UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**
for the Quarterly Period Ended March 31, 2007

or

¨ **Transition Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**
for the transition period from ______ to ______

Commission File Number: 000-26926

SCANSOURCE, INC.

(Exact name of registrant as specified in its charter)

SOUTH CAROLINA **(State or other jurisdiction of** **incorporation or organization)**	**57-0965380** **(I.R.S. Employer** **Identification No.)**
6 Logue Court, Greenville, South Carolina **(Address of principal executive offices)**	**29615** **(Zip Code)**

(864) 288-2432

(Registrant s telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ¨ No x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer ¨ Accelerated filer x Non-Accelerated filer ¨

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at May 28, 2007
Common Stock, no par value per share	**25,841,721 shares**

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SCANSOURCE, INC.

INDEX TO FORM 10-Q

March 31, 2007

Cautionary Statements

Certain of the statements contained in this Form 10-Q, as well as in the Company s other filings with the Securities and Exchange Commission (SEC), that are not historical facts are forward-looking statements subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. The Company cautions readers of this report that a number of important factors could cause the Company s activities and/or actual results in fiscal 2007 and beyond to differ materially from those expressed in any such forward-looking statements. These factors include, without limitation: the Company s dependence on vendors, product supply and availability, senior management, centralized functions and third-party shippers; the Company s ability to compete successfully in a highly competitive market and to manage significant additions in personnel and increases in working capital; the Company s ability to collect outstanding accounts receivable; the Company s entry into new product markets in which it has no prior experience; the Company s susceptibility to quarterly fluctuations in net sales and results of operations; the Company s ability to manage successfully pricing or stock rotation opportunities associated with inventory value decreases; narrow profit margins; inventory risks due to shifts in market demand; dependence on information systems; credit exposure due to the deterioration in the financial condition of our customers; a downturn in the general economy; the inability to obtain required capital; potential adverse effects of acquisitions; fluctuations in interest rates, foreign currency exchange rates and exposure to foreign markets; the imposition of governmental controls, currency devaluations, export license requirements and restrictions on the export of certain technology; dependence on third party freight forwarders and the third party warehouse in Europe; political instability, trade restrictions and tariff changes; difficulties in staffing and managing international operations; changes in the interpretation and enforcement of laws (in particular related to items such as duty and taxation); difficulties in collecting accounts receivable, longer collection periods and the impact of local economic conditions and practices; the impact of changes in income tax legislation; acts of war or terrorism; exposure to natural disasters; potential impact of labor strikes; volatility of the stock market; and the accuracy of forecast data; changes in accounting standards and other factors described herein and in other reports and documents filed by the Company with the SEC, including Item 1A of the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

Additional discussion of these and other factors affecting our business and prospects is contained in our periodic filings with the SEC, copies of which can be obtained at the Investor Relations section of our website at *www.scansource.com*. We provide our annual and quarterly reports free of charge on *www.scansource.com*, as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC. We provide a link to all SEC filings where our periodic reports and current reports on Form 8-K and any amendments to previously filed reports may be accessed, free of charge.

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Explanatory Note

Concurrently with the filing of this Form 10-Q, the Company is filing Amendment No.1 on Form 10-K/A to its Annual Report on Form 10-K for the fiscal year ended June 30, 2006. In this Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2007, the Company is restating its condensed consolidated financial statements and related disclosures as of March 31, 2006 and for the three months ended March 31, 2006. The restatement includes adjustments arising from a review of the Company s historical stock option grant practices, including adjustments to stock based compensation expense as a result of an analysis of the Company s historical stock option measurement dates. In October, 2006, the Company s Board of Directors appointed a Special Committee ,which was assisted by independent legal counsel and accounting experts, to conduct a review of the Company s historical stock option granting practices. The Special Committee reported its results in January, 2007 and the Company completed its accounting analysis in April, 2007, concluding that a restatement was necessary. See Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement related to stock options , and Note 1A to the Notes to Consolidated Financial Statements included in Part II, Item 8 of such amended Annual Report on Form 10-K/A for more information.

In the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006, the Company restated its consolidated balance sheets of June 30, 2006 and June 30, 2005; the consolidated statements of operations, stockholders equity and cash flows for the years ended June 30, 2006, June 30, 2005 and June 30, 2004; and related disclosures. The restatement included adjustments arising from the review of the Company s stock option grant practices and related accounting issues for the fiscal periods from 1994 to 2006. The Company also recorded adjustments affecting previously-reported financial statements for fiscal years prior to fiscal 2004, the impact of which has been reflected as an adjustment to retained earnings as of June 30, 2003. The Form 10-K/A also includes the restatement of selected consolidated financial data as of and for the years ended June 30, 2006, 2005, 2004, 2003 and 2002, which is included in Item 6, Selected Financial Data, of the Form 10-K/A, and the unaudited quarterly financial data for each of the quarters in the years ended June 30, 2006 and 2005, which is included in Item 8, Financial Statements and Supplementary Data, of the Form 10-K/A.

