SCANSOURCE INC
Form 10-Q
June 18, 2007
Table of Contents

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 December 31, 2006**

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 ¨ Nox

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

SCANSOURC E, INC.

INDEX TO FORM 10-Q

December 31, 2006

			Page No.
PART I.	**FINANCIAL INFORMATION**		
	Item 1.	Financial Statements (Unaudited):	
		Condensed Consolidated Balance Sheets as of December 31, 2006 and June 30, 2006 (restated)	4
		Condensed Consolidated Income Statements for the Quarters and Six Months Ended December 31, 2006 and 2005 (restated)	6
		Condensed Consolidated Statements of Cash Flows for the Six Months Ended December 31, 2006 and 2005 (restated)	7
		Notes to Condensed Consolidated Financial Statements	8
	Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	28
	Item 3.	Quantitative and Qualitative Disclosures About Market Risk	36
	Item 4.	Controls and Procedures	37
PART II.	**OTHER INFORMATION**		
	Item 1.	Legal Proceedings	40
	Item 4.	Submission of Matters to a Vote of Security Holders	41
	Item 6.	Exhibits	42
SIGNATURES			43

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.

2

Table of Contents

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 December 31, 2006, the Company is restating its condensed consolidated financial statements and related disclosures as of December 31, 2005 and for the three months ended December 31, 2005. 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, and, (ii) information as of December 31, 2005 and for the three and six-month periods then ended included in this Quarterly Report on Form 10-Q, and (iii) information as of March 31, 2006 and for three and nine-month periods then ended which is included in the Quarterly Report on Form 10-Q for the period ended March 31, 2007. 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 December 31, 2006 and does not reflect events occurring after December 31, 2006. 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 period ended September 30, 2006, and its Quarterly Report on Form 10-Q for the period ended March 31, 2007, 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 announcement on January 25, 2007 for the second quarter of fiscal year 2007 that ended December 31, 2006 was limited to sales and gross margin, which were not impacted by the restatement.

Table of Contents

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

SCA N*SOURCE*, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands)

Assets	**December 31, 2006**	**June 30, 2006 (restated) [1]**
Current assets:		
Cash and cash equivalents	$ 2,730	$ 3,831
Trade and notes receivable:		
Trade, less allowance of $12,714 at December 31, 2006 and $11,508 at June 30, 2006	317,672	300,240
Other	8,846	4,558
Inventories	274,723	244,005
Prepaid expenses and other assets	2,455	2,293
Deferred income taxes	17,243	15,709
Total current assets	623,669	570,636
Property and equipment, net	26,347	27,098
Goodwill	37,835	14,404
Other assets, including identifiable intangible assets	18,027	5,359
Total assets	$ 705,878	$ 617,497

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

See Notes to Condensed Consolidated Financial Statements

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except for share information)

(Continued)

Liabilities and Shareholders Equity	December 31, 2006	June 30, 2006 (restated) [1]
Current liabilities:		
Current portion of long-term debt	$ 214	$ 229
Short-term borrowings	3,077	
Trade accounts payable	286,306	271,519
Accrued expenses and other liabilities	32,159	30,359
Income taxes payable	3,991	6,358
Total current liabilities	325,747	308,465
Long-term debt	17,307	4,398
Borrowings under revolving credit facility	57,970	27,558
Other long-term liabilities	3,889	2,757
Total liabilities	404,913	343,178
Minority interest	501	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, 25,758,637 and 25,725,214 shares issued and outstanding at December 31, 2006 and June 30, 2006, respectively	81,466	76,915
Retained earnings	213,129	191,876
Accumulated other comprehensive income	5,869	4,618
Total shareholders equity	300,464	273,409
Total liabilities and shareholders equity	$ 705,878	$ 617,497

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

See Notes to Condensed Consolidated Financial Statements

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED INCOME STATEMENTS (UNAUDITED)

(In thousands, except per share data)

	Quarter ended December 31,		Six months ended December 31,	
	2006	2005 (restated) [1]	2006	2005 (restated) [1]
Net sales	$ 473,734	$ 408,468	$ 969,963	$ 798,864
Cost of goods sold	420,957	366,633	865,348	716,700
Gross profit	52,777	41,835	104,615	82,164
Operating expenses:				
Selling, general and administrative expenses	36,899	26,786	67,219	52,233
Operating income	15,878	15,049	37,396	29,931
Other expense (income):				
Interest expense	1,754	455	3,525	966
Interest income	(174)	(155)	(282)	(304)
Other, net	(126)	(68)	(562)	(40)
Total other expense (income)	1,454	232	2,681	622
Income before income taxes and minority interest	14,424	14,817	34,715	29,309
Provision for income taxes	5,620	5,824	13,417	11,245
Income before minority interest	8,804	8,993	21,298	18,064
Minority interest in income of consolidated subsidiaries, net of income tax expense of $8 and $15, respectively	13	51	46	109
Net income	$ 8,791	$ 8,942	$ 21,252	$ 17,955
Per share data:				
Net income per common share, basic	$ 0.34	$ 0.35	$ 0.83	$ 0.71
Weighted-average shares outstanding, basic	25,749	25,402	25,739	25,367
Net income per common share, assuming dilution	$ 0.34	$ 0.34	$ 0.81	$ 0.69
Weighted-average shares outstanding, assuming dilution	26,236	25,994	26,225	25,944

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

See Notes to Condensed Consolidated Financial Statements

6

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

	Six Months Ended December 31,	
	2006	**2005 (restated) (1)**
Cash flows from operating activities:		
Net income	$ 21,252	$ 17,955
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	2,677	2,743
Amortization of intangible assets	896	101
Allowance for accounts and notes receivable	4,969	1,612
Share-based compensation and restricted stock	2,086	2,070
Impairment of capitalized software	148	
Deferred income tax (benefit) expense	(2,374)	275
Excess tax benefits from share-based payment arrangements	(2,105)	(1,366)
Minority interest in income of subsidiaries	46	109
Changes in operating assets and liabilities, net of acquisitions:		
Trade and notes receivable	(10,349)	(37,582)
Other receivables	(3,236)	400
Inventories	(24,773)	(13,112)
Prepaid expenses and other assets	(144)	(1,778)
Other noncurrent assets	(583)	4,642
Trade accounts payable	14,014	35,056
Accrued expenses and other liabilities	2,447	2,062
Income taxes payable	(346)	(1,677)
Net cash (used in) provided by operating activities	4,625	11,510
Cash flows used in investing activities:		
Capital expenditures	(1,959)	(2,475)
Cash paid for business acquisitions, net of cash acquired	(50,585)	(1,348)
Net cash used in investing activities	(52,544)	(3,823)
Cash flows from financing activities:		
Increases (decreases) in short-term borrowings, net	2,980	(4,478)
Advances (payments) on revolving credit, net	28,386	(1,384)
Exercise of stock options	390	1,095
Excess tax benefits from share-based payment arrangements	2,105	1,366
Advances (repayments) of long-term debt borrowings	12,894	(1,709)
Net cash provided by (used in) financing activities	46,755	(5,110)
Effect of exchange rate changes on cash and cash equivalents	63	(259)
(Decrease) Increase in cash and cash equivalents	(1,101)	2,318
Cash and cash equivalents at beginning of period	3,831	8,609

Cash and cash equivalents at end of period	$ 2,730	$ 10,927

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

See Notes to Condensed Consolidated Financial Statements

Table of Contents

SCANS *OURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(1) Basis of Presentation

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

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

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

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

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

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

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

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

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

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

Restatement expense by period
(in thousands)

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

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

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

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

Table of Contents

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

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

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

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

Condensed Consolidated Statements of Cash Flows (Unaudited)

(in thousands)

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

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

Table of Contents

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

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

(b) Inventory Reserves

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

Reclassifications

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

Cash and Cash Equivalents

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

Derivative Financial Instruments

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

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

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

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

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

Inventories

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

Vendor Programs

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

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

16

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

Product Warranty

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

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

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

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

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

Goodwill and Other Identifiable Intangible Assets

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

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

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

Fair Value of Financial Instruments

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

Contingencies

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

Revenue Recognition

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

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

Shipping Revenue and Costs

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

Advertising Costs

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

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 gains, net of losses, were $43,000 and $33,000 for the quarters ended December 31, 2006 and 2005, respectively. Such gains, net of losses, were $388,000 for the six months ended December 31, 2006 and losses, net of gains, were $48,000 for the six months ended December 31, 2005.

