hospitals, churches, universities and other parties interested in pursuing long-term care initiatives. We currently manage 15 facilities with over 800 total beds, comprised of six skilled nursing centers, seven assisted living residences and two independent living/senior housing facilities. Of these properties, we own two of the skilled nursing centers totaling 112 beds, lease a third totaling 106 beds, own one assisted living residence totaling 45 beds, own 48.5% of another assisted living facility with 30 beds, and own 50% of three assisted living residences totaling 72 beds. The rest of the properties are managed on behalf of third-party owners (including a hospital and a university). All of the properties are located in Ohio.

In recent years, we observed the trend that more seniors were staying in their homes for a longer period of time prior to moving into a long-term care setting. We have also observed that more seniors are using nursing and assisted living facilities for short rehabilitation stays and then moving back to their homes. We have taken advantage of this opportunity and expanded our operations to provide personal care and health care services in the home. Accordingly, in January, 2005, we acquired Assured Health Care, a home health care service provider located in Dayton, Ohio. Assured has been providing home health care services in the greater Dayton area for 10 years. In April, 2005, we opened a satellite office of Assured in Springfield, Ohio; and our expansion plans call for opening additional offices in areas where our properties are located.

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The table set forth below shows the Net Income (Loss) from both our management and facility-based care operation and our home based care operation for the years ended December 31, 2006 and 2005.

	(Amounts in 000s)					
	Manage-ment and Facility Based Care	Home Based Care	Total Segments	Discon-tinued operations	Cor-porate	Total
Year ended December 31, 2006:						
Net Revenue	21,329	2,804	24,133		(1,584)	22,549
Net Profit (Loss)	(2,431)	17	(2,414)	(27)		(2,441)
Total Assets	22,109	2,392	24,501	885		25,386
Capital Spending	1,020	6	1,026			1,026
Year ended					n"	
December 31, 2005:					SIZE="2">46,755	(5,110)

Effect of exchange rate changes on cash and cash equivalents	63	(259)
(Decrease) Increase in cash and cash equivalents	(1,101)	2,318
Cash and cash equivalents at beginning of period	3,831	8,609
Cash and cash equivalents at end of period	$ 2,730	$ 10,927

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(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

See Notes to Condensed Consolidated Financial Statements

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SCANS *OURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(1) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Scan*Source*, Inc. (the Company) have been prepared by the Company s management in accordance with generally accepted accounting principles for interim financial information and applicable rules and regulations of the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for annual financial statements. The unaudited condensed consolidated financial statements included herein contain all adjustments (consisting of normal recurring adjustments) which are, in the opinion of management, necessary to present fairly the financial position as of December 31, 2006 and June 30, 2006, the results of operations for the quarters and six months ended December 31, 2006 and 2005 and the statement of cash flows for the six months ended December 31, 2006 and 2005. The results of operations for the quarters and six months ended December 31, 2006 and 2005 are not necessarily indicative of the results to be expected for a full year. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

(1A.) Special Committee Review of Past Stock Option Granting Practices

On October 9, 2006, the Company announced that the Company s Board of Directors had appointed a Special Committee, comprised solely of independent directors who were not members of the compensation committee during the review period (the Special Committee), to conduct a review of the Company s stock option grant practices and related accounting issues from the time of its initial public offering in 1994 to the present. The Special Committee was assisted in its review by independent legal counsel and advisors. During the three month investigation, the Special Committee and its independent counsel, assisted by independent forensic accountants, reviewed the facts and circumstances surrounding stock option grants made to executive officers, employees and non-employee directors, searched relevant physical and electronic documents and interviewed current and former directors, officers and employees.

On January 19, 2007, the Company announced that the Board of Directors had received the findings of the Special Committee from its review of the Company s stock option grant practices and related accounting issues. In conjunction with these findings, the Board also received from the Special Committee, and approved, recommendations with respect to the Company s stock option grant process. For more information regarding the Special Committee s findings, see Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement related to stock options of, and Note 1A to the Notes to Consolidated Financial Statements included in the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006. The Special Committee also, in its findings, recommended that management determine the impact on the Company s accounting for the options grants referenced in the findings and make appropriate adjustments and required disclosures.

On April 20, 2007, the Company announced that the Company s management had completed the analysis called for by the Special Committee and had reached a determination that, under applicable accounting principles, the appropriate measurement dates for certain stock options differed from the recorded measurement dates for certain stock option grants. The Company announced that it expected the difference in these measurement dates would result in non-cash, stock based compensation expenses and that it was expected that, as a result of the effects on previously reported financial statements, restatements would be required for certain periods.

The Company also announced on April 20, 2007 that its Board of Directors determined that the Company s previously issued financial statements included in its Annual Report on Form 10-K for the fiscal year ended June 30, 2006, and perhaps financial statements for earlier periods, including other historical financial information, related disclosures and applicable reports of its independent registered public accounting firm, should no longer be relied upon, and that the Company would restate previously issued financial statements as necessary.

On May 15, 2007, the Company announced that its Board of Directors had determined, in consultation with the

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Company s management and its independent registered public accounting firm, and based on guidance recently issued by the Office of Chief Accountant of the SEC regarding restatements relating to accounting for stock option grants, that the restatement of the Company s financial statements would include a restatement of financial statements for fiscal years 2004, 2005 and 2006 and restated quarterly financial information for fiscal 2005 and 2006 quarters (in addition to the other disclosures set forth in the referenced guidance, as applicable) and that accordingly, such annual and quarterly financial statements should no longer be relied upon. Further, with respect to financial statements for all earlier periods, the restatement would effect financial statements for prior fiscal years, and, based on the referenced SEC guidance, those adjustments would be reflected in selected financial data for fiscal years ended June 30, 2002 and 2003 with columns labeled restated , and as part of the opening balances for the fiscal year ended June 30, 2004.

Accordingly, as a result of the findings of the Special Committee and the results of management s accounting analysis, the Company has, concurrent with this filing, filed an amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006 to restate its financial statements included therein, consistent with the foregoing guidance. See Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement related to stock options of, and Note 1A to the Notes to Consolidated Financial Statements included in such amended Annual Report on Form 10-K/A for more information.

The Company has reviewed stock option grant practices and as a result has determined that for certain of its grants the appropriate measure date differed from the recorded measurement date. As a result, the Company performed an accounting analysis which resulted in the restatement of compensation expense related payroll taxes, and resulting income tax.

In accordance with Accounting Principles Board (APB) Statement No. 25, *Accounting for Stock Issued to Employees*, and Financial Accounting Standards Board (FASB) Statement No. 123(R) for fiscal year 2006, the restated consolidated financial statements reflect additional compensation expense to the extent the fair market value of a share of common stock on the correct measurement date exceeded the exercise price of the option. The additional non-cash compensation expense was amortized over the required service period, which was generally the vesting period of each respective grant.

The restatement has resulted in additional stock-based compensation expense and other expenses related to audit adjustments partially offset by income tax benefits, as follows:

Restatement expense by period
(in thousands)

Fiscal year ended June 30,	Compensation adjustments	Related income tax expense (benefit)	Audit adjustments	Related income tax expense (benefit)	Total restatement net of tax
1995	$ 16	$ (6)			$ 10
1996	20	(8)			12
1997	129	(49)			80
1998	191	(63)			128
1999	605	(216)			389
2000	690	(213)			477
2001	908	(282)			626
2002	1,255	(259)			996
2003	1,426	(290)	185	(70)	1,251
Subtotal	5,240	(1,386)	185	(70)	3,969
2004	666	(57)	407	(154)	862
2005	1,158	(340)	(1,112)	422	128
2006	(82)	29	534	(187)	294

Total through June 30, 2006	$ 6,982	$ (1,754)	$ 14	$ 11	$ 5,253

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The restatement is comprised of (i) $5.3 million of additional non-cash stock option compensation, (ii) an additional expense associated with payroll taxes of $1.6 million related to exercises of stock options for the same periods, and (iii) because the Company receives a tax deduction upon the exercise of employee stock options that were granted in the money, an income tax benefit of $1.7 million, resulting in a cumulative after tax adjustment to reduce net income over the period 1995 to 2006 by $5.3 million. Additionally, the audit adjustments described below in Restatement related to audit differences impact the restatement by $25,000. The expected impact of the restatement on fiscal year 2007 and future years is approximately $0.7 million of additional stock option expense although this amount may decrease if future forfeitures are greater than anticipated forfeitures. No single year impact is material for fiscal year 2007 and future years.

The cumulative after tax adjustment for fiscal years 1995 through 2003 subtotaled above is included in the restated fiscal year 2004 balance sheet as a reduction in retained earnings

As part of the restatement process, management reviewed any other items in our previously issued financial statements which it believed should be corrected. There were two additional adjustments as of our fiscal 2006 year end audit; one related to the overstatement of the allowance for doubtful accounts and the other related to an understated accrual for value added tax on goods and services. The aggregate adjustments for these items decreased net income by $25,000. For the fiscal year ended June 30, 2006, net income decreased $330,000; for fiscal year ended June 30, 2005, net income increased $689,000; for fiscal year ended June 30, 2004, net income decreased $250,300, and for fiscal year 2003 and prior fiscal years, net income decreased $115,100.

The table below shows the effect of the restatement adjustments on our previously reported condensed consolidated balance sheet for June 30, 2006.

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Consolidated Condensed Balance Sheets (Unaudited)

(in thousands)

	June 30, 2006			
	As previously reported	Restatement adjustments	Audit adjustments	Restated
Assets				
Current assets:				
Cash and cash equivalents	$ 3,831	$	$	$ 3,831
Trade and notes receivable:				
Trade, less allowance of $14,008, (11,508 restated)	297,740		2,500	300,240
Other	4,558			4,558
Inventories	244,005			244,005
Prepaid expenses and other assets	2,293			2,293
Prepaid taxes				
Deferred income taxes	14,659	300	750	15,709
Total current assets	567,086	300	3,250	570,636
Property and equipment, net	27,098			27,098
Goodwill	14,404			14,404
Other assets, including identifiable intangible assets	4,631	1,473	(745)	5,359
Total assets	$ 613,219	$ 1,773	$ 2,505	$ 617,497
Liabilities and Shareholders Equity				
Current liabilities:				
Current portion of long-term debt	$ 229	$	$	$ 229
Short-term borrowings				
Trade accounts payable	271,519			271,519
Accrued expenses and other liabilities	26,170	1,677	2,512	30,359
Income taxes payable	5,072	1,269	17	6,358
Total current liabilities	302,990	2,946	2,529	308,465
Deferred income taxes				
Long-term debt	4,398			4,398
Borrowings under revolving credit facility	27,558			27,558
Other long-term liabilities	2,757			2,757
Total liabilities	337,703	2,946	2,529	343,178
Minority interest	910			910
Shareholders equity:				
Preferred stock, no par value; 3,000,000 shares authorized, none issued				
Common stock, no par value; 45,000,000 shares authorized, 25,725,214 shares issued and outstanding	72,860	4,055		76,915

Retained earnings	197,129	(5,228)	(25)	191,876
Accumulated other comprehensive income	4,617		1	4,618
Total shareholders equity	274,606	(1,173)	(24)	273,409
Total liabilities and shareholders equity	$ 613,219	$ 1,773	$ 2,505	$ 617,497

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table shows the impact of the restatement adjustments described above on the previously reported consolidated condensed statement of income for the quarter and six months ended December 31, 2005.