Except as set forth in the previous paragraph, we do not intend to amend any of our other previously filed annual reports on Form 10-K or quarterly reports on Form 10-Q for the periods affected by the restatement or adjustments but have amended and restated (i) information as of September 30, 2005 and for the three month period then ended included in the Quarterly Report on Form 10-Q for the period ended September 30, 2006, (ii) information as of December 31, 2005 and for the three and six-month periods then ended included in the Quarterly Report on Form 10-Q for the period ended December 31, 2006, and (iii) information as of March 31, 2006 and for three and nine-month periods then ended which is included in this Quarterly Report on Form 10-Q. Except as otherwise specifically noted in this Quarterly Report in Form 10-Q and except for the sections of this Form 10-Q entitled Special Committee Review of Past Stock Option Granting Practices in Item 1, Note 1A to the Notes to Condensed Consolidated Financial Statements, and Item 4 Controls and Procedures, all of the information in this Quarterly Report on Form 10-Q is as of March 31, 2007 and does not reflect events occurring after March 31, 2007. Accordingly, this Quarterly Report on Form 10-Q should be read in conjunction with the Company s amended Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006, its Quarterly Report on Form 10-Q for the quarter ended September 30, 2006, and its Quarterly Report on Form 10-Q for the quarter ended December 31, 2006, as well as any Current Reports filed on Form 8-K.

On October 26, 2006, the Company announced unaudited results for the first quarter of fiscal year 2007 that ended on September 30, 2006. The announced results were impacted by the restatement. The Company s earnings announcements on April 26, 2007 and January 25, 2007 for the third and second quarters of fiscal year 2007, respectively, were limited to sales and gross margin, which were not impacted by the restatement.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

SCAN*SOURCE*, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands)

Assets	**March 31, 2007**	**June 30, 2006 (restated) [1]**
Current assets:		
Cash and cash equivalents	$ 3,036	$ 3,831
Trade and notes receivable:		
Trade, less allowance of $14,442 at March 31, 2007 and $11,508 at June 30, 2006	333,823	300,240
Other	8,020	4,558
Inventories	291,332	244,005
Prepaid expenses and other assets	3,012	2,293
Deferred income taxes	16,604	15,709
Total current assets	655,827	570,636
Property and equipment, net	25,767	27,098
Goodwill	37,865	14,404
Other assets, including identifiable intangible assets	17,724	5,359
Total assets	$ 737,183	$ 617,497

[1] See Note 1A, Notes to Condensed Consolidated Financial Statements

See Notes to Condensed Consolidated Financial Statements

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except for share information)

(Continued)

Liabilities and Shareholders Equity	**March 31, 2007**	**June 30, 2006 (restated) [1]**
Current liabilities:		
Current portion of long-term debt	$ 230	$ 229
Short-term borrowings	3,019	
Trade accounts payable	250,054	271,519
Accrued expenses and other liabilities	33,197	30,359
Income taxes payable	3,986	6,358
Total current liabilities	290,486	308,465
Long-term debt	17,239	4,398
Borrowings under revolving credit facility	112,403	27,558
Other long-term liabilities	4,427	2,757
Total liabilities	424,555	343,178
Minority interest	512	910
Commitments and contingencies		
Shareholders equity:		
Preferred stock, no par value; 3,000,000 shares authorized, none issued		
Common stock, no par value; 45,000,000 shares authorized, 25,837,348 and 25,725,214 shares issued and outstanding at March 31, 2007 and June 30, 2006, respectively	82,794	76,915
Retained earnings	223,200	191,876
Accumulated other comprehensive income	6,122	4,618
Total shareholders equity	312,116	273,409
Total liabilities and shareholders equity	$ 737,183	$ 617,497

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

See Notes to Condensed Consolidated Financial Statements

SCAN*SOURCE*, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED INCOME STATEMENTS (UNAUDITED)

(In thousands, except per share data)

	Quarter ended March 31,		Nine months ended March 31,	
	2007	2006 (restated) [1]	2007	2006 (restated) [1]
Net sales	$ 492,678	$ 405,592	$ 1,462,642	$ 1,204,456
Cost of goods sold	441,641	364,332	1,306,990	1,081,033
Gross profit	51,037	41,260	155,652	123,423
Operating expenses:				
Selling, general and administrative expenses	33,795	26,820	101,014	79,051
Operating income	17,242	14,440	54,638	44,372
Other expense (income):				
Interest expense	1,939	633	5,464	1,598
Interest income	(246)	(243)	(529)	(547)
Other, net	141	(121)	(420)	(160)
Total other expense (income)	1,834	269	4,515	891
Income before income taxes and minority interest	15,408	14,171	50,123	43,481
Provision for income taxes	5,326	5,150	18,743	16,395
Income before minority interest	10,082	9,021	31,380	27,086
Minority interest in income of consolidated subsidiaries, net of income tax expense of $20 and $37, respectively, and $36 and $72, respectively	11	15	57	126
Net income	$ 10,071	$ 9,006	$ 31,323	$ 26,960
Net income per common share, basic	$ 0.39	$ 0.35	$ 1.22	$ 1.06
Weighted-average shares outstanding, basic	25,770	25,555	25,749	25,429
Net income per common share, assuming dilution	$ 0.38	$ 0.35	$ 1.19	$ 1.04
Weighted-average shares outstanding, assuming dilution	26,194	26,101	26,213	25,996