Income Taxes

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

Deferred Income Taxes

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

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

Share-Based Payment

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

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

Comprehensive Income

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

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

Accounting Standards Recently Issued

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

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

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

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

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

Table of Contents

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

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

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

(5) Revolving Credit Facility and Subsidiary Lines of Credit

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

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

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

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

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

(7) Goodwill and Identifiable Intangible Assets

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

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

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

Included within other assets are identifiable intangible assets as follows:

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

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

(8) Segment Information

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

North American Distribution

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

24

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

International Distribution

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

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

Selected financial information of each business segment are presented below:

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

*

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

Table of Contents

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

Assets for each business segment are summarized below:

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

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

(9) Commitments and Contingencies

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

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

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

(10) Acquisitions

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

SCAN*SOURCE*, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

(11) Subsequent Events and Other Matters

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

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

Results of Operations

Net Sales

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

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

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

North American Distribution

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

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

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

International Distribution

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

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

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

Gross Profit

The following tables summarize the Company s gross profit:

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

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

North American Distribution

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

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

International Distribution

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

Table of Contents

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

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

Operating Expenses

The following table summarizes the Company s operating expenses:

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

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

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

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

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

Operating Income

The following table summarizes the Company s operating income:

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

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

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

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

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

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

Total Other Expense (Income)

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

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

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

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

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

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

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

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

Provision for Income Taxes

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

Minority Interest in Income of Consolidated Subsidiaries

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

Net Income

The following table summarizes the Company s net income:

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

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

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

Table of Contents

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

Liquidity and Capght;font-size:9pt;">83,543

73,241

Total Holdings Partnership Distributions

$
100,149

$
93,904

$
138,312

$
135,665

The distributions are recorded as a reduction to consolidated stockholders' equity, with the exception of distributions made to APAM, which are eliminated upon consolidation.
Note 9. Compensation and Benefits
Total compensation and benefits consists of the following:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
Salaries, incentive compensation and benefits [1]	$84,062	$77,212	$165,544	$154,308
Restricted share-based award compensation expense	12,364	10,799	24,131	21,183
Total salaries, incentive compensation and benefits	96,426	88,011	189,675	175,491
Pre-offering related compensation - share-based awards	6,339	7,136	12,678	14,955
Total compensation and benefits	$102,765	$95,147	$202,353	$190,446

[1] Excluding restricted share-based award compensation expense

Incentive compensation
Cash incentive compensation paid to members of Artisan's investment teams and members of its distribution teams is generally based on formulas that are tied directly to revenues. These payments are made in the quarter following the quarter in which the incentive was earned with the exception of fourth quarter payments which are paid in the fourth quarter of the year. Cash incentive compensation paid to most other employees is discretionary and subjectively determined based on individual performance and Artisan's overall results during the applicable year and has historically been paid in the fourth quarter of the year. The cash incentive compensation earned by executive officers for the year ended December 31, 2016, was paid in the three months ended March 31, 2017.
Restricted share-based awards
Artisan has registered 14,000,000 shares of Class A common stock for issuance under the 2013 Omnibus Incentive Compensation Plan (the "Plan"). Pursuant to the Plan, APAM has granted a combination of restricted stock awards and restricted stock units (collectively referred to as "restricted share-based awards") of Class A common stock to employees. The restricted share-based awards generally vest on a pro rata basis over five years. Certain share-based awards will vest upon a combination of both (1) pro-rata annual time vesting and (2) qualifying retirement (as defined in the award agreements).

Unvested awards are subject to forfeiture upon termination of employment. Grantees receiving the awards are entitled to dividends on unvested and vested shares and units. 7,998,198 shares of Class A common stock were reserved and available for issuance under the Plan as of June 30, 2017.

During the six months ended June 30, 2017, Artisan granted 1,267,250 restricted stock awards and 1,250 restricted stock units of Class A common stock to employees of the Company. Total compensation expense associated with the 2017 grants is expected to be approximately $35.9 million. Compensation expense related to the restricted share-based awards is recognized based on the estimated grant date fair value on a straight-line basis over the requisite service period of the award. The initial requisite service period is generally five years for restricted share-based awards.

The Company’s accounting policy is to record the impact of forfeitures when they occur. 3,108 restricted share-based awards were forfeited during the six months ended June 30, 2017.
The following table summarizes the restricted share-based award activity for the six months ended June 30, 2017:

	Weighted-Average Grant Date Fair Value	Number of Awards
Unvested at January 1, 2017	$ 44.47	3,394,910
Granted	$ 28.30	1,268,500
Forfeited	$ 41.08	(3,108)
Vested	$ 36.48	(184,378)
Unvested at June 30, 2017	$ 40.22	4,475,924

Compensation expense recognized related to the restricted share-based awards was $12.3 million and $10.8 million for the three months ended June 30, 2017 and 2016, respectively, and $24.1 million and $21.2 million for the six months ended June 30, 2017 and 2016, respectively. The unrecognized compensation expense for the unvested awards as of June 30, 2017 was $122.7 million with a weighted average recognition period of 3.3 years remaining. The initial requisite service period and remaining weighted average recognition period for all types of restricted share-based awards are substantially equivalent.
During the six months ended June 30, 2017, the Company withheld a total of 31,014 restricted shares as a result of net share settlements to satisfy employee tax withholding obligations. The Company paid $0.9 million in employee tax withholding obligations related to these settlements during the six months ended June 30, 2017. These net share settlements had the effect of shares repurchased and retired by the Company, as they reduced the number of shares outstanding.
Pre-offering related compensation - share-based awards
Holdings historically granted Class B share-based awards to certain employees. These awards vested over a period of five years. Prior to the IPO, all vested Class B awards were subject to mandatory redemption on termination of employment for any reason and were reflected as liabilities measured at fair value; unvested Class B awards were forfeited on termination of employment.
The vested Class B liability awards of a terminated employee were historically redeemed in cash in annual installments, generally over the five years following termination of employment. The remaining $0.5 million of redemption payments for Class B awards of partners whose services to Holdings terminated prior to the IPO was paid during the six months ended June 30, 2017.
As a part of the IPO Reorganization, the Class B grant agreements were amended to eliminate the cash redemption feature. The amendment was considered a modification under ASC 718 and the Class B awards have been classified as equity awards since such modification. Compensation expense is recorded for unvested Class B awards on a straight-line basis over the remaining vesting period.
The following table summarizes the activity related to unvested Class B awards for the six months ended June 30, 2017:

	Weighted-Average Grant Date Fair Value	Number of Class B Awards
Unvested Class B awards at January 1, 2017	$ 30.00	845,220
Granted	—	—
Forfeited	—	—
Vested	—	—
Unvested Class B awards at June 30, 2017	$ 30.00	845,220

Compensation expense recognized related to the unvested Class B awards was $6.4 million and $7.2 million for the three months ended June 30, 2017 and 2016, respectively, and $12.7 million and $15.0 million for the six months ended June 30, 2017 and 2016, respectively. There is no remaining unrecognized compensation expense for the

unvested Class B awards as of June 30, 2017, as the Class B awards became fully vested on July 1, 2017.

Table of Contents

Note 10. Income Taxes and Related Payments
APAM is subject to U.S. federal, state and local income taxation on APAM's allocable portion of Holdings' income. APAM's effective income tax rate was lower than the U.S. federal statutory rate of 35% primarily due to a rate benefit attributable to the fact that, for the six months ended June 30, 2017, approximately 38% of Artisan Partners Holdings' full year projected taxable earnings were attributable to other partners and not subject to corporate-level taxes. The effective tax rate was also lower due to dividends paid on unvested share-based awards, net of higher tax expense related to the vesting of restricted share-based awards. These favorable items are partially offset by the impact of certain permanent items, primarily attributable to pre-IPO share-based compensation expenses, that are not deductible for tax purposes.
Components of the provision for income taxes consist of the following:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
Current:				
Federal	$5,234	$3,238	$7,858	$5,908
State and local	640	506	1,001	1,050
Foreign	120	161	227	346
Total	5,994	3,905	9,086	7,304
Deferred:				
Federal	8,463	8,257	17,598	15,936
State and local	484	472	1,006	911
Total	8,947	8,729	18,604	16,847
Income tax expense	$14,941	$12,634	$27,690	$24,151

In connection with the IPO, APAM entered into two tax receivable agreements ("TRAs"). The first TRA generally provides for the payment by APAM to a private equity fund (the "Pre-H&F Corp Merger Shareholder") of 85% of the applicable cash savings, if any, of U.S. federal, state and local income taxes that APAM actually realizes (or is deemed to realize in certain circumstances) as a result of (i) the tax attributes of the preferred units APAM acquired in the merger of a wholly-owned subsidiary of the Pre-H&F Corp Merger Shareholder into APAM in March 2013, (ii) net operating losses available as a result of the merger and (iii) tax benefits related to imputed interest.
The second TRA generally provides for the payment by APAM to current or former limited partners of Holdings of 85% of the applicable cash savings, if any, of U.S. federal, state and local income taxes that APAM actually realizes (or is deemed to realize in certain circumstances) as a result of (i) certain tax attributes of their partnership units sold to APAM or exchanged (for shares of Class A common stock, convertible preferred stock or other consideration) and that are created as a result of such sales or exchanges and payments under the TRAs and (ii) tax benefits related to imputed interest. Under both agreements, APAM generally will retain the benefit of the remaining 15% of the applicable tax savings.
For purposes of the TRAs, cash savings of income taxes are calculated by comparing APAM's actual income tax liability to the amount it would have been required to pay had it not been able to utilize any of the tax benefits subject to the TRAs, unless certain assumptions apply. The TRAs will continue in effect until all such tax benefits have been utilized or expired, unless APAM exercises its right to terminate the agreements or payments under the agreements are accelerated in the event that APAM materially breaches any of its material obligations under the agreements.
The actual increase in tax basis, as well as the amount and timing of any payments under these agreements, will vary depending upon a number of factors, including the timing of sales or exchanges by the holders of limited partnership units, the price of the Class A common stock at the time of such sales or exchanges, whether such sales or exchanges are taxable, the amount and timing of the taxable income APAM generates in the future and the tax rate then applicable and the portion of APAM's payments under the TRAs constituting imputed interest or depreciable basis or amortizable basis.

Payments under the TRAs, if any, will be made pro rata among all TRA counterparties entitled to payments on an annual basis to the extent APAM has sufficient taxable income to utilize the increased depreciation and amortization charges and imputed interest deductions. Artisan expects to make one or more payments under the TRAs, to the extent they are required, prior to or within 125 days after APAM's U.S. federal income tax return is filed for each fiscal year. Interest on the TRA payments will accrue at a rate equal to one-year LIBOR plus 100 basis points two days prior to the due date (without extension) of such tax return until such payments are made.