Condensed Consolidated Income Statements (Unaudited)
(in thousands, except per share data)

	Quarter ended December 31, 2005				Six months ended December 31, 2005			
	As previously reported	Restatement adjustments	Audit adjustments	Restated	As previously reported	Restatement adjustments	Audit adjustments	Restated
Net sales	$ 408,468	$	$	$ 408,468	$ 798,864	$	$	$ 798,864
Cost of goods sold	366,633			366,633	716,700			716,700
Gross profit	41,835			41,835	82,164			82,164
Operating expenses:								
Selling, general and administrative expenses	26,272	209	305	26,786	51,281	464	488	52,233
Operating income	15,563	(209)	(305)	15,049	30,883	(464)	(488)	29,931
Other expense (income):								
Interest expense	455			455	966			966
Interest income	(155)			(155)	(304)			(304)
Other, net	(62)		(6)	(68)	(110)		70	(40)
Total other expense (income)	238		(6)	232	552		70	622
Income before income taxes and minority interest	15,325	(209)	(299)	14,817	30,331	(464)	(558)	29,309
Provision for income taxes	6,024	(82)	(118)	5,824	11,637	(177)	(215)	11,245
Income before minority interest	9,301	(127)	(181)	8,993	18,694	(287)	(343)	18,064
Minority interest in income of consolidated subsidiaries, net of income tax expense	51			51	110		(1)	109
Net income	$ 9,250	$ (127)	$ (181)	$ 8,942	$ 18,584	$ (287)	$ (342)	$ 17,955
Per share data:								
Net income per common share, basic	$ 0.36	$	$ (0.01)	$ 0.35	$ 0.73	$ (0.01)	$ (0.01)	$ 0.71
Net income per common share, assuming dilution	$ 0.35	$	$ (0.01)	$ 0.34	$ 0.71	$ (0.01)	$ (0.01)	$ 0.69

Weighted-average shares outstanding, basic	25,402		25,402	25,367		25,367
Weighted-average shares outstanding, assuming dilution	26,135	(141)	25,994	26,085	(141)	25,944

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table shows the impact of the restatement adjustments described above on certain line items of the previously reported consolidated condensed statement of cash flows for the six months ended December 31, 2005.

Condensed Consolidated Statements of Cash Flows (Unaudited)

(in thousands)

	Six Months Ended December 31, 2005			
	As previously reported	Restatement adjustments	Audit adjustments	Restated
Cash flows from operating activities:				
Net income	$ 18,584	$ (287)	$ (342)	$ 17,955
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation	2,743			2,743
Amortization of intangible assets	101			101
Allowance for accounts and notes receivable	1,602		10	1,612
Share-based compensation and restricted stock	1,827	243		2,070
Impairment of capitalized software				
Deferred income tax (benefit) expense	544	(269)		275
Excess tax benefits from share-based payment arrangements	(1,125)	(241)		(1,366)
Minority interest in income of subsidiaries	110		(1)	109
Changes in operating assets and liabilities, net of acquisitions:				
Trade and notes receivable	(37,582)			(37,582)
Other receivables	400			400
Inventories	(13,112)			(13,112)
Prepaid expenses and other assets	(1,778)			(1,778)
Other noncurrent assets	4,642			4,642
Trade accounts payable	35,056			35,056
Accrued expenses and other liabilities	1,292	222	548	2,062
Income taxes payable	(1,554)	91	(214)	(1,677)
Net cash (used in) provided by operating activities	11,750	(241)	1	11,510
Cash flows used in investing activities:				
Capital expenditures	(2,475)			(2,475)
Cash paid for business acquisitions, net of cash acquired	(1,348)			(1,348)
Net cash used in investing activities	(3,823)			(3,823)
Cash flows from financing activities:				
Increases (decreases) in short-term borrowings, net	(4,478)			(4,478)
Advances (payments) on revolving credit, net	(1,384)			(1,384)
Exercise of stock options	1,096		(1)	1,095
Excess tax benefits from share-based payment arrangements	1,125	241		1,366
Advances (repayments) of long-term debt borrowings	(1,709)			(1,709)

Net cash provided by (used in) financing activities	(5,350)	241	(1)	(5,110)
Effect of exchange rate changes on cash and cash equivalents	(259)			(259)
(Decrease) Increase in cash and cash equivalents	2,318			2,318
Cash and cash equivalents at beginning of period	8,609			8,609
Cash and cash equivalents at end of period	$ 10,927	$	$	$ 10,927

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

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(2) Business Description

The Company is a leading wholesale distributor of specialty technology products, providing value-added distribution sales to resellers in the specialty technology markets. The Company has two geographic distribution segments: one serving North America from the Memphis, Tennessee distribution center, and an international segment currently serving Latin America (including Mexico) and Europe from distribution centers located in Florida and Mexico, and in Belgium, respectively. The North American distribution segment markets automatic identification and data capture (AIDC) and point-of-sale (POS) products through its Scan*Source* sales unit; voice, data and converged communications equipment through its Catalyst *Telecom* sales unit; voice, data and converged communications products through its Para*con* sales unit; video conferencing and telephony products through its T2 Supply unit; and electronic security products through its Scan*Source* Security Distribution unit. The international distribution segment markets AIDC and POS products through its Scan*Source* sales unit.

(3) Summary of Significant Accounting Policies and Accounting Standards Recently Issued

Stock Split

Effective June 5, 2006, the Board of Directors of the Company approved a two-for-one stock split of the common stock effected in the form of a 100% common stock dividend. All shares and per share amounts have been retroactively adjusted to reflect the stock split.

Consolidation Policy

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant inter-company accounts and transactions have been eliminated.

Minority Interest

Minority interest represents that portion of the net equity of majority-owned subsidiaries of the Company held by minority shareholders. The minority shareholders share of the subsidiaries income or loss is listed separately in the Condensed Consolidated Income Statements. Effective July 1, 2006, the Company acquired an additional 8% of Netpoint International, Inc. (Netpoint) and now owns 92% of the subsidiary.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its estimates, including those related to the allowance for uncollectible accounts receivable and inventory reserves. Management bases its estimates on assumptions that management believes to be reasonable under the circumstances, the results of which form a basis for making judgments about the carrying value of assets and liabilities that are not readily available from other sources. Actual results may differ from these estimates under different assumptions or conditions; however, management believes that its estimates, including those for the above described items, are reasonable and that the actual results will not vary significantly from the estimated amounts.

The following significant accounting policies relate to the more significant judgments and estimates used in the preparation of the consolidated financial statements:

(a) Allowances for Trade and Notes Receivable

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The Company maintains an allowance for uncollectible accounts receivable for estimated losses resulting from customers failure to make payments on accounts receivable due to the Company. Management determines the estimate of the allowance for uncollectible accounts receivable by considering a number of factors, including: (1) historical experience, (2) aging of the accounts receivable and (3) specific information obtained by the Company on the financial condition and the current creditworthiness of its customers. If the financial condition of the Company s customers were to deteriorate and reduce the ability of the Company s customers to make payments on their accounts, the Company may be required to increase its allowance by recording additional bad debt expense. Likewise, should the financial condition of the Company s customers improve and result in payments or settlements of previously reserved amounts, the Company may be required to record a reduction in bad debt expense to reverse the recorded allowance. A provision for estimated losses on returns and allowances is recorded at the time of sale based on historical experience.

(b) Inventory Reserves

Management determines the inventory reserves required to reduce inventories to the lower of cost or market based principally on the effects of technological changes, quantities of goods on hand, and other factors. An estimate is made of the market value, less cost to dispose, of products whose value is determined to be impaired. If these products are ultimately sold at less than estimated amounts, additional reserves may be required. Likewise, if these products are sold for more than the estimated amounts, reserves may be reduced.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation in the accompanying financial statements.

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. Book overdrafts, representing checks prepared but not yet cleared at the Company s bank, of $67,156,000 and $43,421,000 as of December 31, 2006 and June 30, 2006, respectively, are included in accounts payable.

Derivative Financial Instruments

The Company s foreign currency exposure results from purchasing and selling internationally in several foreign currencies. In addition, the Company has foreign currency risk related to debt that is denominated in currencies other than the U.S. Dollar. The Company may reduce its exposure to fluctuations in foreign exchange rates by creating offsetting positions through the use of derivative financial instruments or multi-currency borrowings. The market risk related to the foreign exchange agreements is offset by changes in the valuation of the underlying items. The Company currently does not use derivative financial instruments for trading or speculative purposes, nor is the Company a party to leveraged derivatives.

Derivative financial instruments are accounted for on an accrual basis with gains and losses on these contracts recorded in income in the period in which their value changes, with the offsetting entry for unsettled positions being booked to either other assets or other liabilities. These contracts are generally for a duration of 90 days or less. The Company has elected not to designate its foreign currency contracts as hedging instruments. They are, therefore, marked to market with changes in their value recorded in the Consolidated Income Statement each period. The underlying exposures are denominated primarily in British Pounds, Euros, and Canadian Dollars. Summarized financial information related to these derivative contracts and changes in the underlying value of the foreign currency exposures follows:

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	Quarter ended December 31,		Six months ended December 31,	
	2006	2005 (restated) [1]	2006	2005 (restated) [1]
Foreign exchange derivative contract gains/(losses)	$ 145,000	$ (9,000)	$ 157,000	$ (39,000)
Foreign currency transactional and remeasurement gains, net of losses	(102,000)	42,000	231,000	(9,000)
Net foreign currency transactional and remeasurement gains/(losses)	$ 43,000	$ 33,000	$ 388,000	$ (48,000)

(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

The Company had three currency forward contracts outstanding as of December 31, 2006 with a net liability under these contracts of $19,000. At June 30, 2006 the Company had three currency forward contracts outstanding with a net liability under these contracts of $25,000. These amounts are included in accrued expenses and other liabilities. The following table provides information about our outstanding foreign currency derivative financial instruments:

	As of December 31, 2006		As of June 30, 2006	
Forward Contracts:	**Notional Amount**	**Adjustment to Fair Market Value Compared to Notional Amount**	**Notional Amount**	**Adjustment to Fair Market Value Compared to Notional Amount**
British Pound Functional Currency				
Purchase British Pound, sell Euro	$ 5,750,000	$ (23,000)	$ 5,584,000	$ (21,000)
Euro Functional Currency				
Purchase Euro, sell British Pound	$ 2,938,000	4,000	$ 2,774,000	(4,000)
US Dollar Functional currency				
Purchase US Dollar, sell Canadian Dollar	$ 2,146,000		$ 2,242,000	
		$ (19,000)		$ (25,000)

The notional amount of forward exchange contracts is the amount of foreign currency to be bought or sold at maturity. Notional amounts are indicative of the extent of the Company s involvement in the various types and uses of derivative financial instruments and are not a measure of the Company s exposure to credit or market risks through its use of derivatives. The estimated fair value of derivative financial instruments represents the amount required to enter into similar offsetting contracts with similar remaining maturities based on quoted market prices.