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

See Notes to Condensed Consolidated Financial Statements

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

	Nine Months Ended March 31, 2007	Nine Months Ended March 31, 2006 (restated) (1)
Cash flows from operating activities:		
Net income	$ 31,323	$ 26,960
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	3,808	4,154
Amortization of intangible assets	1,345	150
Allowance for accounts and notes receivable	7,017	2,451
Share-based compensation and restricted stock	2,884	3,237
Impairment of capitalized software	148	
Deferred income tax (benefit) expense	(1,346)	(2,091)
Excess tax benefits from share-based payment arrangements	(2,105)	(1,427)
Minority interest in income of subsidiaries	57	126
Changes in operating assets and liabilities, net of acquisitions:		
Trade and notes receivable	(27,853)	(44,950)
Other receivables	(2,795)	(489)
Inventories	(40,835)	(40,916)
Prepaid expenses and other assets	(699)	558
Other noncurrent assets	(1,092)	4,738
Trade accounts payable	(22,611)	66,343
Accrued expenses and other liabilities	3,950	5,304
Income taxes payable	(411)	(1,154)
Net cash (used in) provided by operating activities	(49,215)	22,994
Cash flows used in investing activities:		
Capital expenditures	(2,501)	(4,029)
Cash paid for business acquisitions, net of cash acquired	(50,585)	(1,348)
Net cash used in investing activities	(53,086)	(5,377)
Cash flows from financing activities:		
Increases (decreases) in short-term borrowings, net	2,877	(4,478)
Advances (payments) on revolving credit, net	82,616	(6,414)
Exercise of stock options	970	2,303
Excess tax benefits from share-based payment arrangements	2,105	1,427
Advances (repayments) of long-term debt borrowings	12,841	(1,926)
Net cash provided by (used in) financing activities	101,409	(9,088)
Effect of exchange rate changes on cash and cash equivalents	97	(261)
(Decrease) Increase in cash and cash equivalents	(795)	8,268
Cash and cash equivalents at beginning of period	3,831	8,609
Cash and cash equivalents at end of period	$ 3,036	$ 16,877

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

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SCAN*SOURCE*, 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 March 31, 2007 and June 30, 2006, the results of operations for the quarters and nine months ended March 31, 2007 and 2006 and the statement of cash flows for the nine months ended March 31, 2007 and 2006. The results of operations for the quarters and nine months ended March 31, 2007 and 2006 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

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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:

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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 nine months ended March 31, 2006.

Condensed Consolidated Income Statements (Unaudited)

(in thousands, except per share data)

	Quarter ended March 31, 2006				Nine months ended March 31, 2006			
	As previously reported	Restatement adjustments	Audit adjustments	Restated	As previously reported	Restatement adjustments	Audit adjustments	Restated
Net sales	$ 405,592	$	$	$ 405,592	$ 1,204,456	$	$	$ 1,204,456
Cost of goods sold	364,332			364,332	1,081,032		1	1,081,033
Gross profit	41,260			41,260	123,424		(1)	123,423
Operating expenses:								
Selling, general and administrative expenses	26,134	348	338	26,820	77,415	812	824	79,051
Operating income	15,126	(348)	(338)	14,440	46,009	(812)	(825)	44,372
Other expense (income):								
Interest expense	633			633	1,599		(1)	1,598
Interest income	(243)			(243)	(547)			(547)
Other, net	(118)		(3)	(121)	(228)		68	(160)
Total other expense (income)	272		(3)	269	824		67	891
Income before income taxes and minority interest	14,854	(348)	(335)	14,171	45,185	(812)	(892)	43,481
Provision for income taxes	5,398	(127)	(121)	5,150	17,035	(304)	(336)	16,395
Income before minority interest	9,456	(221)	(214)	9,021	28,150	(508)	(556)	27,086
Minority interest in income of consolidated subsidiaries, net of income tax expense	15			15	125		1	126
Net income	$ 9,441	$ (221)	$ (214)	$ 9,006	$ 28,025	$ (508)	$ (557)	$ 26,960
Per share data:								
Net income per common share, basic	$ 0.37	$ (0.01)	$ (0.01)	$ 0.35	$ 1.10	$ (0.02)	$ (0.02)	$ 1.06
Net income per common share, assuming dilution	$ 0.36	$ (0.01)	$	$ 0.35	$ 1.07	$ (0.02)	$ (0.01)	$ 1.04
Weighted-average shares outstanding, basic	25,555			25,555	25,429			25,429

Weighted-average shares outstanding, assuming dilution	26,329	(228)	26,101	26,284	(288)	25,996

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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 nine months ended March 31, 2006.