Amounts payable under tax receivable agreements are estimates which may be impacted by factors, including but not limited to, expected tax rates, projected taxable income, and projected ownership levels and are subject to change. Changes in the estimates of amounts payable under tax receivable agreements are recorded as non-operating income (loss) in the Consolidated Statements of Operations.

Table of Contents

The change in the Company's deferred tax assets related to the tax benefits described above and the change in corresponding amounts payable under the TRAs for the six months ended June 30, 2017 is summarized as follows:

	Amounts payable under tax receivable agreements	Deferred Tax Asset - Amortizable basis
December 31, 2016	$ 586,246	$ 653,942
2017 Follow-On Offering	96,406	113,419
2017 Holdings Common Unit Exchanges	9,993	11,756
Amortization	—	(20,973)
Payments under TRA	(22,788)	—
June 30, 2017	$ 669,857	$ 758,144

Net deferred tax assets comprise the following:

	As of June 30, 2017	As of December 31, 2016
Deferred tax assets:		
Amortizable basis [1]	$758,144	$ 653,942
Other [2]	29,509	24,576
Total deferred tax assets	787,653	678,518
Less: valuation allowance [3]	—	—
Net deferred tax assets	$787,653	$ 678,518

[1] Represents the unamortized step-up of tax basis and other tax attributes from the merger and partnership unit sales and exchanges described above. These future tax benefits are subject to the TRA agreements.

[2] Represents the net deferred tax assets associated with the merger described above and other miscellaneous deferred tax assets.

[3] Artisan assessed whether the deferred tax assets would be realizable and determined based on its history of taxable income that the benefits would more likely than not be realized. Accordingly, no valuation allowance is required.

Accounting standards establish a minimum threshold for recognizing, and a system for measuring, the benefits of income tax return positions in financial statements. There were no uncertain tax positions recorded as of June 30, 2017 and December 31, 2016.

In the normal course of business, Artisan is subject to examination by federal and certain state, local and foreign tax regulators. As of June 30, 2017, U.S. federal income tax returns for the years 2014 through 2015 are open and therefore subject to examination. State and local tax returns are generally subject to examination from 2013 to 2015. Foreign tax returns are generally subject to examination from 2013 to 2015.

Note 11. Accumulated Other Comprehensive Income (Loss)

Accumulated Other Comprehensive Income (Loss), net of tax, in the accompanying Condensed Consolidated Statements of Financial Condition represents the portion of accumulated other comprehensive income attributable to APAM, and consists of the following:

	As of June 30,	As of December

	2017	31, 2016
Unrealized gain on investments, net of tax	$89	$ 37
Foreign currency translation gain (loss)	(1,474)	(1,685)
Accumulated Other Comprehensive Income (Loss)	$(1,385)	$ (1,648)

Comprehensive income (loss) attributable to noncontrolling interests - Artisan Partners Holdings in the Consolidated Statements of Comprehensive Income (Loss) represents the portion of comprehensive income (loss) attributable to the equity ownership interests in Holdings held by the limited partners of Holdings.

16

Table of Contents

Note 12. Earnings Per Share

Basic earnings per share is computed under the two-class method by dividing income available to Class A common stockholders by the weighted average number of Class A common shares outstanding during the period. Unvested restricted share-based awards are excluded from the number of Class A common shares outstanding for the basic earnings per share calculation because the shares have not yet been earned by employees. Income available to Class A common stockholders is computed by reducing net income attributable to APAM by earnings (distributed and undistributed) allocated to participating securities, according to their respective rights to participate in those earnings. Unvested share-based awards are participating securities because the awards include non-forfeitable dividend rights during the vesting period. Class B and Class C common shares do not share in profits of APAM and therefore are not reflected in the calculations.

The computation of basic and diluted earnings per share under the two-class method for the three and six months ended June 30, 2017 and 2016 were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
Basic and Diluted Earnings Per Share	2017	2016	2017	2016
Numerator:				
Net income attributable to APAM	$26,632	$ 18,384	$46,427	$ 34,645
Less: Allocation to participating securities	6,339	4,121	9,198	6,878
Net income available to common stockholders	$20,293	$ 14,263	$37,229	$ 27,767
Denominator:				
Weighted average shares outstanding	45,241,102	38,023,586	43,142,011	37,497,268
Earnings per share	$0.45	$ 0.38	$0.86	$ 0.74

Allocation to participating securities in the table above generally represents dividends paid to holders of unvested restricted share-based awards and reduces net income available to common stockholders.

There were no dilutive securities outstanding during the three and six months ended June 30, 2017 and 2016. The Holdings limited partnership units are anti-dilutive primarily due to the impact of public company expenses and unrecognized share-based compensation expense. Unvested restricted share-based awards are considered participating securities and are therefore anti-dilutive. The following table summarizes the weighted-average shares outstanding that are excluded from the calculation of diluted earnings per share because their effect would have been anti-dilutive:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
Anti-Dilutive Weighted Average Shares Outstanding	2017	2016	2017	2016
Holdings limited partnership units	26,080,376	32,725,890	28,133,767	33,233,419
Unvested restricted share-based awards	4,486,196	3,904,554	4,205,581	3,638,178
Total	30,566,572	36,630,444	32,339,348	36,871,597

Note 13. Indemnifications

In the normal course of business, APAM enters into agreements that include indemnities in favor of third parties. Holdings has also agreed to indemnify APAM as its general partner, Artisan Investment Corporation (“AIC”) as its former general partner, the directors and officers of APAM, the directors and officers of AIC as its former general partner, the members of its former Advisory Committee, and its partners, directors, officers, employees and agents. Holdings’ subsidiaries may also have similar agreements to indemnify their respective general partner(s), directors, officers, directors and officers of their general partner(s), partners, members, employees, and agents. The Company’s maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against us that have not yet occurred. APAM maintains insurance policies that may provide coverage against certain claims under these indemnities.

Note 14. Related Party Transactions

Several of the current named executive officers of APAM and certain members of APAM’s board (or their affiliates) are limited partners of Holdings. As a result, certain transactions (such as TRA payments) between Artisan and the

limited partners of Holdings are considered to be related party transactions with respect to these persons.

Affiliate transactions—Artisan Funds

Artisan has an agreement to serve as the investment adviser to Artisan Funds, with which certain Artisan employees are affiliated. Under the terms of the agreement, which generally is reviewed and continued by the board of directors of Artisan Funds annually, a fee is paid to Artisan based on an annual percentage of the average daily net assets of each Artisan Fund ranging from 0.625% to 1.25%. Artisan generally collects revenues related to these services on the last business day of each month and records them in Management Fees in the Consolidated Statement of Operations. Artisan has contractually agreed to waive its management fees or reimburse for expenses incurred to the extent necessary to limit annualized ordinary operating expenses incurred by certain of the Artisan Funds to not more than a fixed percentage (ranging from 0.88% to 1.50%) of a Fund's average daily net assets. In addition, Artisan may voluntarily waive fees or reimburse any of the Artisan Funds for other expenses. The officers and a director of Artisan Funds who are affiliated with Artisan receive no compensation from the funds. Fees for managing the Funds and amounts waived or reimbursed by Artisan for fees and expenses (including management fees) are as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
Investment management fees:				
Artisan Funds	$116,200	$115,061	$226,774	$226,236
Fee waiver / expense reimbursement:				
Artisan Funds	$115	$222	$312	$356

Affiliate transactions—Artisan Global Funds

Artisan has an agreement to serve as the investment manager to Artisan Global Funds, with which certain Artisan employees are affiliated. Under the terms of these agreements, a fee is paid based on an annual percentage of the average daily net assets of each fund ranging from 0.75% to 1.75%. Artisan reimburses each sub-fund of Artisan Global Funds to the extent that sub-fund's expenses, not including Artisan's fee, exceed certain levels, which range from 0.10% to 0.20%. In addition, Artisan may voluntarily waive fees or reimburse any of the Artisan Global Funds for other expenses. The directors of Artisan Global Funds who are affiliated with Artisan receive no compensation from the funds. Accounts receivable included $2.1 million and $1.8 million due from Artisan Global Funds as of June 30, 2017 and December 31, 2016, respectively. Fees for managing Artisan Global Funds and amounts reimbursed to Artisan Global Funds by Artisan are as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
Investment management fees:				
Artisan Global Funds	$7,706	$3,667	$14,516	$7,292
Fee waiver / expense reimbursement:				
Artisan Global Funds	$54	$172	$70	$260

Affiliate transactions—Privately Offered Funds

Pursuant to written agreements, Artisan serves as the investment manager of certain privately offered investment funds constituting the firm's privately offered strategy. Under the terms of these agreements, Artisan earns a management fee and is entitled to receive an allocation of profits. Artisan made an initial seed investment of $20.0 million in the privately offered investment funds. Certain related parties, including employees, officers and members of the Company's board invested an additional $12.7 million in the funds. These related party investors do not pay a management fee or incentive allocation. In addition, for a period of time following the formation of the privately offered funds, Artisan has agreed to reimburse the funds to the extent that expenses, excluding Artisan's management fee and transaction related costs, exceed 1.00% per annum of the net assets of the funds. Artisan may also voluntarily waive fees or reimburse the funds for other expenses. Expense reimbursements totaled $33 thousand for the three

months ended June 30, 2017.

Note 15. Subsequent Events

Distributions and dividends

On July 27, 2017, APAM, acting as the general partner of Artisan Partners Holdings, declared a distribution by Artisan Partners Holdings of $39.3 million to holders of Artisan Partners Holdings partnership units, including APAM. On the same date, the board of directors of APAM declared a quarterly dividend of $0.60 per share of Class A common stock. The APAM dividend is payable on August 31, 2017, to shareholders of record as of August 17, 2017.