Inventories

Inventories (consisting of AIDC, POS, business phone, converged communications equipment, video conferencing equipment, and electronic security system products) are stated at the lower of cost (first-in, first-out method) or market.

Vendor Programs

The Company receives incentives from vendors related to cooperative advertising allowances, volume rebates and other incentive agreements. These incentives are generally under quarterly, semi-annual or annual agreements with the vendors. Some of these incentives are negotiated on

an ad hoc basis to support specific programs mutually developed between the Company and the vendor. Vendors generally require that we use their cooperative advertising allowances exclusively for advertising or other marketing programs. Incentives received from vendors for specifically identified incremental cooperative advertising programs are recorded as adjustments to selling, general and administrative expenses. EITF Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received*

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from a Vendor (EITF 02-16) requires that the portion of these vendor funds in excess of our costs to be reflected as a reduction of inventory. Such funds are recognized as a reduction of the cost of products sold when the related inventory is sold.

The Company records unrestricted, volume rebates received as a reduction of inventory and as a reduction of the cost of goods sold when the related inventory is sold. Amounts received or receivable from vendors that are not yet earned are deferred in the consolidated balance sheet. In addition, the Company may receive early payment discounts from certain vendors. The Company records early payment discounts received as a reduction of inventory and recognizes the discount as a reduction of cost of goods sold when the related inventory is sold. EITF 02-16 requires management to make certain estimates of the amounts of vendor incentives that will be received. Actual recognition of the vendor consideration may vary from management estimates based on actual results.

Product Warranty

The Company s vendors generally warrant the products distributed by the Company and allow the Company to return defective products, including those that have been returned to the Company by its customers. The Company does not independently warrant the products it distributes; however, to maintain customer relations, the Company facilitates vendor warranty policies by accepting for exchange, with the Company s prior approval, most defective products within 30 days of invoicing. The Company offers certain warranty service programs and records a provision for estimated service warranty costs at the time of sale, adjusting periodically to reflect actual experience. To date neither warranty expense, nor the accrual for warranty costs has been material to the Company s consolidated financial statements.

Property and Equipment, and Other Assets (except Other Identifiable Intangible Assets)

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over estimated useful lives of 3 to 5 years for furniture, equipment and computer software, 40 years for buildings and 15 years for building improvements. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life. Maintenance, repairs and minor renewals are charged to expense as incurred. Additions, major renewals and betterments to property and equipment are capitalized.

For property and equipment and other assets, except other identifiable intangible assets, if the sum of the expected cash flows, undiscounted and without interest, is less than the carrying amount of the asset, an impairment loss is recognized as the amount by which the carrying amount of the asset exceeds its fair value.

The Company reviews its long-lived assets for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable or may be impaired. Impairment charges of $0 and $148,000 were recognized for the quarter and six months ended December 31, 2006, and $0 for the quarter and six months ended December 31, 2005 in operating expenses for the impairment of certain capitalized assets for the North American distribution segment. These assets included software that was no longer functional based on operational needs.

Goodwill and Other Identifiable Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired in acquisitions accounted for using the purchase method. During fiscal years 2006 and 2005, the Company performed its annual test of goodwill to determine if there was impairment. The Company s impairment tests included the determination of each reporting unit s fair value using market multiples and discounted cash flows modeling. No impairment was required to be recorded related to the Company s annual impairment testing. In addition, the Company performs an impairment analysis for goodwill whenever indicators of impairment are present. No such indicators existed for the quarters ended December 31, 2005 and 2006, respectively.

The Company reviews the carrying value of its intangible assets with finite lives, which includes customer lists, debt issue costs, trade names, and non-compete agreements, as current events and circumstances warrant to determine whether

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there are any impairment losses. If indicators of impairment are present in intangible assets used in operations, and future cash flows are not expected to be sufficient to recover the assets carrying amount, an impairment loss is charged to expense in the period identified. Customer lists are amortized using the straight-line method over their estimated useful lives, which range from 5 to 10 years. Debt issue costs are amortized over the term of the credit facility. Trade names are amortized over 10 years. Non-compete agreements are amortized over their contract life. These assets are included in other assets (see Note 7).

Fair Value of Financial Instruments

The fair value of financial instruments is the amount at which the instrument could be exchanged in a current transaction between willing parties. The carrying values of financial instruments such as accounts receivable, accounts payable, accrued liabilities, borrowings under the revolving credit facility and subsidiary lines of credit approximate fair value based upon either short maturities or variable interest rates of these instruments.

Contingencies

The Company accrues for contingent obligations, including estimated legal costs, when it is probable that a liability is incurred and the amount is reasonably estimable. As facts concerning contingencies become known, management reassesses its position and makes appropriate adjustments to the financial statements. Estimates that are particularly sensitive to future changes include tax, legal, and other regulatory matters, which are subject to change as events evolve and as additional information becomes available during the administrative and litigation process.

Revenue Recognition

Revenue is recognized once four criteria are met: (1) the Company must have persuasive evidence that an arrangement exists; (2) delivery must occur, which happens at the point of shipment (this includes the transfer of both title and risk of loss, provided that no significant obligations remain); (3) the price must be fixed and determinable; and (4) collectibility must be reasonably assured. A provision for estimated losses on returns is recorded at the time of sale based on historical experience.

The Company has service revenue associated with configuration and marketing, which is recognized when the work is complete and all obligations are substantially met. The Company also sells third-party services, such as maintenance contracts. Since the Company is acting as an agent for these services, revenue is recognized net of cost at the time of sale. Revenue from multiple element arrangements is allocated to the various elements based on the relative fair value of the elements, and each revenue cycle is considered a separate accounting unit with recognition of revenue based on the criteria met for the individual element of the multiple deliverables.

Shipping Revenue and Costs

Shipping revenue is included in net sales and related costs are included in cost of goods sold. Shipping revenue for the quarter and six months ended December 31, 2006 was $2.7 million and $5.5 million, respectively. Shipping revenue for the quarter and six months ended December 31, 2005 was $2.0 million and $4.1 million, respectively.

Advertising Costs

The Company defers advertising related costs until the advertising is first run in trade or other publications, or in the case of brochures, until the brochures are printed and available for distribution. Advertising costs, included in marketing costs, after vendor reimbursement, were not significant in the quarters or six months ended December 31, 2006 or 2005. Deferred advertising costs at December 31, 2006 and 2005 were not significant.

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Foreign Currency

The currency effects of translating the financial statements of the Company s foreign entities that operate in their local currency are included in the cumulative currency translation adjustment component of accumulated other comprehensive income. The assets and liabilities of these foreign entities are translated into U.S. Dollars using the exchange rate at the end of the respective period. Sales, costs and expenses are translated at average exchange rates effective during the respective period.

Foreign currency transactional and re-measurement gains and losses are included in other expense (income) in the Condensed Consolidated Income Statement. Such gains, net of losses, were $43,000 and $33,000 for the quarters ended December 31, 2006 and 2005, respectively. Such gains, net of losses, were $388,000 for the six months ended December 31, 2006 and losses, net of gains, were $48,000 for the six months ended December 31, 2005.

Income Taxes

Income taxes are accounted for under the liability method. Deferred income taxes reflect tax consequences on future years of differences between the tax bases of assets and liabilities and their financial reporting amounts. Valuation allowances are provided against deferred tax assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. Federal income taxes are not provided on the undistributed earnings of foreign subsidiaries because it has been the practice of the Company to reinvest those earnings in the business outside of the United States.

Deferred Income Taxes

Deferred income taxes are determined in accordance with SFAS No.109, *Accounting for Income Taxes*. Deferred tax assets and liabilities are recognized for the expected future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carryforwards. The Company evaluates the tax assets and liabilities on a periodic basis and adjusts the balances as appropriate.

The Company records valuation allowances to reduce its deferred tax assets to the amount expected to be realized. In assessing the adequacy of recorded valuation allowances, the Company considers a variety of factors including, the scheduled reversal of deferred tax liabilities, future taxable income, and prudent and feasible tax planning strategies. In the event the Company determines it would be able to use a deferred tax asset in the future in excess of its net carrying value, an adjustment to the deferred tax asset would reduce income tax expense, thereby increasing net income in the period such determination was made. Likewise, should the Company determine that it was unable to use all or part of its net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income tax expense, thereby reducing net income in the period such determination was made.

Share-Based Payment

Effective July 1, 2005, the Company began accounting for share-based compensation under the provisions of SFAS No. 123(R), Share-Based Payment, which requires the recognition of the fair value of share-based compensation. Under the fair value recognition provisions of SFAS No. 123(R), share-based compensation is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award. The Company has used the Black-Scholes valuation model to estimate fair value of share-based awards, which requires various assumptions including estimating stock price volatility, forfeiture rates and expected life.

For the quarter and six months ended December 31, 2006, the number of options exercised for shares of common stock were 17,794 and 35,555, respectively. For the quarter and six months ended December 31, 2005, the number of options exercised for shares of common stock were 160,654 and 183,926, respectively.

Comprehensive Income

Comprehensive income is comprised of net income and foreign currency translation. The foreign currency translation gains or losses are not tax-effected because the earnings of foreign subsidiaries are considered by Company management

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to be permanently reinvested. For the quarter and six months ended December 31, 2006, comprehensive income consisted of net income of the Company of $8.8 million and $21.3 million, respectively, and net translation adjustments of $1.1 million and $1.3 million, respectively. For the quarter and six months ended December 31, 2005, comprehensive income consisted of net income of the Company of $8.9 million and $18.0 million, respectively, and net translation adjustments of $308,000 and $507,000, respectively.