Condensed Consolidated Statements of Cash Flows (Unaudited)

(in thousands)

	Nine Months Ended March 31, 2006			
	As previously reported	Restatement adjustments	Audit adjustments	Restated
Cash flows from operating activities:				
Net income	$ 28,025	$ (508)	$ (557)	$ 26,960
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation	4,154			4,154
Amortization of intangible assets	150			150
Allowance for accounts and notes receivable	2,442		9	2,451
Share-based compensation and restricted stock	2,893	344		3,237
Impairment of capitalized software				
Deferred income tax (benefit) expense	(1,563)	(528)		(2,091)
Excess tax benefits from share-based payment arrangements	(1,186)	(241)		(1,427)
Minority interest in income of subsidiaries	125		1	126
Changes in operating assets and liabilities, net of acquisitions:				
Trade and notes receivable	(44,950)			(44,950)
Other receivables	(489)			(489)
Inventories	(40,916)			(40,916)
Prepaid expenses and other assets	556		2	558
Other noncurrent assets	4,738			4,738
Trade accounts payable	66,343			66,343
Accrued expenses and other liabilities	3,954	468	882	5,304
Income taxes payable	(1,042)	224	(336)	(1,154)
Net cash (used in) provided by operating activities	23,234	(241)	1	22,994
Cash flows used in investing activities:				
Capital expenditures	(4,029)			(4,029)
Cash paid for business acquisitions, net of cash acquired	(1,348)			(1,348)
Net cash used in investing activities	(5,377)			(5,377)
Cash flows from financing activities:				
Increases (decreases) in short-term borrowings, net	(4,478)			(4,478)
Advances (payments) on revolving credit, net	(6,414)			(6,414)
Exercise of stock options	2,303			2,303
Excess tax benefits from share-based payment arrangements	1,186	241		1,427
Advances (repayments) of long-term debt borrowings	(1,925)		(1)	(1,926)
Net cash provided by (used in) financing activities	(9,328)	241	(1)	(9,088)
Effect of exchange rate changes on cash and cash equivalents	(261)			(261)

(Decrease) Increase in cash and cash equivalents	8,268			8,268
Cash and cash equivalents at beginning of period	8,609			8,609
Cash and cash equivalents at end of period	$ 16,877	$	$	$ 16,877

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(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

The Company maintains an allowance for uncollectible accounts receivable for estimated losses resulting from

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 $46,655,000 and $43,421,000 as of March 31, 2007 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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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Quarter ended March 31, 2007	Quarter ended March 31, 2006 (restated) [1]	Nine months ended March 31, 2007	Nine months ended March 31, 2006 (restated) [1]
Foreign exchange derivative contract gains/(losses)	$ (36,000)	$ (98,000)	$ 121,000	$ (138,000)
Foreign currency transactional and remeasurement gains/(losses)	(199,000)	66,000	32,000	58,000
Net foreign currency transactional and remeasurement gains/(losses)	$ (235,000)	$ (32,000)	$ 153,000	$ (80,000)

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

The Company had three currency forward contracts outstanding as of March 31, 2007 with a net liability under these contracts of $8,000. 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 March 31, 2007		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	$ 5,844,000	$ (3,000)	$ 5,584,000	$ (21,000)
Euro Functional Currency				
Purchase Euro, sell British Pound	$ 2,953,000	(5,000)	$ 2,774,000	(4,000)
US Dollar Functional currency				
Purchase US Dollar, sell Canadian Dollar	$ 2,168,000		$ 2,242,000	
		$ (8,000)		$ (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

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

expenses. EITF Issue No. 02-16*, Accounting by a Customer (Including a Reseller) for Certain Consideration Received 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 these 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 nine months ended March 31, 2007, and $0 for the quarter and nine months ended March 31, 2006 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 March 31, 2006 and 2007, respectively.

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

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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 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 nine months ended March 31, 2007 was $2.7 million and $8.2 million, respectively. Shipping revenue for the quarter and nine months ended March 31, 2006 was $2.1 million and $6.2 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 nine months ended March 31, 2007 or 2006. Deferred advertising costs at March 31, 2007 and 2006 were not significant.

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 losses, net of gains, were $235,000 and $32,000 for the quarters ended March 31, 2007 and 2006, respectively. Such gains, net of losses, were $153,000 for the nine months ended March 31, 2007 and losses, net of gains, were $80,000 for the nine months ended March 31, 2006.

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 nine months ended March 31, 2007, the number of options exercised for shares of common stock were 81,481 and 117,036, respectively. For the quarter and nine months ended March 31, 2006, the number of options exercised for shares of common stock were 159,513 and 343,439, respectively.