Table of Contents

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

Overview

We are an investment management firm focused on providing high-value added, active investment strategies to sophisticated clients globally. Our operations are conducted through Artisan Partners Holdings and its subsidiaries. We derive essentially all of our revenues from investment management fees. Nearly all our fees are based on a specified percentage of clients' average assets under our management. We operate our business in a single segment.
Our autonomous investment teams manage a broad range of U.S., non-U.S., and global investment strategies that are diversified by asset class, market cap and investment style. Strategies are offered through multiple investment vehicles to accommodate a broad range of client mandates. We expect to launch additional strategies over time through various investment vehicles.
Assets under management within our privately offered strategies are included in the reported firm-wide, separate account, and institutional AUM figures. Management fees and assets under management within our privately offered strategies are excluded from the weighted average fee calculations. Management fees earned on consolidated investment products are excluded from the weighted average fee calculation and from total revenues, since any such revenues are eliminated upon consolidation.
During the June quarter, our AUM increased to $109.4 billion at June 30, 2017, an increase of $5.6 billion, or 5.4%, compared to $103.8 billion at March 31, 2017, as a result of $7.1 billion in market appreciation, partially offset by $1.5 billion of net client cash outflows. Compared to June 30, 2016, AUM increased $14.4 billion, or 15.2%, due to $17.4 billion in market appreciation, partially offset by $3.0 billion of net client cash outflows. Average AUM for the June quarter of 2017 was $107.2 billion, an increase of 6.0% compared to average AUM for the March quarter of 2017 of $101.1 billion and an 11.0% increase from the average of $96.6 billion for the June quarter of 2016.
Revenues were $380.3 million for the six months ended June 30, 2017, a 7% increase from revenues of $355.3 million for the six months ended June 30, 2016. Operating margin was 32.7% for the six months ended June 30, 2017 compared to 32.0% for the six months ended June 30, 2016. Adjusted operating margin was 36.1% for the six months ended June 30, 2017 compared to 36.2% for the six months ended June 30, 2016.
Business highlights for the quarter ended June 30, 2017 included:

- Our investment teams continue to generate strong absolute and relative investment returns for clients and investors. Eight of Artisan's 11 investment strategies with at least a five-year track record have beaten their broad-based benchmark indexes since inception by an average of between 1.56% and 5.44% per year, after management fees. Those eight strategies represented over 90% of our AUM at the end of the second quarter.
- During the quarter, six of our eight investment teams experienced positive net client cash flows. Firm-wide net outflows of $1.5 billion were primarily driven by net outflows from the Non-U.S. Growth and U.S. Mid-Cap Growth strategies.
- Our Thematic team launched its first investment strategy, the Artisan Thematic strategy.
- Our Credit team launched its second investment strategy, which we are offering to clients and investors through a private fund structure.
- We hosted a four-day investment forum, bringing together all of our investment team leaders and representatives of over 100 current and prospective clients, consultants, and intermediary partners.
- We declared and paid dividends of $0.60 per share of Class A common stock.

Organizational Structure

Organizational Structure

On March 12, 2013, Artisan Partners Asset Management Inc. ("APAM") and the intermediary holding company through which APAM conducts its operations, Artisan Partners Holdings LP ("Holdings"), completed a series of transactions ("the IPO Reorganization") to reorganize their capital structures in connection with the initial public offering ("IPO") of APAM's Class A common stock. The IPO Reorganization and IPO were completed on March 12, 2013. The IPO Reorganization was designed to create a capital structure that preserves our ability to conduct our business through Holdings, while permitting us to raise additional capital and provide access to liquidity through a public company.
Our employees and other limited partners of Holdings held approximately 34% of the equity interests in Holdings as of June 30, 2017. As a result, our post-IPO results reflect that significant noncontrolling interest.

19

2017 Follow-On Offering and Holdings Unit Exchanges

On February 28, 2017, APAM completed an offering of 5,626,517 shares of Class A common stock and utilized all of the proceeds to purchase an aggregate of 5,626,517 common units from certain limited partners of Holdings. In connection with the offering, APAM received 5,626,517 GP units of Holdings.

During the six months ended June 30, 2017, certain limited partners of Holdings exchanged 680,897 common units (along with a corresponding number of shares of Class B or C common stock of APAM) for 680,897 shares of Class A common stock. In connection with the exchanges, APAM received 680,897 GP units of Holdings.

APAM's equity ownership interest in Holdings increased from 57% at December 31, 2016 to 66% at June 30, 2017, as a result of these transactions and other equity transactions during the period.

Tax Impact of IPO Reorganization

In connection with the IPO, APAM entered into two tax receivable agreements ("TRAs"). The first TRA generally provides for the payment by APAM to a private equity fund (the "Pre-H&F Corp Merger Shareholder") of 85% of the applicable cash savings, if any, of U.S. federal, state and local income taxes that APAM actually realizes (or is deemed to realize in certain circumstances) as a result of (i) the tax attributes of the preferred units APAM acquired in the merger of a wholly-owned subsidiary of the Pre-H&F Corp Merger Shareholder into APAM in March 2013, (ii) net operating losses available as a result of the merger and (iii) tax benefits related to imputed interest.

The second TRA generally provides for the payment by APAM to current or former limited partners of Holdings of 85% of the applicable cash savings, if any, of U.S. federal, state and local income taxes that APAM actually realizes (or is deemed to realize in certain circumstances) as a result of (i) certain tax attributes of their partnership units sold to us or exchanged (for shares of Class A common stock, convertible preferred stock or other consideration) and that are created as a result of such sales or exchanges and payments under the TRAs and (ii) tax benefits related to imputed interest. Under both agreements, APAM generally will retain the benefit of the remaining 15% of the applicable tax savings.

The change in the Company's deferred tax assets related to the tax benefits described above and the change in corresponding amounts payable under the TRAs for the six months ended June 30, 2017 is summarized as follows:

	Amounts payable under tax receivable agreements	Deferred Tax Asset - Amortizable basis
	(unaudited; in millions)	
December 31, 2016	$586.2	$ 653.9
2017 Follow-On Offering and Exchanges	106.5	125.2
Amortization	—	(21.0)
Payments under TRA	(22.8)	—
June 30, 2017	$669.9	$ 758.1

Financial Overview

Economic Environment

Global equity market conditions can materially affect our financial performance. During the three and six months ended June 30, 2017, market appreciation increased our AUM by 6.9% and 14.8%, respectively. The following table presents the total returns of relevant market indices for the three and six months ended June 30, 2017 and 2016:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
S&P 500 total returns	3.1%	2.5 %	9.3 %	3.8 %

MSCI All Country World total returns	4.3%	1.0 %	11.5%	1.2 %
MSCI EAFE total returns	6.1%	(1.5)%	13.8%	(4.4)%
Russell Midcap® total returns	2.7%	3.2 %	8.0 %	5.5 %

Table of Contents

Key Performance Indicators

When we review our performance we consider, among other things, the following:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
	(unaudited; dollars in millions)			
Assets under management at period end	$109,405	$94,959	$109,405	$94,959
Average assets under management [1]	$107,250	$96,623	$104,210	$94,747
Net client cash flows	$(1,522)	$(2,320)	$(1,795)	$(3,659)
Total revenues	$196.2	$180.8	$380.3	$355.3
Weighted average fee [2]	73.4 bps	75.2 bps	73.5 bps	75.3 bps
Operating margin	33.9 %	32.6 %	32.7 %	32.0 %
Adjusted operating margin [3]	37.1 %	36.6 %	36.1 %	36.2 %

[1] We compute average assets under management by averaging day-end assets under management for the applicable period.

[2] We compute our weighted average fee by dividing annualized investment management fees by average assets under management for the applicable period.

[3] Adjusted measures are non-GAAP measures and are explained and reconciled to the comparable GAAP measures in "Supplemental Non-GAAP Financial Information" below.

Because we earn investment management fees based primarily on the value of the assets we manage across a reporting period, we believe that average assets under management for a period is a better metric for understanding changes in our revenues than period end assets under management. The weighted average fee represents annualized investment management fees as a percentage of average assets under management for the applicable period.

We have historically been disciplined about maintaining our rates of fees. Over time, industry-wide fee pressure could cause us to reduce our fees. The decrease in the weighted average fee rate is primarily a result of the shift in the mix of our AUM between our investment strategies and vehicles, primarily the reduction in the proportion of our total assets managed through Artisan Funds.

Assets Under Management and Investment Performance

Changes to our operating results from one period to another are primarily caused by changes in the amount of our assets under management. Changes in the relative composition of our assets under management among our investment strategies and vehicles and the effective fee rates on our products also impact our operating results.

The amount and composition of our assets under management are, and will continue to be, influenced by a variety of factors including, among others:

- investment performance, including fluctuations in both the financial markets and foreign currency exchange rates and the quality of our investment decisions;
- flows of client assets into and out of our various strategies and investment vehicles;
- our decision to close strategies or limit the growth of assets in a strategy or a vehicle when we believe it is in the best interest of our clients; as well as our decision to re-open strategies, in part or entirely;
- our ability to attract and retain qualified investment, management, and marketing and client service professionals;
- industry trends towards products or strategies that we do not offer;
- competitive conditions in the investment management and broader financial services sectors; and
- investor sentiment and confidence.