Accounting Standards Recently Issued

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which requires companies to provide additional information regarding the effect of a company s choice to use fair value on its earnings and to display the fair value of those assets and liabilities which the company has chosen to use on the face of the balance sheet. SFAS No. 159 is effective for the Company as of the year ending June 30, 2009. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS No. 159 will have on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements.* SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. SAB No. 108 is effective for the Company s fiscal year 2007 annual financial statements. The Company is currently evaluating the potential impact that the adoption of SAB No. 108 will have on its consolidated financial statements; the impact is not expected to be material.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R*). SFAS No. 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS No. 158 will become effective for the Company as of the fiscal year ending June 30, 2007. The Company does not have a defined benefit pension plan and is currently evaluating the potential impact, if any, the adoption of SFAS No. 158 will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for the Company beginning July 1, 2008. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS No. 157 will have on its consolidated financial statements.

On July 13, 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements by prescribing a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. Additionally, FIN 48 provides guidance on de-recognition of tax benefits previously recognized and additional disclosures for unrecognized tax benefits, interest and penalties. FIN 48 is effective for fiscal years beginning after December 15, 2006, and is required to be adopted by the Company in the first quarter of fiscal year 2008. The Company is currently evaluating whether the adoption of FIN 48 will have a material effect on its consolidated financial position, results of operations or cash flows.

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(4) Earnings Per Share

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

	Net Income	Shares	Per Share Amount
Quarter ended December 31, 2006:			
Income per common share, basic	$ 8,791,000	25,749,000	$ 0.34
Effect of dilutive stock options		487,000	
Income per common share, assuming dilution	$ 8,791,000	26,236,000	$ 0.34
Six months ended December 31, 2006:			
Income per common share, basic	$ 21,252,000	25,739,000	$ 0.83
Effect of dilutive stock options		486,000	
Income per common share, assuming dilution	$ 21,252,000	26,225,000	$ 0.81
Quarter ended December 31, 2005 (restated)[1]:			
Income per common share, basic	$ 8,942,000	25,402,000	$ 0.35
Effect of dilutive stock options		592,000	
Income per common share, assuming dilution	$ 8,942,000	25,994,000	$ 0.34
Six months ended December 31, 2005 (restated)[1]:			
Income per common share, basic	$ 17,955,000	25,367,000	$ 0.71
Effect of dilutive stock options		577,000	
Income per common share, assuming dilution	$ 17,955,000	25,944,000	$ 0.69

(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

For the quarter and six months ended December 31, 2006, there were 299,000 and 541,000 weighted average shares, respectively, excluded from the computation of diluted earnings per share because their effect would have been antidilutive. For the quarter and six months ended December 31, 2005, there were 298,000 and 308,000 weighted average shares, respectively, excluded from the computation of diluted earnings per share because their effect would have been antidilutive.

(5) Revolving Credit Facility and Subsidiary Lines of Credit

At December 31, 2006 and June 30, 2006, the Company had a multi-currency revolving credit facility with its bank group (the Bank Group) of $140 million and $100 million, respectively, which matures on July 31, 2008. This facility was entered into on July 16, 2004 and has an accordion feature that allows the Company to unilaterally increase the revolving credit line up to a commitment of $150 million. The Company exercised $40 million of its $50 million credit facility accordion during the quarter ended September 30, 2006 and the remaining $10 million during January 2007. (See Note 11 for a discussion of a subsequent amendment). This increased the revolving credit facility exercised amount to $150 million. The facility bears interest at either the 30-day LIBOR rate of interest on U.S. dollar borrowings or the 30, 60, 90 or 180-day LIBOR rate of interest on other currency borrowings. The interest rate is the appropriate LIBOR rate

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plus a rate varying from 0.75% to 1.75% tied to the Company s funded debt to EBITDA ratio ranging from 0.00:1.00 to 2.50:1.00 and a fixed charge coverage ratio of not less than 1.50:1. The effective weighted average interest rate at December 31, 2006 and June 30, 2006 was 5.41% and 4.38%, respectively. The outstanding borrowings at December 31, 2006 were $58.0 million on a total commitment of $150 million, leaving $92.0 million available for additional borrowings. (See Note 11 for a discussion on current commitments). The outstanding borrowings at June 30, 2006 were $27.6 million on a total commitment of $130 million, leaving $102.4 million available for additional borrowings. The facility is collateralized by domestic assets, primarily accounts receivable and inventory. The agreement contains other restrictive financial covenants, including among other things, total liabilities to tangible net worth ratio, capital expenditure limits, and a prohibition on the payment of dividends. On November 9, 2006, a ninety day waiver was received under the Company s revolving credit facility with respect to the delivery of certain quarterly information and documentation to the Company s lenders, to the extent impacted by the review of the Special Committee of the Company s stock option grant practices and related accounting issues. The waiver was extended on February 14, 2007 and on May 14, 2007. The May 14, 2007 waiver covers information and documentation for three quarters and is effective through June 30, 2007 (or as late as July 31, 2007 under certain conditions).

At December 31, 2006 and June 30, 2006, Netpoint, doing business as Scan*Source* Latin America, had an asset-based line of credit with a bank that was due on demand and had a borrowing limit of $1 million. The facility was renewed in January 2007, and is scheduled to mature on January 31, 2008. The facility is collateralized by accounts receivable and eligible inventory, and contains a restrictive covenant which requires an average deposit of $50,000 with the bank. The Company has guaranteed 92% and 84% of the balance on the line as of December 31, 2006 and June 30, 2006, respectively, while the remaining balance was guaranteed by Netpoint s minority shareholder. The facility bears interest at the bank s prime rate minus one percent. At December 31, 2006 and June 30, 2006, the effective interest rate was 7.25%. At December 31, 2006 and June 30, 2006, there were no outstanding balances and outstanding standby letters of credit totaled $40,000, leaving $960,000 available for borrowings.

(6) Short-term Borrowings and Long-term Debt

Short-term borrowings at December 31, 2006 consist of a 3.0 million secured revolving credit facility obtained on August 17, 2006, with a variable interest rate of 4.38% and no maturity date. At December 31, 2006, 2.3 million or $3.1 million was outstanding. The Company had no short-term borrowings at June 30, 2006.

Long-term debt consists of the following at December 31, 2006 and June 30, 2006:

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	December 31, 2006	June 30, 2006
Unsecured note payable to a bank, monthly payments of interest only; 6.00% variable interest rate at December 31, 2006; maturing in fiscal year 2009	$ 13,000,000	$
Note payable to a bank, secured by distribution center land and building; monthly payments of principal and interest of $41,000; 6.35% and 5.88% variable interest rate, respectively at December 31, 2006 and June 30, 2006; maturing in fiscal year 2009 with a balloon payment of approximately $4,175,000	4,521,000	4,627,000
	17,521,000	4,627,000
Less current portion	214,000	229,000
Long-term portion	$ 17,307,000	$ 4,398,000

The $13 million unsecured long-term note payable was entered into on July 25, 2006, and includes a requirement that the Company not encumber its headquarters property except as permitted by the lender. The note payable secured by the distribution center contains certain financial covenants, including minimum net worth, capital expenditure limits, and a maximum debt to tangible net worth ratio, and prohibits the payment of dividends.

(7) Goodwill and Identifiable Intangible Assets

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company performs its annual test of goodwill at the end of each fiscal year to determine if impairment has occurred. In addition, the Company performs an impairment analysis for goodwill whenever indicators of impairment are present. This testing includes the determination of each reporting unit s fair value using market multiples and discounted cash flows modeling. At the end of fiscal year 2006, no impairment charge related to goodwill was recorded. During the first quarter of fiscal year 2007, the Company acquired additional goodwill through the acquisition of T2 Supply, LLC (T2 Supply) and through the purchase of an additional 8% of Netpoint. The table below includes the valuation of goodwill and intangible assets for T2 Supply.

Changes in the carrying amount of goodwill and other intangibles assets for the quarter ended December 31, 2006, by operating segment, are as follows:

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	North American Distribution Segment	International Distribution Segment	Total
Balance as of June 30, 2006	$ 6,259,000	$ 8,145,000	$ 14,404,000
Excess of cost over fair value of acquired net assets, and other	22,435,000	679,000	23,114,000
Fluctuations in foreign currencies		317,000	317,000
Balance as of December 31, 2006	$ 28,694,000	$ 9,141,000	$ 37,835,000

Included within other assets are identifiable intangible assets as follows:

	As of December 31, 2006			As of June 30, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Amortized intangible assets:						
Customer lists	$ 9,868,000	$ 804,000	$ 9,064,000	$ 338,000	$ 302,000	$ 36,000
Debt issue costs	606,000	333,000	273,000	532,000	254,000	278,000
Trade names	825,000	41,000	784,000			
Non-compete agreements	1,635,000	273,000	1,362,000			
Total	$ 12,934,000	$ 1,451,000	$ 11,483,000	$ 870,000	$ 556,000	$ 314,000

The weighted average amortization period for all intangible assets was approximately nine years for the quarter ended December 31, 2006 and four years for the fiscal year ended June 30, 2006. Amortization expense for the quarter and six months ended December 31, 2006 was $448,000 and $895,000, respectively. Amortization expense for fiscal years 2007, 2008, 2009, 2010 and 2011 and thereafter is estimated to be approximately $1.8 million, $1.8 million, $1.6 million, $1.0 million, $1.0 million and $5.2 million, respectively.

(8) Segment Information

The Company is a leading distributor of specialty technology products, providing value-added distribution sales to resellers in the specialty technology markets. The Company has two reporting segments, based on geographic location. The measure of segment profit is operating income, and the accounting policies of the segments are the same as those described in Note 3.

North American Distribution

North American Distribution offers products for sale in five primary categories: (i) AIDC and POS equipment sold by the Scan*Source* sales unit, (ii) voice, data and converged communications equipment sold by the Catalyst *Telecom* sales unit, (iii) voice, data and converged communications products sold by the Para*con* sales unit, (iv) video conferencing and telephone products sold by the T2 Supply sales unit, and (v) electronic security products through its Scan*Source* Security Distribution sales unit. These products are sold to more than 13,000 resellers and integrators of technology products that are geographically disbursed over the United States and Canada in a pattern that mirrors population

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concentration. No single account represented more than 7% of the Company s consolidated net sales during the quarter and six month periods ended December 31, 2006 and 2005.

International Distribution

International Distribution sells to two geographic areas, Latin America (including Mexico) and Europe, and offers AIDC and POS equipment to more than 6,000 resellers and integrators of technology products. This segment began during fiscal 2002 with the Company s purchase of a majority interest in Netpoint and the start-up of the Company s European operations. Of this segment s customers, no single account represented 1% or more of the Company s consolidated net sales during the quarter and six month periods ended December 31, 2006 and 2005.

Inter-segment sales consist of sales by the North American distribution segment to the international distribution segment. All inter-segment revenues and profits have been eliminated in the accompanying consolidated financial statements.