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 to be permanently reinvested. For the quarter and nine months ended March 31, 2007, comprehensive income consisted of net income of the Company of $10.1 million and $31.3 million, respectively, and net translation adjustments of $253,000 and $1.5 million, respectively. For the quarter and nine months ended March 31, 2006, comprehensive income consisted of net income of the Company of $9.0 million and $27.0 million, respectively, and net translation adjustments of $423,000 and $(84,000), 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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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(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 March 31, 2007:			
Income per common share, basic	$ 10,071,000	25,770,000	$ 0.39
Effect of dilutive stock options		424,000	
Income per common share, assuming dilution	$ 10,071,000	26,194,000	$ 0.38
Nine months ended March 31, 2007:			
Income per common share, basic	$ 31,323,000	25,749,000	$ 1.22
Effect of dilutive stock options		464,000	
Income per common share, assuming dilution	$ 31,323,000	26,213,000	$ 1.19
Quarter ended March 31, 2006 (restated)[1]:			
Income per common share, basic	$ 9,006,000	25,555,000	$ 0.35
Effect of dilutive stock options		546,000	
Income per common share, assuming dilution	$ 9,006,000	26,101,000	$ 0.35
Nine months ended March 31, 2006 (restated)[1]:			
Income per common share, basic	$ 26,960,000	25,429,000	$ 1.06
Effect of dilutive stock options		567,000	
Income per common share, assuming dilution	$ 26,960,000	25,996,000	$ 1.04

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

For the quarter and nine months ended March 31, 2007, there were 567,000 and 571,000 weighted average shares, respectively, excluded from the computation of diluted earnings per share because their effect would have been antidilutive. For the quarter and nine months ended March 31, 2006, there were 525,000 and 376,000 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 March 31, 2007 and June 30, 2006, the Company had a multi-currency revolving credit facility with its bank group (the Bank Group) of $150 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 the quarter ended March 31, 2007.

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

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This increased the revolving credit facility exercised amount to $150 million. (See Note 11 for a discussion of a subsequent amendment). 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 March 31, 2007 and June 30, 2006 was 5.73% and 4.38%, respectively. The outstanding borrowings at March 31, 2007 were $112.4 million on a total commitment of $150 million, leaving $37.6 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).

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.

At March 31, 2007 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 March 31, 2007 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. The effective interest rate at March 31, 2007 and June 30, 2006 was 6.86% and 7.25%, respectively. At March 31, 2007 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 March 31, 2007 consist of a 3.0 million secured revolving credit facility obtained on August 17, 2006, with a variable interest rate of 4.62% and no maturity date. At March 31, 2007, 2.3 million or $3.0 million was outstanding. The Company had no short-term borrowings at June 30, 2006.

Long-term debt consists of the following at March 31, 2007 and June 30, 2006:

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SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	March 31, 2007	June 30, 2006
Unsecured note payable to a bank, monthly payments of interest only; 5.97% variable interest rate at March 31, 2007; 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; 6.07% and 5.88% variable interest rate, respectively at March 31, 2007 and June 30, 2006; maturing in fiscal year 2009 with a balloon payment of approximately $4,175,000	4,469,000	4,627,000
	17,469,000	4,627,000
Less current portion	230,000	229,000
Long-term portion	$ 17,239,000	$ 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 March 31, 2007, 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		347,000	347,000
Balance as of March 31, 2007	$ 28,694,000	$ 9,171,000	$ 37,865,000

Included within other assets are identifiable intangible assets as follows:

	As of March 31, 2007			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	$ 1,053,000	$ 8,815,000	$ 338,000	$ 302,000	$ 36,000
Debt issue costs	606,000	376,000	230,000	532,000	254,000	278,000
Trade names	825,000	62,000	763,000			
Non-compete agreements	1,635,000	409,000	1,226,000			
Total	$ 12,934,000	$ 1,900,000	$ 11,034,000	$ 870,000	$ 556,000	$ 314,000

The weighted average amortization period for all intangible assets was approximately nine years for the quarter ended March 31, 2007 and four years for the fiscal year ended June 30, 2006. Amortization expense for the quarter and nine months ended March 31, 2007 was $449,000 and $1.3 million, respectively. Amortization expense for fiscal years 2007, 2008, 2009, 2010, 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 concentration. No single account represented more than 7% of the Company s consolidated net sales during the quarter

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and nine month periods ended March 31, 2007 and 2006.

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 nine month periods ended March 31, 2007 and 2006.

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 March 31,		Nine months ended March 31,	
	2007	2006	2007	2006
Sales:				
North American distribution	$ 418,034,000	$ 353,827,000	$ 1,253,553,000	$ 1,063,210,000
International distribution	79,570,000	56,185,000	228,057,000	155,291,000
Less intersegment sales	(4,926,000)	(4,420,000)	(18,968,000)	(14,045,000)
	$ 492,678,000	$ 405,592,000	$ 1,462,642,000	$ 1,204,456,000
Depreciation and amortization:				
North American distribution	$ 1,404,000	$ 1,306,000	$ 4,634,000	$ 3,882,000
International distribution	175,000	154,000	518,000	422,000
	$ 1,579,000	$ 1,460,000	$ 5,152,000	$ 4,304,000
Operating income:		(restated)**		(restated)**
North American distribution	$ 14,382,000*	$ 11,514,000	$ 46,031,000*	$ 39,332,000
International distribution	2,860,000	2,926,000	8,607,000	5,040,000
	$ 17,242,000	$ 14,440,000	$ 54,638,000	$ 44,372,000
Capital expenditures:				
North American distribution	$ 399,000	$ 1,107,000	$ 2,082,000	$ 3,218,000
International distribution	143,000	467,000	419,000	811,000
	$ 542,000	$ 1,574,000	$ 2,501,000	$ 4,029,000

* Included in North American distribution s operating income for the quarter and nine months ended March 31, 2007 is $3.0 million and $7.9 million, respectively, for the direct costs associated with the special committee review (see note 1A.).