Table of Contents

The table below sets forth changes in our total AUM:

	For the Three Months Ended June 30,		Period-to-Period	
	2017	2016	$	%
	(unaudited; in millions)			
Beginning assets under management	$103,762	$97,032	$6,730	6.9 %
Gross client cash inflows	4,207	3,711	496	13.4 %
Gross client cash outflows	(5,729)	(6,031)	302	5.0 %
Net client cash flows	(1,522)	(2,320)	798	34.4 %
Market appreciation (depreciation) [1]	7,165	231	6,934	3,001.7 %
Net transfers [2]	—	16	(16)	(100.0)%
Ending assets under management	$109,405	$94,959	$14,446	15.2 %
Average assets under management	$107,250	$96,623	$10,627	11.0 %

[1] Includes the impact of translating the value of assets under management denominated in non-USD currencies into U.S. dollars. The impact was immaterial for the periods presented.
[2] Net transfers represent certain amounts that we have identified as having been transferred out of one investment strategy or investment vehicle and into another strategy or vehicle.

	For the Six Months Ended June 30,		Period-to-Period	
	2017	2016	$	%
	(unaudited; in millions)			
Beginning assets under management	$96,845	$99,848	$(3,003)	(3.0)%
Gross client cash inflows	9,367	8,364	1,003	12.0 %
Gross client cash outflows	(11,162)	(12,023)	861	7.2 %
Net client cash flows	(1,795)	(3,659)	1,864	50.9 %
Market appreciation (depreciation) [1]	14,355	(1,230)	15,585	1,267.1 %
Net transfers [2]	—	—	—	— %
Ending assets under management	$109,405	$94,959	$14,446	15.2 %
Average assets under management	$104,210	$94,747	$9,463	10.0 %

[1] Includes the impact of translating the value of assets under management denominated in non-USD currencies into U.S. dollars. The impact was immaterial for the periods presented.
[2] Net transfers represent certain amounts that we have identified as having been transferred out of one investment strategy or investment vehicle and into another strategy or vehicle.

Across the firm, we experienced total net outflows of $1.5 billion and $1.8 billion during the three and six months ended June 30, 2017, respectively. Our Global Equity team's Non-U.S. Growth strategy had net outflows of $1.4 billion and $1.9 billion for the three and six months ended June 30, 2017, respectively. Despite strong investment performance in 2017, we expect the Non-U.S. Growth strategy will continue to experience net outflows due to its relative underperformance in 2015 and 2016.

The strategies managed by our Growth team had total net inflows of $76 million for the three months ended June 30, 2017, primarily as a result of $737 million of net inflows for the Global Opportunities strategy partially offset by $574 million of net outflows from the U.S. Mid-Cap Growth strategy. We expect to continue to experience net inflows in

the Global Opportunities strategy, for which there is strong global demand, and net outflows in the U.S. Mid-Cap Growth strategy, in particular from defined contribution plan clients.

During the three and six months ended June 30, 2017, our High Income strategy, which we launched in March 2014, generated net inflows of $77 million and $293 million, respectively, and our Developing World strategy, which launched at the end of June 2015, generated $81 million and $267 million in net inflows, respectively. Our Global Value strategy generated $145 million and $635 million of net inflows during the three and six months ended June 30, 2017, respectively.

We believe that growth in AUM in an investment strategy requires the availability of attractive investment opportunities relative to the amount of AUM in the strategy at a time when the strategy has a competitive performance track record and there is stable or growing client demand for the strategy or asset class. When we believe that each of these factors is present with respect to an investment strategy, we say we have "realizable capacity" in that strategy. We discuss realizable capacity in general, rather than discussing the capacity of our strategies in precise dollar amounts, because capacity is affected by a number of factors, evolves over time, and is subject to change. We are confident that we have sufficient realizable capacity to continue to thoughtfully grow.

In particular, we believe that we currently have realizable capacity in our Global Opportunities, Global Equity, and High Income strategies, where we believe we are well-positioned to take advantage of client and investor demand. In March 2017, our High Income strategy completed its third year of operations with a strong three-year track record and solid client interest. We believe the High Income strategy has realizable capacity and is positioned well for continued organic growth. Additionally, our Developing World strategy continues to perform well and experience positive inflows, despite having a shorter-term track record.

We monitor the availability of attractive investment opportunities relative to the amount of assets we manage in each of our investment strategies. When appropriate, we will close a strategy to new investors or otherwise take action to slow or restrict its growth, even though our aggregate AUM may be negatively impacted in the short term. We may also re-open a strategy, widely or selectively, to fill available capacity or manage the diversification of our client base in that strategy. We believe that management of our investment capacity protects our ability to manage assets successfully, which protects the interests of our clients and, in the long term, protects our ability to retain client assets and maintain our profit margins.

As of the date of this filing, our Non-U.S. Growth, Non-U.S. Small-Cap Growth, Non-U.S. Value, U.S. Mid-Cap Growth and U.S. Small-Cap Growth strategies are closed to most new investors and client relationships. Our Global Value and Global Opportunities strategies are open across pooled vehicles, but closed to most new separate account clients. We may selectively accept additional separate account clients in those strategies, but we are managing asset flows into those strategies with a bias towards assets from pooled vehicles.

When we close or otherwise restrict the growth of a strategy, we typically continue to allow additional investments in the strategy by existing clients and certain related entities. We may also permit new investments by other eligible investors in our discretion. As a result, during a given period we may have net client cash inflows in a closed strategy. However, when a strategy is closed or its growth is restricted we expect there to be periods of net client cash outflows.

We measure investment performance based upon the results of our "composites", which represent the aggregate performance of all discretionary client accounts, including mutual funds, invested in the same strategy except those accounts with respect to which we believe client-imposed investment restrictions may have a material impact on portfolio construction and those accounts managed in a currency other than U.S. dollars. The results of these excluded accounts, which represented approximately 12% of our assets under management at June 30, 2017, are maintained in separate composites the results of which are not included below.

Table of Contents

The table below sets forth the total AUM for each of our investment teams and strategies as of June 30, 2017, the inception date for each investment composite, and the average annual total returns for each composite (gross of fees) and its respective broad-based benchmark (and style benchmark, if applicable) over a multi-horizon time period as of June 30, 2017. Returns for periods less than one year are not annualized.

Investment Team and Strategy	Inception Date	Strategy AUM (in $MM)	Average Annual Total Returns (gross) (%) 1 YR	3 YR	5 YR	10 YR	Inception	Average Annual Value-Added[1] Since Inception (bps)
Global Equity Team								
Non-U.S. Growth Strategy	1/1/1996	$26,083	15.26%	0.94%	9.28%	3.72%	10.29%	550
MSCI EAFE Index			20.27%	1.15%	8.68%	1.02%	4.78%	
Non-U.S. Small-Cap Growth Strategy	1/1/2002	$795	12.50%	0.39%	10.60%	5.05%	13.25%	295
MSCI EAFE Small Cap Index			23.18%	5.59%	12.93%	3.40%	10.29%	
Global Equity Strategy	4/1/2010	$1,316	16.40%	6.24%	13.56%	N/A	11.96%	381
MSCI All Country World Index			18.78%	4.82%	10.54%	N/A	8.15%	
U.S. Value Team								
U.S. Mid-Cap Value Strategy	4/1/1999	$6,701	17.62%	4.92%	12.66%	8.23%	13.40%	405
Russell Midcap® Index			16.48%	7.69%	14.71%	7.66%	9.35%	
Russell Midcap® Value Index			15.93%	7.45%	15.13%	7.23%	10.04%	
Value Equity Strategy	7/1/2005	$1,991	19.72%	6.64%	12.65%	6.43%	8.46%	(1)
Russell 1000® Index			18.03%	9.25%	14.66%	7.28%	8.47%	
Russell 1000® Value Index			15.53%	7.35%	13.93%	5.56%	7.37%	
Growth Team								
U.S. Mid-Cap Growth Strategy	4/1/1997	$13,879	18.30%	7.68%	14.00%	10.01%	15.18%	487
Russell Midcap® Index			16.48%	7.69%	14.71%	7.66%	10.30%	
Russell Midcap® Growth Index			17.05%	7.82%	14.18%	7.87%	8.89%	
U.S. Small-Cap Growth Strategy	4/1/1995	$2,202	21.35%	9.55%	14.29%	8.76%	10.32%	97
Russell 2000® Index			24.60%	7.35%	13.69%	6.91%	9.36%	
Russell 2000® Growth Index			24.40%	7.64%	13.97%	7.81%	7.65%	
Global Opportunities Strategy	2/1/2007	$13,800	25.93%	11.02%	15.44%	9.85%	10.50%	610
MSCI All Country World Index			18.78%	4.82%	10.54%	3.71%	4.40%	
Global Value Team								
Non-U.S. Value Strategy	7/1/2002	$19,855	23.04%	4.52%	13.60%	7.45%	12.80%	650
MSCI EAFE Index			20.27%	1.15%	8.68%	1.02%	6.31%	
Global Value Strategy	7/1/2007	$18,692	23.80%	6.92%	14.45%	8.86%	8.86%	515
MSCI All Country World Index			18.78%	4.82%	10.54%	3.71%	3.71%	
Emerging Markets Team								
Emerging Markets Strategy	7/1/2006	$277	27.10%	5.04%	5.95%	1.86%	5.63%	40
MSCI Emerging Markets Index			23.75%	1.07%	3.95%	1.91%	5.23%	
Credit Team								
High Income Strategy[2]	4/1/2014	$2,273	13.98%	7.74%	N/A	N/A	7.97%	303
BofA Merrill Lynch High Yield Master II Index			12.75%	4.47%	N/A	N/A	4.94%	
Developing World Team								
Developing World Strategy	7/1/2015	$1,496	27.40%	N/A	N/A	N/A	10.54%	623
MSCI Emerging Markets Index			23.75%	N/A	N/A	N/A	4.31%	
Thematic Team								
Thematic Strategy	5/1/2017	$12	N/A	N/A	N/A	N/A	4.14%	210

S&P 500 Market Index		N/A	N/A	N/A	N/A	2.04%
Total Assets Under Management[3]	$109,405					

[1] Value-added is the amount in basis points by which the average annual gross composite return of each of our strategies has outperformed the broad-based market index most commonly used by our clients to compare the performance of the relevant strategy. Value-added for periods less than one year is not annualized.
[2] The Artisan High Income strategy may hold loans and other security types, including securities with lower credit ratings, that may not be included in the BofA Merrill Lynch High Yield Master II Index. At times, this causes material differences in relative performance.
[3] The Total Assets Under Management includes $33 million of AUM managed in a privately offered strategy managed by the Credit Team.