Selected financial information of each business segment are presented below:

	Quarter ended December 31,		Six months ended December 31,	
	2006	**2005**	**2006**	**2005**
Sales:				
North American distribution	$ 401,517,000	$ 358,984,000	$ 835,519,000	$ 709,383,000
International distribution	80,252,000	55,263,000	148,487,000	99,106,000
Less intersegment sales	(8,035,000)	(5,779,000)	(14,043,000)	(9,625,000)
	$ 473,734,000	$ 408,468,000	$ 969,963,000	$ 798,864,000
Depreciation and amortization:				
North American distribution	$ 1,556,000	$ 1,299,000	$ 3,230,000	$ 2,576,000
International distribution	175,000	132,000	343,000	268,000
	$ 1,731,000	$ 1,431,000	$ 3,573,000	$ 2,844,000
Operating income:		(restated) **		(restated) **
North American distribution	$ 12,373,000 *	$ 13,511,000	$ 31,649,000 *	$ 27,817,000
International distribution	3,505,000	1,537,000	5,747,000	2,114,000
	$ 15,878,000	$ 15,048,000	$ 37,396,000	$ 29,931,000
Capital expenditures:				
North American distribution	$ 1,268,000	$ 1,008,000	$ 1,683,000	$ 2,131,000
International distribution	143,000	269,000	276,000	344,000
	$ 1,411,000	$ 1,277,000	$ 1,959,000	$ 2,475,000

*

Included in North American distribution s operating income for the quarter and six months ended December 31, 2006 is $4.9 million for the direct costs associated with the special committee review (see note 1A.).

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** Restated Operating income per above	Quarter ended December 31, 2005			Six months ended December 31, 2005		
	As previously reported	**Adjustments**	**Restated (1)**	**As previously reported**	**Adjustments**	**Restated (1)**
North American distribution	$ 13,969,000	$ (458,000)	$ 13,511,000	$ 28,655,000	$ (838,000)	$ 27,817,000
International distribution	1,594,000	(57,000)	1,537,000	2,228,000	(114,000)	2,114,000
	$ 15,563,000	$ (515,000)	$ 15,048,000	$ 30,883,000	$ (952,000)	$ 29,931,000

(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

Assets for each business segment are summarized below:

Assets:	**December 31, 2006**	**June 30, 2006** As previously reported	**Adjustments**	**Restated (1)**
North American distribution	$ 571,974,000	$ 504,313,000	$ 4,278,000	$ 508,591,000
International distribution	133,904,000	108,906,000		108,906,000
	$ 705,878,000	$ 613,219,000	$ 4,278,000	$ 617,497,000

(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

(9) Commitments and Contingencies

Contingencies The Company received an assessment for a sales and use tax matter for the five calendar years ended 2003 and the first quarter ended March 31, 2004. Based on this assessment, the Company has determined a probable range for the disposition of that assessment and for subsequent periods. Although the Company is disputing the assessment, it accrued a liability of $1.3 million at June 30, 2005. As of December 31, 2006, the Company has paid approximately $1.0 million. The Company is disputing the entire $1.3 million assessment including payments made on the liability. Although there can be no assurance of the ultimate outcome at this time, the Company intends to vigorously defend its position.

As of December 31, 2006, the Company has an accrued liability of $2.4 million for a value-added tax matter covering a 3.5 year period. This accrual has been recorded to those periods through the restated Form 10-K/A for the year ended June 30, 2006. In providing for this accrual, the Company has recorded a net foreign exchange loss of approximately $108,000 due to changes in rates over the 3.5 year period. The Company is in discussions with the governing tax authority. No assessments have been made by that governing tax authority as of this reporting period. Although there can be no assurance of the ultimate outcome at this time, the Company intends to vigorously defend its position.

The Company has contractual obligations of $250,000 for the purchase of software and improvements of real property at December 31, 2006.

(10) Acquisitions

On July 3, 2006, the Company entered into an agreement with SKC Communications Products, Inc. to purchase the assets of T2 Supply. The purchase price of approximately $50 million includes approximately $34 million of intangible

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assets related to the North American distribution segment. The Company has obtained a third-party valuation related to certain intangible assets and has allocated the purchase price based upon that valuation.

T2 Supply is a distributor of video conferencing and telephony products and is based in Lenexa, Kansas. T2 Supply provides its reseller customers technical support for the configuration of video conferencing and sound solutions, an extended warranty program, training, marketing, a customer resource website, and bridging services. As a result of the acquisition, the Company expects to enhance its long-term convergence strategy by adding video conferencing products and expertise. T2 Supply s customer base of voice and video conferencing resellers will also provide cross-selling opportunities.

(11) Subsequent Events and Other Matters

On February 14, 2007 and on May 14, 2007, extensions were obtained to the ninety day waiver initially received on November 9, 2006 under the Company s revolving credit facility with respect to the delivery of certain quarterly information and documentation to the Company s lenders, to the extent impacted by the review of the Special Committee of the Company s stock option grant practices and related accounting issues. The May 14, 2007 waiver covers information and documentation for three quarters and is effective through June 30, 2007 (or as late as July 31, 2007 under certain conditions).

On February 14, 2007, the Company s revolving credit facility was amended to permit the Company to redeem shares of its capital stock, so long as the amount paid in connection with the redemptions does not exceed $2 million during any fiscal year.

On April 20, 2007, the Company s revolving credit facility Bank Group agreed to an increase in the Bank Group s commitment from $150 million to $200 million. Effective that date, the facility has an accordion feature that allows the Company to unilaterally increase the availability from $180 million to $200 million, in minimum increments of $5 million.

On April 27, 2007, the Company entered into an agreement to lease approximately 600,000 square feet for distribution, warehousing and storage purposes in a building located in Southaven, Mississippi. The lease also provides for a right of first refusal on an additional 147,000 square feet of expansion space. The lease provides for market rental rates and commences upon substantial completion of construction, which is expected to be October 1, 2007, with a term of 120 months, and 2 consecutive 5-year extension options. Subject to finalization of construction costs, the minimum average annual rent commitment is approximately $1.9 million. The lease is conditioned upon the Company receiving approval for certain economic development tax incentives from the state of Mississippi.

On November 21, 2006, a purported stockholder filed a derivative lawsuit in the United States District Court for the District of South Carolina in Greenville, South Carolina against certain current and former officers and directors of the Company and against the Company, as a nominal defendant, asserting causes of action based on alleged violations of securities laws (including alleged violations of Section 10(b), 14(a) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 of the SEC) and other common law claims including, breach of fiduciary duty, aiding and abetting and unjust enrichment relating to allegations concerning certain of the Company s prior stock option grants. It seeks relief in the form of an accounting, rescission, unspecified money damages, disgorgement, attorneys fees, fees and expenses and other relief.

On April 2, 2007 the Court appointed the plaintiff as lead plaintiff and ordered that any later actions filed in the same Court and that relate to the same facts shall be consolidated. Our response, including a motion to dismiss the lawsuit, is currently due on July 11, 2007.

On April 11, 2007, another purported stockholder filed a substantially similar derivative lawsuit also related to the Company s prior grants of stock options. This action was also filed in the United States District Court for the District of South Carolina in Greenville, South Carolina against certain current and former officers and directors of the Company and against the Company, as a nominal defendant, and asserts substantially similar causes of action and claims for relief. The plaintiff in this second action has filed a motion to consolidate the two actions and appoint the plaintiff as a co-lead plaintiff. Our response, including a motion to dismiss the lawsuit, is currently due July 11, 2007. The derivative lawsuits are in a preliminary stage and the Company believes that it is taking appropriate actions regarding both derivative lawsuits.

For more information concerning the review by the Special Committee of the Board of Directors of the Company s stock option granting practices and the findings and recommendations of the Special Committee see Note 1A to the Notes to Consolidated Condensed Financial

Statements presented in Part I, Item I of this report, Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement related to stock options of the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006, and Note 1A to the Notes to Consolidated Financial Statements in the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006. The Company is also continuing voluntarily to provide information to the SEC and the Department of Justice in connection with the Special Committee s review.

On March 12, 2007 the Company s insurance carrier, subject to a reservation of rights, provided a preliminary position on coverage for the first derivative claim in which the carrier indicated that the lawsuit allegations appear to constitute a claim within coverage of the Company s insurance policy. The carrier continues to assess coverage of this matter.

On April 13, 2007, the Company provided notice to the insurance carrier of the second action. The insurance carrier is reviewing the second action and assessing coverage for the matter. The carrier has indicated, however, that its coverage position with regard to the second action will be consistent with the first; i.e., that the allegations of the second derivative lawsuit appear to constitute a claim within the coverage of the Company s insurance policy. The carrier has not recognized as within coverage the costs, fees and expenses incurred for the work related to the Special Committee at this stage. The Company is evaluating its alternatives to address its coverage claim position.

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Results of Operations

Net Sales

The following tables summarize the Company s net sales results (net of inter-segment sales):

	Quarter ended December 31, 2006	Quarter ended December 31, 2005	Difference	Percentage Change
	(In thousands)			
North American distribution	$ 393,482	$ 353,205	$ 40,277	11.4%
International distribution	80,252	55,263	24,989	45.2%
Net sales	$ 473,734	$ 408,468	$ 65,266	16.0%

	Six months ended December 31, 2006	Six months ended December 31, 2005	Difference	Percentage Change
	(In thousands)			
North American distribution	$ 821,476	$ 699,758	$ 121,718	17.4%
International distribution	148,487	99,106	49,381	49.8%
Net sales	$ 969,963	$ 798,864	$ 171,099	21.4%

North American Distribution

North American distribution sales include sales to technology resellers in the United States and Canada from the Company s Memphis, Tennessee distribution center. Sales to technology resellers in Canada account for less than 5% of total net sales for the quarter and six months ended December 31, 2006 and 2005. The 11.4% or $40.3 million increase in North American distribution sales for the quarter ended December 31, 2006, as compared to the same period in the prior year, was due primarily to the reasons described below. The 17.4 % or $121.7 million increase for the six months ended December 31, 2006, as compared to the same period in the prior year, was due to strong AIDC and communication sales.

Sales of the AIDC and POS product categories for the North America distribution segment increased 16.4% as compared to the prior year quarter and 18.2% as compared to the prior year six month period. The growth in both periods was primarily attributable to the AIDC business s gain in market share. The Scan*Source* Security Distribution sales unit was created during the quarter ended December 31, 2004. Sales of that unit were immaterial for the quarter ended December 31, 2006.

Sales of communications products increased 5.7% as compared to the prior year quarter and 16.5% as compared to the prior year six month period. After prior quarter record sales, Catalyst *Telecom*, which distributes small and medium business and enterprise products, experienced weakened sales due to supply chain disruptions and product shortages. Para*con*, which distributes communications products, managed a good quarter despite the sale and transition of a product line between vendors. The communications business also included record sales and increased market share for T2 Supply, a sales unit acquired by the Company on July 3, 2006. Prior twelve month sales for T2 Supply prior to the acquisition were approximately $77 million.