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	Quarter ended			Nine months ended		
	March 31, 2006			March 31, 2006		
** Restated Operating income per above	As previously reported	Adjustments	Restated (1)	As previously reported	Adjustments	Restated (1)
North American distribution	$ 12,146,000	$ (632,000)	$ 11,514,000	$ 40,801,000	$ (1,469,000)	$ 39,332,000
International distribution	2,980,000	(54,000)	2,926,000	5,208,000	(168,000)	5,040,000
	$ 15,126,000	$ (686,000)	$ 14,440,000	$ 46,009,000	$ (1,637,000)	$ 44,372,000

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

Assets for each business segment are summarized below:

		June 30, 2006		
Assets:	March 31, 2007	As previously reported	Adjustments	Restated (1)
North American distribution	$ 608,574,000	$ 504,313,000	$ 4,278,000	$ 508,591,000
International distribution	128,609,000	108,906,000		108,906,000
	$ 737,183,000	$ 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 March 31, 2007, 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 March 31, 2007, 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 $133,000 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 approximately $1.4 million for the purchase of software and equipment at March 31, 2007. In addition, on April 27, 2007, the Company entered into an agreement to lease approximately 600,000 square feet of space in a building in Southaven, Mississippi (see Note 11).

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(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 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 May 14, 2007, an extension was received to the ninety day waiver initially received on November 9, 2006 (and thereafter extended on February 14, 2007) 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 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 March 31, 2007	2006	Difference	Percentage Change
		(In thousands)		
North American distribution	$ 413,108	$ 349,407	$ 63,701	18.2%
International distribution	79,570	56,185	23,385	41.6%
Net sales	$ 492,678	$ 405,592	$ 87,086	21.5%

	Nine months ended March 31, 2007	2006	Difference	Percentage Change
		(In thousands)		
North American distribution	$ 1,234,585	$ 1,049,165	$ 185,420	17.7%
International distribution	228,057	155,291	72,766	46.9%
Net sales	$ 1,462,642	$ 1,204,456	$ 258,186	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 nine months ended March 31, 2007 and 2006. The 18.2% or $63.7 million increase in North American distribution sales for the quarter ended March 31, 2007, as compared to the same period in the prior year, was due primarily to the reasons described below. The 17.7 % or $185.4 million increase for the nine months ended March 31, 2007, 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 15.2% as compared to the prior year quarter and 17.2% as compared to the prior year nine 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 and nine months ended March 31, 2007.

Sales of communications products increased 21.7% as compared to the prior year quarter and 18.2% as compared to the prior year nine month period. The communications business included record sales and increased market share for T2 Supply, a sales unit acquired July 3, 2006. The majority of the increase in the communications products business was due to the inclusion of T2 Supply in this year s results.

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 41.6% or $23.4 million for the quarter ended March 31, 2007 and 46.9% or $72.8 million for the nine month period ended March 31, 2007 as compared to the same periods in the prior year. The increase in sales was primarily attributable to a gain in market share in Europe and Latin America. Without the foreign exchange fluctuations, the increase in sales for the quarter and nine months ended March 31,

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2007 would have been $18.2 million or 32.4% and $60.6 million or 39.0%, respectively.

Gross Profit

The following tables summarize the Company s gross profit:

	Quarter ended March 31, 2007	2006	Difference	Percentage Change	Percentage of Sales March 31, 2007	2006
	(In thousands)					
North American distribution	$ 41,351	$ 33,173	$ 8,178	24.7%	10.0%	9.5%
International distribution	9,686	8,087	1,599	19.8%	12.2%	14.4%
Gross profit	$ 51,037	$ 41,260	$ 9,777	23.7%	10.4%	10.2%

	Nine months ended March 31, 2007	2006	Difference	Change	Percentage of Sales March 31, 2007	2006
	(In thousands)					
North American distribution	$ 127,228	$ 102,909	$ 24,319	23.6%	10.3%	9.8%
International distribution	28,424	20,514	7,910	38.6%	12.5%	13.2%
Gross profit	$ 155,652	$ 123,423	$ 32,229	26.1%	10.6%	10.2%

North American Distribution

Gross profit for the North American distribution segment increased 24.7% or $8.2 million for the quarter ended March 31, 2007 and 23.6% or $24.3 million for the nine month period ended March 31, 2007 as compared to the same periods in the prior year. The increase in gross profit for the quarter and nine months ended March 31, 2007 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 product mix, including higher services revenues.