24

Table of Contents

The tables below set forth changes in our AUM by investment team:

Three Months Ended	By Investment Team								
	Global Equity	U.S. Value	Growth	Global Value	Emerging Markets	Credit	Developing World	Thematic[1]	Total
June 30, 2017	(unaudited; in millions)								
Beginning assets under management	$27,272	$8,927	$27,737	$36,126	$ 258	$2,145	$ 1,297	$ —	$103,762
Gross client cash inflows	655	378	1,470	1,211	3	298	181	11	4,207
Gross client cash outflows	(2,257)	(732)	(1,393)	(1,058)	(1)	(188)	(100)	—	(5,729)
Net client cash flows	(1,602)	(354)	77	153	2	110	81	11	(1,522)
Market appreciation (depreciation)	2,524	119	2,067	2,268	17	51	118	1	7,165
Net transfers[2]	—	—	—	—	—	—	—	—	—
Ending assets under management	$28,194	$8,692	$29,881	$38,547	$ 277	$2,306	$ 1,496	$ 12	$109,405
Average assets under management	$27,874	$8,755	$29,017	$37,694	$ 269	$2,220	$ 1,413	$ 11	$107,250
June 30, 2016									
Beginning assets under management	$30,422	$9,776	$23,877	$30,770	$ 271	$1,343	573	$ —	$97,032
Gross client cash inflows	884	573	726	1,153	2	231	142	—	3,711
Gross client cash outflows	(1,549)	(2,386)	(1,183)	(739)	(68)	(93)	(13)	—	(6,031)
Net client cash flows	(665)	(1,813)	(457)	414	(66)	138	129	—	(2,320)
Market appreciation (depreciation)	(435)	317	740	(502)	8	82	21	—	231
Net transfers[2]	—	—	—	16	—	—	—	—	16
Ending assets under management	$29,322	$8,280	$24,160	$30,698	$ 213	$1,563	723	—	$94,959
Average assets under management	$30,155	$8,895	$24,122	$31,097	$ 215	$1,472	667	$ —	$96,623

(1) For the Thematic team, average assets under management is for the period between April 24, 2017, when the team's strategy began investment operations, and June 30, 2017.

(2) Net transfers represent certain amounts that we have identified as having been transferred out of one investment strategy or investment vehicle and into another strategy or vehicle.

Six Months Ended	By Investment Team Global Equity	U.S. Value	Growth	Global Value	Emerging Markets	Credit	Developing World	Thematic[1]	Total
June 30, 2017	(unaudited; in millions)								
Beginning assets under management	$25,510	$8,588	$25,714	$33,940	$ 228	$1,878	$ 987	$ —	$96,845
Gross client cash inflows	1,824	1,117	2,623	2,686	7	697	402	11	9,367
Gross client cash outflows	(3,916)	(1,389)	(2,866)	(2,481)	(3)	(372)	(135)	—	(11,162)
Net client cash flows	(2,092)	(272)	(243)	205	4	325	267	11	(1,795)
Market appreciation (depreciation)	4,776	376	4,410	4,402	45	103	242	1	14,355
Net transfers[2]	—	—	—	—	—	—	—	—	—
Ending assets under management	$28,194	$8,692	$29,881	$38,547	$ 277	$2,306	$ 1,496	$ 12	$109,405
Average assets under management	$27,275	$8,769	$28,086	$36,409	$ 258	$2,125	$ 1,285	$ 11	$104,210
June 30, 2016									
Beginning assets under management	$32,434	$10,369	$24,929	$30,182	$ 571	$989	374	$ —	$99,848
Gross client cash inflows	2,111	927	1,955	2,363	3	678	327	—	8,364
Gross client cash outflows	(3,435)	(3,902)	(2,437)	(1,618)	(397)	(206)	(28)	—	(12,023)
Net client cash flows	(1,324)	(2,975)	(482)	745	(394)	472	299	—	(3,659)
Market appreciation (depreciation)	(1,788)	886	(287)	(229)	36	102	50	—	(1,230)
Net transfers[2]	—	—	—	—	—	—	—	—	—
Ending assets under management	$29,322	$8,280	$24,160	$30,698	$ 213	$1,563	723	—	$94,959
Average assets under management	$30,014	$9,193	$23,347	$30,004	$ 357	$1,297	535	$ —	$94,747

[1] For the Thematic team, average assets under management is for the period between April 24, 2017, when the team's strategy began investment operations, and June 30, 2017.
[2] Net transfers represent certain amounts that we have identified as having been transferred out of one investment strategy or investment vehicle and into another strategy or vehicle.

The goal of our marketing, distribution and client services efforts is to establish and maintain a client base that is diversified by investment strategy, investment vehicle and distribution channel. As distribution channels have evolved to have more institutional-like decision making processes and longer-term investment horizons, we have expanded our distribution efforts into those areas.
The table below sets forth our AUM by distribution channel:

	As of June 30, 2017[1]		As of June 30, 2016[1]	
	$ in millions	% of total	$ in millions	% of total
	(unaudited)		(unaudited)	
Institutional	$72,934	66.6 %	$61,557	64.8 %
Intermediary	31,472	28.8 %	28,652	30.2 %
Retail	4,999	4.6 %	4,750	5.0 %
Ending Assets Under Management	$109,405	100.0%	$94,959	100.0%

[1] The allocation of AUM by distribution channel involves the use of
estimates and the exercise of judgment.
Our institutional channel includes AUM sourced from defined contribution plan clients, which makes up approximately 15% of our total AUM as of June 30, 2017.

Table of Contents

The following tables set forth the changes in our AUM for Artisan Funds, Artisan Global Funds and separate accounts:

Three Months Ended	Artisan Funds & Artisan Global Funds	Separate Accounts	Total
June 30, 2017	(unaudited; in millions)		
Beginning assets under management	$52,555	$51,207	$103,762
Gross client cash inflows	2,828	1,379	4,207
Gross client cash outflows	(4,271)	(1,458)	(5,729)
Net client cash flows	(1,443)	(79)	(1,522)
Market appreciation (depreciation)	3,513	3,652	7,165
Net transfers [1]	(37)	37	—
Ending assets under management	$54,588	$54,817	$109,405
Average assets under management	$53,957	$53,322	$107,250
June 30, 2016			
Beginning assets under management	$52,113	$44,919	$97,032
Gross client cash inflows	2,763	948	3,711
Gross client cash outflows	(4,737)	(1,294)	(6,031)
Net client cash flows	(1,974)	(346)	(2,320)
Market appreciation (depreciation)	162	69	231
Net transfers [1]	(95)	111	16
Ending assets under management	$50,206	$44,753	$94,959
Average assets under management	$51,619	$45,004	$96,623

[1] Net transfers represent certain amounts that we have identified as having been transferred out of one investment strategy or investment vehicle and into another strategy or vehicle.

Six Months Ended	Artisan Funds & Artisan Global Funds	Separate Accounts	Total
June 30, 2017	(unaudited; in millions)		
Beginning assets under management	$49,367	$47,478	$96,845
Gross client cash inflows	6,654	2,714	9,368
Gross client cash outflows	(8,417)	(2,745)	(11,162)
Net client cash flows	(1,763)	(31)	(1,794)
Market appreciation (depreciation)	7,068	7,286	14,354
Net transfers [1]	(84)	84	—
Ending assets under management	$54,588	$54,817	$109,405
Average assets under management	$52,825	$51,415	$104,210
June 30, 2016			
Beginning assets under management	$53,526	$46,322	$99,848
Gross client cash inflows	6,430	1,934	8,364
Gross client cash outflows	(8,958)	(3,065)	(12,023)
Net client cash flows	(2,528)	(1,131)	(3,659)
Market appreciation (depreciation)	(746)	(484)	(1,230)
Net transfers [1]	(46)	46	—

Ending assets under management	$50,206	$44,753	$94,959
Average assets under management	$50,752	$43,995	$94,747

[(1)] Net transfers represent certain amounts that we have identified as having been transferred out of one investment strategy or investment vehicle and into another strategy or vehicle.