International Distribution

The international distribution segment includes sales to Latin America (including Mexico) and Europe from the Scan*Source* selling unit. Sales for the overall international segment increased 45.2% or $25.0 million for the quarter

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ended December 31, 2006 and 49.8% or $49.4 million for the six month period as compared to the same periods in the prior year. The increase in sales was primarily attributable to market share gains in Mexico and Europe. Europe s market share gain was the result of new customer recruitment from marketing efforts and tradeshows. Further, we still carry higher inventory levels in Europe for both RoHS compliant and non-RoHS compliant inventory (RoHS is a European Union environmental directive which caused manufacturers to comply with new guidelines effective July 1, 2006. The RoHS Directive bans the placing on the European Union market of new electrical and electronic equipment containing more than agreed levels of lead, cadmium, mercury, hexavalent chromium, polybrominated biphenyl (PBB) and polybrominated diphenyl ether (PBDE) flame retardants). The higher inventory levels allowed us better availability than our competition during the quarter and six months ended December 31, 2006. Without the foreign exchange fluctuations, the increase in sales for the quarter and six months ended December 31, 2006 would have been $20.3 million or 36.7% and $42.5 million or 42.9%, respectively.

Gross Profit

The following tables summarize the Company s gross profit:

	Quarter ended December 31, 2006	2005	Difference	Percentage Change	Percentage of Sales December 31, 2006	2005
	(In thousands)					
North American distribution	$ 42,474	$ 34,974	$ 7,500	21.4%	10.8%	9.9%
International distribution	10,303	6,861	3,442	50.2%	12.8%	12.4%
Gross profit	$ 52,777	$ 41,835	$ 10,942	26.2%	11.1%	10.2%

	Six months ended December 31, 2006	2005	Difference	Change	Percentage of Sales December 31, 2006	2005
	(In thousands)					
North American distribution	$ 85,877	$ 69,736	$ 16,141	23.1%	10.5%	10.0%
International distribution	18,738	12,428	6,310	50.8%	12.6%	12.5%
Gross profit	$ 104,615	$ 82,164	$ 22,451	27.3%	10.8%	10.3%

North American Distribution

Gross profit for the North American distribution segment increased 21.4% or $7.5 million for the quarter ended December 31, 2006 and 23.1% or $16.1 million for the six month period as compared to the same periods in the prior year. The increase in gross profit for the quarter and six months ended December 31, 2006 is due to an increased sales volume including the acquisition of T2 Supply.

Gross profit as a percentage of net sales for the North American distribution segment increased compared to the same periods in the prior year due to a favorable customer mix of small to medium customers requiring more value add services which command higher margins.

International Distribution

Gross profit for the international distribution segment increased 50.2% or $3.4 million for the quarter ended December 31, 2006 and 50.8% or $6.3 million for the six month period as compared to the same period in the prior year. The increase was primarily due to increased distribution sales volume.

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Gross profit, as a percentage of net sales, which is typically greater than the North American Distribution segment, increased for the quarter and six month periods ended December 31, 2006 as compared to the same period in the prior year due primarily to the impact of rebates in Europe.

Operating Expenses

The following table summarizes the Company s operating expenses:

	Period ended December 31,				Percentage of Sales December 31,	
	2006	2005 (restated) (1)	Difference	Percentage Change	2006	2005
	(In thousands)					
Quarter	$ 36,899	$ 26,786	$ 10,113	37.8%	7.8%	6.6%
Six months	$ 67,219	$ 52,233	$ 14,986	28.7%	6.9%	6.5%

(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

For the quarter ended December 31, 2006, operating expenses increased compared to the same period in the prior year. The increase is due principally to special committee expenses of $4.9 million related to the Company s stock option investigation, the recognition of higher bad debt expense of approximately $1.2 million which represents a $867,000 increase in the allowance balance over the quarter ended December 31, 2005, amortization expense for T2 Supply intangibles of $395,000, and $2.5 million for both incremental and T2 Supply-related increases in employee headcount and related benefits.

The Company continues to invest in North America customer training and development programs for new technologies and vertical marketing (such as converged communications, RFID Edge, and Solution City) and its electronic security business. In addition, the Company continues to invest in Europe and Latin America due to its growth potential in those markets. In Europe, the Company has expanded geographically, increased marketing, and increased employee headcount. With respect to its Latin American market, the Company has increased employee headcount in Miami and Mexico City in order to serve an expanding customer base and continues its expanded regional VAR training program.

For the six months ended December 31, 2006, operating expenses increased compared to the same period in the prior year. The increase is due principally to $4.9 million special committee expenses related to the Company s stock option investigation, a $4.4 million increase related to increased employee headcount and related benefits, and a $3.4 million increase in bad debt expense.

Operating Income

The following table summarizes the Company s operating income:

	Period ended December 31,				Percentage of Sales December 31,	
	2006	2005 (restated)(1)	Difference	Percentage Change	2006	2005
	(In thousands)					
Quarter	$ 15,878	$ 15,049	$ 829	5.5%	3.4%	3.7%
Six months	$ 37,396	$ 29,931	$ 7,465	24.9%	3.9%	3.7%

(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

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Operating income increased 5.5% or $829,000 for the quarter ended December 31, 2006 and 24.9% or $7.5 million for the six month period ended December 31, 2006 as compared to the same periods in the prior year. The increase was a result of increased gross profit on higher sales volume and improved gross profit margin percentages discussed above.

Operating income as a percentage of net sales decreased compared to the same quarter in the prior year. The decrease in operating margin is primarily due to the increased operating expenses of $4.9 million related to the special committee which were incurred during the quarter ended December 31, 2006.

Operating income as a percentage of net sales increased for the six months ended December 31, 2006 compared to the period in the prior year. The increase in operating margin is primarily due to the increased gross profit amounts discussed above.

Total Other Expense (Income)

The following table summarizes the Company s total other expense (income):

	Quarter ended December 31,				Percentage of Sales December 31,	
	2006	2005 (restated) (1)	Difference	Percentage Change	2006	2005
	(In thousands)					
Interest expense	$ 1,754	$ 455	$ 1,299	285.5%	0.4%	0.1%
Interest income	(174)	(155)	(19)	12.3%	0.0%	0.0%
Net foreign exchange (gains) losses	(42)	(33)	(9)	27.3%	0.0%	0.0%
Other, net	(84)	(35)	(49)	140.0%	0.0%	0.0%
Total other expense	$ 1,454	$ 232	$ 1,222	526.7%	0.3%	0.1%

	Six months ended December 31,				Percentage of Sales December 31,	
	2006	2005 (restated) (1)	Difference	Percentage Change	2006	2005
	(In thousands)					
Interest expense	$ 3,525	$ 966	$ 2,559	264.9%	0.4%	0.1%
Interest income	(282)	(304)	22	-7.2%	0.0%	0.0%
Net foreign exchange (gains) losses	(388)	48	(436)	-908.3%	0.0%	0.0%
Other, net	(174)	(88)	(86)	97.7%	0.0%	0.0%
Total other expense	$ 2,681	$ 622	$ 2,059	331.0%	0.3%	0.1%

(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

Interest expense reflects interest paid on borrowings on the Company s line of credit and long-term debt. Interest expense for the quarter and six months ended December 31, 2006 was $1.8 million and $3.5 million, respectively. Interest expense for the quarter and six months ended December 31, 2005 was $455,000 and $966,000, respectively. The increased expense during the quarter ended December 31, 2006 was primarily due to the acquisition of T2 Supply in the first quarter of fiscal year 2007.

Foreign exchange gains and losses consist of foreign currency transactional and functional currency

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re-measurements, offset by net foreign currency exchange contract gains and losses. Net foreign exchange gains for the quarter and six months ended December 31, 2006 were $42,000 and $388,000, respectively. Net foreign exchange gains for the quarter ended December 31, 2005 were $33,000 and net foreign exchange losses for the six months ended December 31, 2006 were $48,000. The change in foreign exchange gains and losses for the quarter and six months ended December 31, 2006 as compared to the prior year are primarily the result of fluctuations in the value of the Euro versus the British Pound, and to a lesser extent, the U.S. Dollar versus other currencies. The Company utilizes foreign exchange contracts and debt in non-functional currencies to hedge foreign currency exposure. The Company s foreign exchange policy prohibits entering into speculative transactions.

Provision for Income Taxes

Income tax expense was $5.6 million and $13.4 million for the quarter and six months ended December 31, 2006, respectively, reflecting an effective income tax rate of 39.0% and 38.6%, respectively. Income tax expense (restated) was $5.8 million and $11.2 million for the quarter and six months ended December 31, 2005, respectively, reflecting an effective income tax rate of $39.3% and 38.4%, respectively. The change in the effective tax rate is due to the mix of earnings by country, and to the prior year utilization of net operating loss benefits which were fully utilized prior to fiscal year 2007.

Minority Interest in Income of Consolidated Subsidiaries

The Company consolidates subsidiaries that have a minority ownership interest. For the quarter and six months ended December 31, 2006, the Company recorded $13,000 and $46,000, net of income tax, respectively, of minority interest expense in the Company s majority owned subsidiary s net income. For the quarter and six months ended December 31, 2005, the Company recorded $51,000 and $109,000, net of income tax, respectively, of minority interest expense in the Company s majority owned subsidiaries net income. The decrease in minority interest expense is primarily due to the decreased percentage of minority interest in Netpoint, the Company s majority-owned subsidiary.

Net Income

The following table summarizes the Company s net income:

	Period ended				Percentage of Sales	
	December 31,			Percentage	December 31,	
	2006	2005 (restated) (1)	Difference	Change	2006	2005
	(In thousands)					
Quarter	$ 8,791	$ 8,942	$ (151)	-1.7%	1.9%	2.2%
Six months	$ 21,252	$ 17,955	$ 3,297	18.4%	2.2%	2.2%

(1) See Note 1A, Notes to Condensed Consolidated Financial Statements

The increase in the amount of net income is attributable to the changes in operations discussed above.

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Liquidity and Capital Resources

The Company s primary sources of liquidity are cash flow from operations, borrowings under the revolving credit facility, secured and unsecured borrowings, and, to a lesser extent, borrowings under the subsidiary s line of credit, and proceeds from the exercise of stock options.