International Distribution

Gross profit for the international distribution segment increased 19.8% or $1.6 million for the quarter ended March 31, 2007 and 38.6% or $7.9 million for the nine month period ended March 31, 2007 as compared to the same period in the prior year. The increase was primarily due to increased distribution sales volume.

Gross profit, as a percentage of net sales, which is typically greater than the North American Distribution segment, decreased for the quarter and nine month periods ended March 31, 2007 as compared to the same period in the prior year due primarily to lower vendor credits as a percentage of sales in Europe.

Operating Expenses

The following table summarizes the Company s operating expenses:

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	Period ended March 31, 2007	2006 (restated) (1)	Difference	Percentage Change	Percentage of Sales March 31, 2007	2006
	(In thousands)					
Quarter	$ 33,795	$ 26,820	$ 6,975	26.0%	6.9%	6.6%
Nine months	$ 101,014	$ 79,051	$ 21,963	27.8%	6.9%	6.6%

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

For the quarter ended March 31, 2007, operating expenses increased compared to the same period in the prior year. The increase is due principally to special committee expenses of $3.0 million related to the Company s stock option investigation, incremental and T2 Supply-related increases in employee headcount and related benefits of approximately $1.9 million, the recognition of higher bad debt expense of approximately $1.2 million, and amortization expense for T2 Supply intangibles of $395,000.

The Company continues to invest in North America customer training and development programs for new technologies and vertical marketing (such as converged communications and IMPACT NOW), its electronic security business, and in additional resources for our rapidly growing T2 Supply 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 to offer VAR education and training events.

For the nine months ended March 31, 2007, operating expenses increased compared to the same period in the prior year. The increase is due principally to $7.9 million special committee expenses related to the Company s stock option investigation, $6.2 million increase related to increased employee headcount and related benefits, a $4.6 million increase in bad debt expense, and $1.2 million of amortization related to the T2 Supply acquisition.

Operating Income

The following table summarizes the Company s operating income:

	Period ended March 31, 2007	2006 (restated) (1)	Difference	Percentage Change	Percentage of Sales March 31, 2007	2006
	(In thousands)					
Quarter	$ 17,242	$ 14,440	$ 2,802	19.4%	3.5%	3.6%
Nine months	$ 54,638	$ 44,372	$ 10,266	23.1%	3.7%	3.7%

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

Operating income increased 19.4% or $2.8 million for the quarter ended March 31, 2007 and 23.1% or $10.3 million for the nine month period ended March 31, 2007 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, somewhat offset by increased operating expenses, including the special committee costs.

Operating income as a percentage of net sales remained consistent compared to the same periods in the prior year.

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Total Other Expense (Income)

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

	Quarter ended				Percentage of Sales	
	March 31,			Percentage	March 31,	
	2007	2006 (restated) (1)	Difference	Change	2007	2006
	(In thousands)					
Interest expense	$ 1,939	$ 633	$ 1,306	206.3%	0.4%	0.2%
Interest income	(246)	(243)	(3)	1.2%	0.0%	-0.1%
Net foreign exchange (gains) losses	235	32	203	634.4%	0.0%	0.0%
Other, net	(94)	(153)	59	-38.6%	0.0%	0.0%
Total other expense	$ 1,834	$ 269	$ 1,565	581.8%	0.4%	0.1%

	Nine months ended				Percentage of Sales	
	March 31,			Percentage	March 31,	
	2007	2006 (restated) (1)	Difference	Change	2007	2006
	(In thousands)					
Interest expense	$ 5,464	$ 1,599	$ 3,865	241.7%	0.3%	0.1%
Interest income	(529)	(547)	18	-3.3%	0.0%	0.0%
Net foreign exchange (gains) losses	(153)	80	(233)	-291.3%	0.0%	0.0%
Other, net	(267)	(241)	(26)	10.8%	0.0%	0.0%
Total other expense	$ 4,515	$ 891	$ 3,624	406.7%	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 nine months ended March 31, 2007 was $1.9 million and $5.5 million, respectively. Interest expense for the quarter and nine months ended March 31, 2006 was $633,000 and $1.6 million, respectively. The increased expense during the quarter ended March 31, 2007 was primarily due to higher average debt balances 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 re-measurements, offset by net foreign currency exchange contract gains and losses. Net foreign exchange losses for the quarter ended March 31, 2007 were $235,000 and net foreign exchanges gains for the nine months ended March 31, 2007 were $153,000. Net foreign exchange losses for the quarter and nine months ended March 31, 2006 were $32,000 and $80,000, respectively. The change in foreign exchange gains and losses for the quarter and nine months ended March 31, 2007 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.