27

Table of Contents

Results of Operations

Three months ended June 30, 2017, Compared to Three months ended June 30, 2016

	For the Three Months Ended June 30,		For the Period-to-Period	
	2017	2016	$	%
Statements of operations data:	(unaudited; in millions, except per share data)			
Revenues	$196.2	$ 180.8	$ 15.4	9 %
Operating Expenses				
Total compensation and benefits	102.8	95.2	7.6	8 %
Other operating expenses	26.9	26.7	0.2	1 %
Total operating expenses	129.7	121.9	7.8	6 %
Total operating income	66.5	58.9	7.6	13 %
Non-operating income (loss)				
Interest expense	(2.9)	(2.9)	—	— %
Other non-operating income	0.2	—	0.2	100 %
Total non-operating income (loss)	(2.7)	(2.9)	0.2	7 %
Income before income taxes	63.8	56.0	7.8	14 %
Provision for income taxes	15.0	12.7	2.3	18 %
Net income before noncontrolling interests	48.8	43.3	5.5	13 %
Less: Noncontrolling interests - Artisan Partners Holdings	22.2	25.0	(2.8)	(11)%
Less: Noncontrolling interests - consolidated investment products	—	—	—	
Net income attributable to Artisan Partners Asset Management Inc.	$26.6	$ 18.3	$ 8.3	45 %
Per Share Data				
Net income available to Class A common stock per basic and diluted share	$0.45	$ 0.38		
Weighted average basic and diluted shares of Class A common stock outstanding	45,241,103	38,023,586		

Revenues

Essentially all of our revenues consist of investment management fees earned from managing clients' assets. Our investment management fees fluctuate based on a number of factors, including the total value of our AUM, the composition of AUM among investment vehicles and our investment strategies, changes in the investment management fee rates on our products, the extent to which we enter into fee arrangements that differ from our standard fee schedules, which can be affected by custom and the competitive landscape in the relevant market, and for the few accounts on which we earn performance-based fees, the investment performance of those accounts relative to their designated benchmarks.

The increase in revenues of $15.4 million, or 9%, for the three months ended June 30, 2017, compared to the three months ended June 30, 2016, was driven primarily by a $10.6 billion, or 11%, increase in our average AUM. The increase was partially offset by the decline in our weighted average investment management fee from 75.2 basis points for the three months ended June 30, 2016 to 73.4 basis points for the three months ended June 30, 2017. The decrease in the weighted average fee rate is primarily the result of a shift in the mix of our AUM between our investment strategies and vehicles, primarily a reduction in the proportion of our total assets managed through Artisan Funds.

The following table sets forth the weighted average fee and composition of revenue and AUM by investment vehicle:

	Separate Accounts		Artisan Funds and Artisan Global Funds	
For the Three Months Ended June 30,	2017	2016	2017	2016
	(unaudited; dollars in millions)			

Investment management fees	$72.3	$62.0	$123.9	$118.8
Weighted average fee	54.4 basis points	55.3 basis points	92.1 basis points	92.5 basis points
Percentage of ending AUM	50 %	47 %	50 %	53 %

28

Separate account AUM consists of the assets we manage in or through vehicles other than Artisan Funds or Artisan Global Funds. Separate account AUM includes assets we manage in traditional separate accounts, as well as assets we manage in Artisan-branded collective investment trusts, in funds (both public and private) that we sub-advise, and in our own privately offered funds.

Operating Expenses

The increase in total operating expenses of $7.8 million for the three months ended June 30, 2017, compared to the three months ended June 30, 2016, was a result of higher incentive compensation expense due to increased revenues, increased post-IPO equity compensation expense, an increase in the number of full-time employees, and costs incurred related to our eighth investment team founded in the fourth quarter of 2016. These increases were partially offset by decreases in third-party intermediary and pre-offering related equity compensation expenses.

Compensation and Benefits

	For the Three Months Ended June 30,		Period-to-Period	
	2017	2016	$	%
	(unaudited; in millions)			
Salaries, incentive compensation and benefits [1]	$84.1	$77.2	$ 6.9	9 %
Restricted share-based award compensation expense	12.3	10.8	1.5	14 %
Total salaries, incentive compensation and benefits	96.4	88.0	8.4	10 %
Pre-offering related compensation - share-based awards	6.4	7.2	(0.8)	(11)%
Total compensation and benefits	$102.8	$95.2	$ 7.6	8 %

[1] Excluding restricted share-based award compensation expense

The increase in salaries, incentive compensation, and benefits was driven primarily by a $4.8 million increase in incentive compensation paid to our investment and marketing professionals as a result of the increase in revenue and average AUM. The remaining increase is primarily due to costs associated with our eighth investment team, which was founded in the fourth quarter of 2016.

Restricted share-based award compensation expense increased $1.5 million primarily as a result of our January 2017 grant of 1,267,250 restricted stock awards and 1,250 restricted stock units of Class A common stock to certain of our employees. Total compensation expense associated with the 2017 grants is expected to be approximately $35.9 million.

Pre-offering related compensation expense, which consists of the amortization expense on pre-offering Class B awards, decreased $0.8 million as certain awards became fully vested during 2016 and 2017. As of July 1, 2017, all Class B awards were fully vested.

Total salaries, incentive compensation and benefits was 49% of our revenues for the three months ended June 30, 2017, and 2016.

Other operating expenses

Other operating expenses increased $0.2 million for the three months ended June 30, 2017, compared to the three months ended June 30, 2016, primarily due to an increase in general and administrative expenses, which can fluctuate from period to period.

The increases were partially offset by a $1.2 million decrease in distribution, servicing and marketing expenses as a result of a decrease in third-party intermediary payments due to lower AUM sourced through third-party intermediaries (across all channels) that charge a fee for administrative and distribution services, a portion of which is borne by Artisan.

Provision for Income Taxes

The provision for income taxes primarily represents APAM’s U.S. federal, state and local income taxes on its allocable portion of Holdings’ income, as well as foreign income taxes payable by Holdings’ subsidiaries. APAM’s effective income tax rate for the three months ended June 30, 2017 and 2016, was 23.4% and 22.5%, respectively. Several

factors contribute to the effective tax rate, including a rate benefit attributable to the fact that approximately 38% and 46% of Holdings' full year projected taxable earnings were not subject to corporate-level taxes for the three months ended June 30, 2017 and 2016, respectively. Thus, income before income taxes includes amounts that are attributable to noncontrolling interests and not taxable to APAM and its subsidiaries, which reduces the effective tax rate. The effective tax rate in both periods was also lower due to dividends paid on unvested share-based awards, net of higher tax expense related to the vesting of restricted share-based awards. These favorable impacts were partially offset by the impact of certain permanent items, primarily attributable to pre-IPO share-based compensation expenses, that are not deductible for tax purposes. These factors are expected to continue to impact the effective tax rate for future years, although as APAM's equity ownership in Holdings increases, the effective tax rate will likewise increase as more income will be subject to corporate-level taxes. Pre-IPO share-based compensation expenses and the related impact to the effective tax rate no longer exist after the awards were fully vested on July 1, 2017.

Table of Contents

Earnings Per Share

Weighted average basic and diluted shares of Class A common stock outstanding were higher for the three months ended June 30, 2017, compared to the three months ended June 30, 2016, as a result of the 2017 Follow-On Offering, Holdings unit exchanges, and equity award grants. See Note 12, “Earnings Per Share” in the Notes to the Unaudited Consolidated Financial Statements for further discussion of earnings per share.

Six months ended June 30, 2017, Compared to Six months ended June 30, 2016

	For the Six Months Ended June 30,		Period-to-Period	
	2017	2016	$	%
Statements of operations data:	(unaudited; in millions, except per share data)			
Revenues	$380.3	$ 355.3	$ 25.0	7 %
Operating Expenses				
Total compensation and benefits	202.4	190.5	11.9	6 %
Other operating expenses	53.4	51.1	2.3	5 %
Total operating expenses	255.8	241.6	14.2	6 %
Total operating income	124.5	113.7	10.8	9 %
Non-operating income (loss)				
Interest expense	(5.8)	(5.8)	—	— %
Other non-operating income	0.4	—	0.4	— %
Total non-operating income (loss)	(5.4)	(5.8)	0.4	7 %
Income before income taxes	119.1	107.9	11.2	10 %
Provision for income taxes	27.7	24.2	3.5	14 %
Net income before noncontrolling interests	91.4	83.7	7.7	9 %
Less: Noncontrolling interests - Artisan Partners Holdings	45.0	49.1	(4.1)	(8)%
Less: Noncontrolling interests - consolidated investment products	—	—	—	— %
Net income attributable to Artisan Partners Asset Management Inc.	$46.4	$ 34.6	$ 11.8	34 %
Per Share Data				
Basic and diluted earnings per share - Class A common shares	$0.86	$ 0.74		
Weighted average shares of Class A common stock outstanding	43,142,013	37,497,268		

Revenues

The increase in revenues of $25.0 million, or 7%, for the six months ended June 30, 2017, compared to the six months ended June 30, 2016, was driven primarily by a $9.5 billion, or 10%, increase in our average AUM.

Our weighted average investment management fee rate was 73.5 basis points for the six months ended June 30, 2017, compared to 75.3 basis points for the six months ended June 30, 2016. The following table sets forth the weighted average fee (which reflects the additional services we provide to pooled vehicles) and composition of revenue and AUM by investment vehicle:

	Separate Accounts		Artisan Funds and Artisan Global Funds	
For the Six Months Ended June 30,	2017	2016	2017	2016
	(unaudited; dollars in millions)			
Investment management fees	$139.0	$121.8	$241.3	$233.5
Weighted average fee	54.4 basis points	55.5 basis points	92.1 basis points	92.5 basis points
Percentage of ending AUM	50 %	47 %	50 %	53 %

30

Table of Contents

Operating Expenses

The increase in total operating expenses of $14.2 million for the six months ended June 30, 2017, compared to the six months ended June 30, 2016, was a result of higher incentive compensation expense due to increased revenues, an increase in the number of full-time employees, costs incurred related to our eighth investment team founded in the fourth quarter of 2016, increases in general and administrative and technology expenses, and increased post-IPO equity compensation expense. These increases were partially offset by decreases in third-party intermediary and pre-offering related equity compensation expenses.