The Company s cash and cash equivalent balance totaled $2.7 million at December 31, 2006 compared to $3.8 million at June 30, 2006. Domestic cash is generally swept on a nightly basis to pay down the Company s line of credit. The Company s working capital increased to $297.9 million at December 31, 2006 from $262.2 million at June 30, 2006. The increase in working capital resulted primarily from a $17.4 million increase in the Company s trade and notes receivable and a $30.7 million increase in inventories, partially offset by a $14.8 million increase in trade accounts payable, financed through an increase in the revolving credit facility. These increases support the worldwide growth of the Company, including the T2 Supply acquisition, and allow for greater customer financing as allowed by our return on invested capital (ROIC) model.

The increase in the amount of trade accounts receivable is attributable to an increase in sales during the quarter. The number of days sales outstanding (DSO) in ending trade receivables increased to 60 days at December 31, 2006 compared to 59 days at June 30, 2006. The increase in DSO for the quarter ended December 31, 2006 is a result of longer negotiated terms on larger, strategic deals reflecting the Company s decision to manage receivables to attain return on invested capital targets. Inventory turnover decreased to 6.5 times in the quarter ended December 31, 2006 from 7.2 times in the quarter ended June 30, 2006 but is within the Company s target rates.

Cash provided by operating activities was $4.6 million for the six months ended December 31, 2006 compared to $11.5 million of cash provided by operating activities for the six months ended December 31, 2005. The decrease in cash provided by operating activities was primarily attributable to the timing of vendor payments (in accordance with such terms).

Cash used in investing activities for the six months ended December 31, 2006 was $52.5 million. Cash used for business acquisitions totaled $50.6 million, primarily for the acquisition of T2 Supply and for an additional ownership interest in the Company s majority-owned subsidiary, Netpoint. The Company s capital expenditures of $2.0 million were primarily for purchases of equipment, software, and furniture.

Cash used in investing activities for the six months ended December 31, 2005 was $3.8 million, which included $2.5 million for capital expenditures and $1.3 million primarily for the purchase of additional ownership interest in the Company s majority-owned subsidiary, Netpoint, and its now wholly-owned subsidiary, OUI. The Company s capital expenditures included $1.1 million related to the expansion of the Memphis, Tennessee distribution center, as well as purchases of software, furniture and equipment.

At December 31, 2006 and June 30, 2006, the Company had a multi-currency revolving credit facility with its Bank Group of $140 million and $100 million, respectively, which matures on July 31, 2008. This facility was entered into on July 16, 2004 and has an accordion feature that allows the Company to unilaterally increase the revolving credit line up to a commitment of $150 million. The Company exercised $40 million of its $50 million credit facility accordion during the quarter ended September 30, 2006 and the remaining $10 million during January 2007. This increased the revolving credit facility exercised amount to $150 million. The facility bears interest at either the 30-day LIBOR rate of interest on U.S. dollar borrowings or the 30, 60, 90 or 180-day LIBOR rate of interest on other currency borrowings. The interest rate is the appropriate LIBOR rate plus a rate varying from 0.75% to 1.75% tied to the Company s funded debt to EBITDA ratio ranging from 0.00:1.00 to 2.50:1.00 and a fixed charge coverage ratio of not less than 1.50:1. The effective weighted average interest rate at December 31, 2006 and June 30, 2006 was 5.41% and 4.38%, respectively. The outstanding borrowings at December 31, 2006 were $58.0 million on a total commitment of $150 million, leaving $92.0 million available for additional borrowings. The outstanding borrowings at June 30, 2006 were $27.6 million on a total commitment of $130 million, leaving $102.4 million available for additional borrowings. The facility is collateralized by domestic assets, primarily accounts receivable and inventory. The agreement contains other restrictive financial covenants, including among other things, total liabilities to tangible net worth ratio, capital expenditure limits,

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

and a prohibition on the payment of dividends. On November 9, 2006, a ninety day waiver was received under the Company s revolving credit facility with respect to the delivery of certain quarterly information and documentation to the Company s lenders, to the extent impacted by the review of the Special Committee of the Company s stock option grant practices and related accounting issues. The waiver was extended on February 14, 2007 and on May 14, 2007. The May 14, 2007 waiver covers information and documentation for three quarters and is effective through June 30, 2007 (or as late as July 31, 2007 under certain conditions). Subject to the waivers noted above, the Company was in compliance with its covenants at December 31, 2006.

On February 14, 2007, the Company s revolving credit facility was amended to permit the Company to redeem shares of its capital stock, so long as the amount paid in connection with the redemptions does not exceed $2 million during any fiscal year.

On April 20, 2007, the Company s revolving credit facility Bank Group agreed to an increase in the Bank Group s commitment from $150 million to $200 million. Effective that date, the facility has an accordion feature that allows the Company to unilaterally increase the availability from $180 million to $200 million, in minimum increments of $5 million.

At December 31, 2006 and June 30, 2006, Netpoint, doing business as Scan*Source* Latin America, had an asset-based line of credit with a bank that was due on demand and had a borrowing limit of $1 million. The facility was renewed in January 2007, and is scheduled to mature on January 31, 2008. The facility is collateralized by accounts receivable and eligible inventory, and contains a restrictive covenant which requires an average deposit of $50,000 with the bank. The Company has guaranteed 92% and 84% of the balance on the line as of December 31, 2006 and June 30, 2006, respectively, while the remaining balance was guaranteed by Netpoint s minority shareholder. The facility bears interest at the bank s prime rate minus one percent. At December 31, 2006 and June 30, 2006, the effective interest rate was 7.25%. At December 31, 2006 and June 30, 2006, there were no outstanding balances and outstanding standby letters of credit totaled $40,000, leaving $960,000 available for borrowings. The Company was in compliance with its covenants at December 31, 2006.

On July 25, 2006, the Company entered into an agreement with a bank for a $13.0 million unsecured long-term note payable with monthly payments of interest only. At December 31, 2006, the balance of the note was $13.0 million and the effective rate of interest was 6.00%. The note matures in fiscal year 2009.

On August 17, 2006, the Company obtained an overdraft facility with a borrowing limit of 3 million. At December 31, 2006, the balance was 2.3 million or $3.1 million, and the effective rate of interest was 4.38%.

Cash provided by financing activities for the six months ended December 31, 2006 totaled $46.8 million, including advances of $28.4 million under the Company s credit facility, $12.9 million in additional long-term debt, a $3.0 million increase in short-term borrowings, $2.1 million in excess tax benefits from share-based payment arrangements, and $390,000 in proceeds from stock option exercises offset, in part, by the purchase of $39,000 of common stock.

Cash used in financing activities for the six months ended December 31, 2005 totaled $5.1 million, including a $4.5 million decrease in short-term borrowings, payments of $1.4 million under the Company s credit facility, and $1.7 million in payments on long-term debt, offset with $1.4 million in excess tax benefits from share-based payment arrangements and $1.1 million in proceeds from stock option exercises.

The Company believes that it has sufficient liquidity to meet its forecasted cash requirements for at least the next fiscal year.

Accounting Standards Recently Issued

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which requires companies to provide additional information regarding the effect of a company s choice to use fair value on its earnings and to display the fair value of those assets and liabilities which the company has chosen to use

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

on the face of the balance sheet. SFAS No. 159 is effective for the Company as of the year ending June 30, 2009. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS No. 159 will have on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements.* SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. SAB No. 108 is effective for the Company s fiscal year 2007 annual financial statements. The Company is currently evaluating the potential impact that the adoption of SAB No. 108 will have on its consolidated financial statements; the impact is not expected to be material.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R*). SFAS No. 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS No. 158 will become effective for the Company as of the fiscal year ending June 30, 2007. The Company does not have a defined benefit pension plan and is currently evaluating the potential impact, if any, the adoption of SFAS No. 158 will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for the Company beginning July 1, 2008. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS No. 157 will have on its consolidated financial statements.

On July 13, 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements by prescribing a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. Additionally, FIN 48 provides guidance on de-recognition of tax benefits previously recognized and additional disclosures for unrecognized tax benefits, interest and penalties. FIN 48 is effective for fiscal years beginning after December 15, 2006, and is required to be adopted by the Company in the first quarter of fiscal year 2008. The Company is currently evaluating whether the adoption of FIN 48 will have a material effect on its consolidated financial position, results of operations or cash flows.

Impact of Inflation

The Company has not been adversely affected by inflation as technological advances and competition within specialty technology markets has generally caused prices of the products sold by the Company to decline. Management believes that any price increases could be passed on to its customers, as prices charged by the Company are not set by long-term contracts.

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Item 3. Quantitative and Qualitati ve Disclosures about Market Risk

The Company s principal exposure to changes in financial market conditions in the normal course of its business is a result of its selective use of bank debt and transacting business in foreign currencies in connection with its foreign operations. The Company has chosen to present this information below in a sensitivity analysis format.

The Company is exposed to changes in interest rates primarily as a result of its borrowing activities, which include revolving credit facilities with a group of banks used to maintain liquidity and fund the Company s business operations. The nature and amount of the Company s debt may vary as a result of future business requirements, market conditions and other factors. The definitive extent of the Company s interest rate is not quantifiable or predictable because of the variability of future interest rates and business financing requirements, but the Company does not believe such risk is material. A hypothetical 100 basis point increase or decrease in interest rates on borrowings on the Company s revolving line of credit, variable rate long term debt and subsidiary line of credit for the quarter and six months ended December 31, 2006 would have resulted in an approximately $286,000 and $594,000 increase or decrease, respectively, in pre-tax income. The Company does not currently use derivative instruments or take other actions to adjust the Company s interest rate risk profile.

The Company is exposed to foreign currency risks that arise from its foreign operations in Canada, Mexico and Europe. These risks include the translation of local currency balances of foreign subsidiaries, inter-company loans with foreign subsidiaries and transactions denominated in non-functional currencies. Foreign exchange risk is managed by using foreign currency forward and option contracts to hedge these exposures, as well as balance sheet netting of exposures. The Company s Board of Directors has approved a foreign exchange hedging policy to minimize foreign currency exposure. The Company s policy is to utilize financial instruments to reduce risks where internal netting cannot be effectively employed and not to enter into foreign currency derivative instruments for speculative or trading purposes. The Company monitors its risk associated with the volatility of certain foreign currencies against its functional currencies and enters into foreign exchange derivative contracts to minimize short-term currency risks on cash flows. The Company continually evaluates foreign exchange risk and may enter into foreign exchange transactions in accordance with its policy. Foreign currency gains and losses are included in other expense (income).

The Company has elected not to designate its foreign currency contracts as hedging instruments, and therefore, the instruments are marked to market with changes in their values recorded in the Consolidated Income Statement each period. The underlying exposures are denominated primarily in British Pounds, Euros, and Canadian Dollars. At December 31, 2006, the Company had currency forward contracts outstanding with a net liability under these contracts of $19,000. At June 30, 2006, the Company had currency forward contracts outstanding with a net liability under these contracts of $25,000.