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

Provision for Income Taxes

Income tax expense was $5.3 million and $18.7 million for the quarter and nine months ended March 31, 2007, respectively, reflecting an effective income tax rate of 34.6% and 37.4%, respectively. Income tax expense (restated) was $5.2 million and $16.4 million for the quarter and nine months ended March 31, 2006, respectively, reflecting an effective income tax rate of $36.3% and 37.7%, 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 nine months ended March 31, 2007, the Company recorded $11,000 and $57,000, net of income tax, respectively, of minority interest expense in the Company s majority owned subsidiary s net income. For the quarter and nine months ended March 31, 2006, the Company recorded $15,000 and $126,000, 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 March 31, 2007	Period ended March 31, 2006 (restated) [1]	Difference	Percentage Change	Percentage of Sales March 31, 2007	Percentage of Sales March 31, 2006
	(In thousands)					
Quarter	$ 10,071	$ 9,006	$ 1,065	11.8%	2.0%	2.2%
Nine months	$ 31,323	$ 26,960	$ 4,363	16.2%	2.1%	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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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
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 $3.0 million at March 31, 2007 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 $365.3 million at March 31, 2007 from $262.2 million at June 30, 2006. The increase in working capital resulted primarily from a $33.6 million increase in the Company s trade and notes receivable, a $47.3 million increase in inventories, and a $21.5 million decrease 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 61 days at March 31, 2007 compared to 59 days at June 30, 2006. The increase in DSO for the quarter ended March 31, 2007 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 6.2 times in the quarter ended March 31, 2007 from 7.2 times in the quarter ended June 30, 2006 due to higher inventory levels created by the duplication of inventory related to the transition to RoHS compliant products (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).

Cash used in operating activities was $49.2 million for the nine months ended March 31, 2007 compared to $23.0 million of cash provided by operating activities for the nine months ended March 31, 2006. The increase in cash used in operating activities was primarily attributable to the timing of periodic vendor payments (in accordance with such terms).

Cash used in investing activities for the nine months ended March 31, 2007 was $53.1 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 $2.5 million were primarily for purchases of equipment, software, and furniture.

Cash used in investing activities for the nine months ended March 31, 2006 was $5.4 million, which included $4.0 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 were primarily for purchases of equipment, software, and furniture.

At March 31, 2007 and June 30, 2006, the Company had a multi-currency revolving credit facility with its Bank Group of $150 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 the quarter ended March 31, 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 March 31, 2007 and June 30, 2006 was 5.73% and 4.38%, respectively. The outstanding borrowings at March 31, 2007 were $112.4 million on a total commitment of $150 million, leaving $37.6 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

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

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). Subject to the waivers noted above, the Company was in compliance with its covenants at March 31, 2007.

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 March 31, 2007 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 March 31, 2007 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. The effective interest rate at March 31, 2007 and June 30, 2006 was 6.86% and 7.25%, respectively. At March 31, 2007 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 March 31, 2007.

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 March 31, 2007, the balance of the note was $13.0 million and the effective rate of interest was 5.97%. 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 March 31, 2007, the balance was 2.3 million or $3.0 million, and the effective rate of interest was 4.62%.

Cash provided by financing activities for the nine months ended March 31, 2007 totaled $101.4 million, including advances of $82.6 million under the Company s credit facility, $12.8 million in additional long-term debt, a $2.9 million increase in short-term borrowings, $2.1 million in excess tax benefits from share-based payment arrangements, and $970,000 in proceeds from stock option exercises.

Cash used in financing activities for the nine months ended March 31, 2006 totaled $9.1 million, including a $4.5 million decrease in short-term borrowings, $1.9 million in payments on long-term debt and payments of $6.4 million on advances under the Company s credit facility, offset by $1.4 million in excess tax benefits from share-based payment arrangements, and $2.3 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 Financial Accounting Standards Board (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

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

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 Qualitative 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 nine months ended March 31, 2007 would have resulted in an approximately $311,000 and $905,000 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 March 31, 2007, the Company had currency forward contracts outstanding with a net liability under these contracts of $8,000. 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 March 31, 2007, 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 March 31, 2007 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:

- <u>Conducting a complete review of substantially all stock options granted for the period from 1994 to 2006</u> 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.

- <u>Modifying policies and procedures</u> 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.

- <u>Changing personnel and responsibilities for authority and oversight</u> 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.

- <u>Clarifying Board procedures for grant approval and documentation</u> 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.

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

The Company initiated the review of stock option grants described above during the fiscal quarter ended December 31, 2006. Thereafter, on April 12, 2007, stock option grant policies were approved by the Board of Directors. 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 March 31, 2007 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting. Subsequent to March 31, 2007, the Company began taking the remaining remediation actions described above, including the establishment of detailed stock option grant procedures.

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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PART II. OTHER INFORMATION

Item 6. Exhibits

Exhibits

10.1	Amendment dated as of February 14, 2007 to Amended and Restated Credit Agreement dated as of July 16, 2004, as amended, among Scan*Source*, 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.
10.2	Waivers dated as of February 14, 2007 to Amended and Restated Credit Agreement dated as of July 16, 2004, as amended, among Scan*Source*, 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