The Company does not utilize financial instruments for trading or other speculative purposes, nor does it utilize leveraged financial instruments. On the basis of the fair value of the Company s market sensitive instruments at December 31, 2006, the Company does not consider the potential near-term losses in future earnings, fair values and cash flows from reasonably possible near-term changes in interest rates and exchange rates to be material.

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Item 4. Controls and Procedures

Special Committee Review of Stock Option Grant Practices and Restatement

On October 9, 2006, a Special Committee of the Board of Directors, consisting solely of independent directors, began a review of the Company s historical stock option grant practices and related accounting issues from the time of its initial public offering in 1994 to 2006. The Special Committee with the assistance of independent legal counsel concluded its review and reported its findings and recommendations to management on January 15, 2007. The findings of the Special Committee were reported to the SEC in a Current Report on Form 8-K filing dated January 19, 2007 and indicated that, among other things, that there were deficiencies in the administration and oversight of the Company s stock option grant process including a lack of adequate processes and procedures for making grants, and an inattention to the need for accurate and timely documentation of grant decisions.

The Special Committee also recommended that management determine the impact of the findings on the Company s accounting for the option grants referenced in the findings and make appropriate adjustments and required disclosures.

In accordance with the Special Committee s recommendations, management initiated a detailed analysis of the facts and circumstances for all options granted between 1994 and 2006 and initially concluded that under applicable accounting rules, the appropriate measurement dates for certain stock option grants differed from the recorded measurement grant dates. Management completed the analysis and provided a preliminary estimate to the Board of the adjustment required for the changes to measurement dates to appropriately account for such grants.

On April 16, 2007, after consultation with management, the Board determined that the Company s previously issued financial statements included in its Annual Report on Form 10-K for the year ended June 30, 2006 (and perhaps financial statements for earlier periods) should no longer be relied upon because the adjustments were material and would require restatement. The non-cash stock based compensation adjustments reflected in the restatement total $5.3 million and relate primarily to stock option grant measurement date errors.

For more information regarding the review of the Company s stock option grant practices and the related restatement of financial statements included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006, see Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement related to stock options of, and Note 1A to the Notes to Consolidated Condensed Financial Statements presented in Part I, Item I of this report and Note 1A to the Notes to Consolidated Financial Statements included in the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

Evaluation of Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. The Company s Chief Executive Officer (CEO) and Chief Financial Officer (CFO) evaluated, with the participation of management, the effectiveness of the Company s disclosure controls and procedures as of the end of the period covered by this report as required by Rule 13a-15 or 15d-15 of the Exchange Act.

Based on this evaluation, which included the findings of the Special Committee s investigation and the restatement described herein, our CEO and CFO concluded that disclosure controls and procedures were not effective at a reasonable assurance level on December 31, 2006 because of a material weakness in internal control over financial reporting as it relates to stock option granting practices, as described in Management s Report on Internal Control Over Financial Reporting (Restated) in Item 9A, Controls and Procedures, in the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

Specifically, the Company did not have adequate controls in place over the determination of appropriate measurement dates and the related accounting for the stock option compensation costs included in selling, general and administrative expenses. As discussed below, certain changes to the Company s internal controls have been implemented as of the date of this filing

Changes in Internal Control over Financial Reporting

Management has taken and continues to take additional steps to remediate the material weakness discussed above for the

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Item 4. Controls and Procedures

fiscal year ending June 30, 2007, to significantly strengthen stock option grant practices and to implement processes to prevent and detect any future instances of improper accounting for stock options. The Board of Directors has reviewed and approved the steps being taken, including enhancements to policies and procedures, assignment of appropriate personnel to provide oversight over the administration and accounting for the stock option plans, and clear statements of the responsibilities and authority with respect to the granting of equity awards. These steps include:

Conducting a complete review of substantially all stock options granted for the period from 1994 to 2006 Management performed a detailed review of the facts and circumstances surrounding each option grant made to employees for the period from 1994 to 2006, and believes that all accounting issues were identified and have been appropriately adjusted.

Modifying policies and procedures Specific requirements for documentation of stock option award authorization and details, including timing of grant activities, are now identified in policies and procedures. These policies and procedures include procedures for determining the grant date, the exercise price, the detailed lists of award recipients and other procedures for ensuring that the awards are in accordance with the applicable stock option plan provisions and that the administration and accounting occurs within the appropriate time frame.

Changing personnel and responsibilities for authority and oversight The authority to grant equity awards is now clearly stated as the responsibility of the Compensation Committee of the Board, except that equity awards for newly-hired employees may be delegated to the CEO within appropriate written guidelines. The CFO and General Counsel of the Company have been given responsibility for ensuring compliance with the equity award policies and oversight for documentation and accounting for stock option awards.

Clarifying Board procedures for grant approval and documentation The Compensation Committee of the Board will have regularly scheduled meetings to discuss option awards and will document their meetings in minutes. Equity awards will only be approved at these meetings and will be promptly communicated to the CFO and the General Counsel. The minutes of the meetings will explicitly state the details of the awards including grantees, exercise price, number of shares underlying awards, and vesting schedules.

Enhancing stock option administration An independent third-party specializing in stock option administration is being hired to provide administrative services for the Company s stock option plans.

There were no changes in the Company s internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or 15d-15 of the Exchange Act, that occurred during the Company s fiscal quarter ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting. The Company initiated the review of stock option grants by management described above during the fiscal quarter ended December 31, 2006. Stock option grant policies were approved by the Board of Directors on April 12, 2007. The Company began taking the remaining remediation actions described above, including the establishment of detailed stock option grant procedures, during the fiscal quarter ending June 30, 2007.

Limitations on the Effectiveness of Controls

The Company maintains a system of internal accounting controls to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with management s authorization and recorded properly to permit the preparation of financial statements in accordance with accounting principles generally accepted in the United States. However, the Company s management, including the CEO and CFO, does not expect that the Company s disclosure controls or internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty. Breakdowns in the control systems can occur because of a simple error or mistake. Additionally, controls can be

circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control

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Item 4. Controls and Procedures (continued)

system, misstatements due to error or fraud may occur and not be detected.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On November 21, 2006, a purported stockholder filed a derivative lawsuit in the United States District Court for the District of South Carolina in Greenville, South Carolina against certain current and former officers and directors of the Company and against the Company, as a nominal defendant, asserting causes of action based on alleged violations of securities laws (including alleged violations of Section 10(b), 14(a) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 of the SEC) and other common law claims including, breach of fiduciary duty, aiding and abetting and unjust enrichment relating to allegations concerning certain of the Company s prior stock option grants. It seeks relief in the form of an accounting, rescission, unspecified money damages, disgorgement, attorneys fees, fees and expenses and other relief. On April 2, 2007 the Court appointed the plaintiff as lead plaintiff and ordered that any later actions filed in the same Court and that relate to the same facts shall be consolidated. Our response, including a motion to dismiss the lawsuit, is currently due on July 11, 2007.

On April 11, 2007, another purported stockholder filed a substantially similar derivative lawsuit also related to the Company s prior grants of stock options. This action was also filed in the United States District Court for the District of South Carolina in Greenville, South Carolina against certain current and former officers and directors of the Company and against the Company, as a nominal defendant, and asserts substantially similar causes of action and claims for relief. The plaintiff in this second action has filed a motion to consolidate the two actions and appoint the plaintiff as a co-lead plaintiff. Our response, including a motion to dismiss the lawsuit, is currently due July 11, 2007. The derivative lawsuits are in a preliminary stage and the Company believes that it is taking appropriate actions regarding both derivative lawsuits.

For more information concerning the review by the Special Committee of the Board of Directors of the Company s stock option granting practices and the findings and recommendations of the Special Committee see Note 1A to the Notes to Consolidated Condensed Financial Statements presented in Part I, Item I of this report, Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement related to stock options of the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006, and Note 1A to the Notes to Consolidated Financial Statements in the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006. The Company is also continuing voluntarily to provide information to the SEC and the Department of Justice in connection with the Special Committee s review.

On March 12, 2007 the Company s insurance carrier, subject to a reservation of rights provided a preliminary position on coverage for the first derivative claim in which the carrier indicated that the lawsuit allegations appear to constitute a claim within coverage of the Company s insurance policy. The carrier continues to assess coverage of this matter.

On April 13, 2007, the Company provided notice to the insurance carrier of the second action. The insurance carrier is reviewing the second action and assessing coverage for the matter. The carrier has indicated, however, that its coverage position with regard to the second action will be consistent with the first; i.e., that the allegations of the second derivative lawsuit appear to constitute a claim within the coverage of the Company s insurance policy. The carrier has not recognized as within coverage the costs, fees and expenses incurred for the work related to the Special Committee at this stage. The Company is evaluating its alternatives to address its coverage claim position.

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

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

The Company s annual meeting of shareholders was held on December 7, 2006. At the annual meeting, the shareholders (i) elected five directors who constitute all the directors continuing on the Board of Directors after the meeting, (ii) approved the Company s Amended and Restated Directors Equity Compensation Plan, and (iii) ratified the appointment of independent auditors for fiscal 2007. Votes on each matter presented at the annual meeting were as follows:

(i) Election of directors:

	Number of Shares	
Nominees	**For**	**Withheld**
Michael L. Baur	12,926,798	11,747,414
Steven R. Fischer	22,054,639	2,619,573
James G. Foody	22,106,925	2,567,287
Michael J. Grainger	22,272,296	2,401,916
John P. Reilly	22,270,996	2,403,216

(ii) Proposal to amend the Company s Amended and Restated Directors Equity Compensation Plan:

	Number of Shares
For	18,484,510
Against	3,652,422
Abstain	28,694
Broker Non-Votes	2,508,586

(iii) Proposal to ratify the appointment of Ernst & Young as the Company s independent auditors for the fiscal year ending June 30, 2007:

	Number of Shares
For	24,568,123
Against	94,512
Abstain	11,576

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Item 6. Exhibits

Exhibits

10.1	Waivers dated as of November 9, 2006 to Amended and Restated Credit Agreement dated as of July 16, 2004, as amended, among ScanSource, Inc., Netpoint International, Inc., Scansource Europe Limited, Scansource UK Limited, 4100 Quest, LLC, Partner Services, Inc. and T2 Supply, Inc., Branch Banking and Trust Company of South Carolina, Wachovia Bank, National Association, Fifth Third Bank, First Tennessee Bank National Association and Capital One, N.A.
31.1	Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

SCANSOURCE, INC.

/s/ MICHAEL L. BAUR
MICHAEL L. BAUR
President and Chief Executive Officer

(Principal Executive Officer)

/s/ RICHARD P. CLEYS
RICHARD P. CLEYS
Vice President and Chief Financial Officer

(Principal Financial Officer)

Date: June 18, 2007

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