Compensation and Benefits

	For the Six Months Ended June 30,		Period-to-Period	
	2017	2016	$	%
	(unaudited; in millions)			
Salaries, incentive compensation and benefits [1]	$165.6	$154.3	$11.3	7 %
Restricted share-based award compensation expense	24.1	21.2	2.9	14 %
Total salaries, incentive compensation and benefits	189.7	175.5	14.2	8 %
Pre-offering related compensation - share-based awards	12.7	15.0	(2.3)	(15)%
Total compensation and benefits	$202.4	$190.5	$11.9	6 %

[1] Excluding share-based compensation

The increase in salaries, incentive compensation, and benefits was driven primarily by a $7.2 million increase in incentive compensation paid to our investment and marketing professionals as a result of higher investment management fee revenue. The remaining increase is primarily due to costs associated with our eighth investment team.

Restricted share-based award compensation expense increased $2.9 million primarily as a result of restricted share-based awards granted in January 2017.

Pre-offering related compensation expense, which consists of the amortization expense on pre-offering Class B awards decreased $2.3 million, as certain awards became fully vested during 2016 and 2017. As of July 1, 2017, all Class B awards were fully vested.

Total salaries, incentive compensation and benefits was 50% and 49% of our revenues for the six months ended June 30, 2017, and 2016, respectively.

Other operating expenses

Other operating expenses increased $2.3 million for the six months ended June 30, 2017 compared to the six months ended June 30, 2016, primarily due to a $2.1 million increase in general and administrative expenses, which can fluctuate from period to period, and a $1.3 million increase in communication and technology expenses as a result of increased information subscriptions and market data costs related to firm initiatives.

The increases were partially offset by a $1.9 million decrease in distribution, servicing and marketing expenses as a result of a decrease in third-party intermediary expenses due to lower AUM sourced through third-party intermediaries (across all channels) that charge a fee for administrative and distribution services, a portion of which is borne by Artisan.

Provision for Income Taxes

The provision for income taxes primarily represents APAM’s U.S. federal, state and local income taxes on its allocable portion of Holdings’ income, as well as foreign income taxes payable by Holdings’ subsidiaries. APAM’s effective income tax rate for the six months ended June 30, 2017 and 2016, was 23.3% and 22.4%, respectively. Several factors contribute to the effective tax rate, including a rate benefit attributable to the fact that approximately 38% and 46% of Holdings’ full year projected taxable earnings were not subject to corporate-level taxes for the six months ended June 30, 2017 and 2016, respectively. Thus, income before income taxes includes amounts that are attributable to noncontrolling interests and not taxable to APAM and its subsidiaries, which reduces the effective tax rate. The effective tax rate in both periods was also lower due to dividends paid on unvested share-based awards, net of higher tax expense related to the vesting of restricted share-based awards. These favorable impacts were partially offset by

the impact of certain permanent items, primarily attributable to pre-IPO share-based compensation expenses, that are not deductible for tax purposes. These factors are expected to continue to impact the effective tax rate for future years, although as APAM's equity ownership in Holdings increases, the effective tax rate will likewise increase as more income will be subject to corporate-level taxes. Pre-IPO share-based compensation expenses and the related impact to the effective tax rate no longer exist after the awards were fully vested on July 1, 2017.

Earnings Per Share

Weighted average basic and diluted shares of Class A common stock outstanding were higher for the six months ended June 30, 2017, compared to the six months ended June 30, 2016, as a result of stock offerings, unit exchanges, and equity award grants. See Note 12, "Earnings Per Share" in the Notes to the Unaudited Consolidated Financial Statements for further discussion of earnings per share.

Table of Contents

Supplemental Non-GAAP Financial Information

Our management uses non-GAAP measures (referred to as “adjusted” measures) of net income and operating income to evaluate the profitability and efficiency of the underlying operations of our business and as a factor when considering net income available for distributions and dividends. These adjusted measures remove the impact of (1) pre-offering related compensation and (2) net gain (loss) on the tax receivable agreements (if any). These adjustments also remove the non-operational complexities of our structure by adding back non-controlling interests and assuming all income of Artisan Partners Holdings is allocated to APAM. Management believes these non-GAAP measures provide more meaningful information to analyze our profitability and efficiency between periods and over time. We have included these non-GAAP measures to provide investors with the same financial metrics used by management to manage the company.

Non-GAAP measures should be considered in addition to, and not as a substitute for, financial measures prepared in accordance with GAAP. Our non-GAAP measures may differ from similar measures used by other companies, even if similar terms are used to identify such measures. Our non-GAAP measures are as follows:

- Adjusted net income represents net income excluding the impact of (1) pre-offering related compensation and (2) net gain (loss) on the tax receivable agreements (if any). Adjusted net income also reflects income taxes assuming the vesting of all unvested Class A share-based awards and as if all outstanding limited partnership units of Artisan Partners Holdings had been exchanged for Class A common stock of APAM on a one-for-one basis. Assuming full vesting and exchange, all income of Artisan Partners Holdings is treated as if it were allocated to APAM, and the adjusted provision for income taxes represents an estimate of income tax expense at an effective rate reflecting assumed federal, state, and local income taxes. The estimated adjusted effective tax rate was 37.0% for the periods presented.
- Adjusted net income per adjusted share is calculated by dividing adjusted net income by adjusted shares. The number of adjusted shares is derived by assuming the vesting of all unvested Class A share-based awards and the exchange of all outstanding limited partnership units of Artisan Partners Holdings for Class A common stock of APAM on a one-for-one basis.
- Adjusted operating income represents the operating income of the consolidated company excluding pre-offering related compensation.
- Adjusted operating margin is calculated by dividing adjusted operating income by total revenues.
- Adjusted EBITDA represents adjusted net income before taxes, interest expense and depreciation and amortization, adjusted to exclude the impact of net income attributable to non-controlling interests, pre-offering related compensation and net gain (loss) on the tax receivable agreements (if any).

Pre-offering related compensation includes the amortization of unvested Class B common units of Artisan Partners Holdings that were granted before and were unvested at our IPO, which closed on March 12, 2013. As of July 1, 2017, all Class B common units of Artisan Partners Holdings are vested.

Net gain (loss) on the tax receivable agreements represents the income (expense) associated with the change in estimate of amounts payable under the tax receivable agreements entered into in connection with APAM’s initial public offering and related reorganization.

Table of Contents

The following table sets forth, for the periods indicated, a reconciliation from GAAP financial measures to non-GAAP measures:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
	(unaudited; in millions, except per share data)			
Reconciliation of non-GAAP financial measures:				
Net income attributable to Artisan Partners Asset Management Inc. (GAAP)	$26.6	$18.3	$46.4	$34.6
Add back: Net income attributable to noncontrolling interests - Artisan Partners Holdings	22.2	25.0	45.0	49.1
Add back: Provision for income taxes	15.0	12.7	27.7	24.2
Add back: Pre-offering related compensation - share-based awards	6.4	7.2	12.7	15.0
Add back: Net (gain) loss on the tax receivable agreements	—	—	—	—
Less: Adjusted provision for income taxes	25.9	23.4	48.7	45.5
Adjusted net income (Non-GAAP)	$44.3	$39.8	$83.1	$77.4
Average shares outstanding				
Class A common shares	45.2	38.0	43.1	37.5
Assumed vesting or exchange of:				
Unvested Class A restricted share-based awards	4.5	3.9	4.2	3.6
Artisan Partners Holdings units outstanding (noncontrolling interest)	26.1	32.8	28.2	33.3
Adjusted shares	75.8	74.7	75.5	74.4
Basic and diluted earnings per share (GAAP)	$0.45	$0.38	$0.86	$0.74
Adjusted net income per adjusted share (Non-GAAP)	$0.58	$0.53	$1.10	$1.04
Operating income (GAAP)	$66.5	$58.9	$124.5	$113.7
Add back: Pre-offering related compensation - share-based awards	6.4	7.2	12.7	15.0
Adjusted operating income (Non-GAAP)	$72.9	$66.1	$137.2	$128.7
Operating margin (GAAP)	33.9 %	32.6 %	32.7 %	32.0 %
Adjusted operating margin (Non-GAAP)	37.1 %	36.6 %	36.1 %	36.2 %
Net income attributable to Artisan Partners Asset Management Inc. (GAAP)	$26.6	$18.3	$46.4	$34.6
Add back: Net income attributable to noncontrolling interests - Artisan Partners Holdings	22.2	25.0	45.0	49.1
Add back: Pre-offering related compensation - share-based awards	6.4	7.2	12.7	15.0
Add back: Net (gain) loss on the tax receivable agreements	—	—	—	—
Add back: Interest expense	2.9	2.9	5.8	5.8
Add back: Provision for income taxes	15.0	12.7	27.7	24.2
Add back: Depreciation and amortization	1.2	1.2	2.5	2.4
Adjusted EBITDA (Non-GAAP)	$74.3	$67.3	$140.1	$131.1

Table of Contents

Liquidity and Capital Resources

Our working capital needs, including accrued incentive compensation payments, have been and are expected to be met primarily through cash generated by our operations. The assets and liabilities of consolidated investment products attributable to third-party investors do not impact our liquidity and capital resources. We have no right to the benefits from, nor do we bear the risks associated with, the assets and liabilities of consolidated investment products, beyond our direct equity investment and any investment management fees and incentive allocations earned. Accordingly, assets and liabilities attributable to consolidated investment products are excluded from the amounts and discussions below. The following table shows our liquidity position as of June 30, 2017, and December 31, 2016.

	June 30, 2017	December 31, 2016
	(unaudited; in millions)	
Cash and cash equivalents	$190.3	$ 156.8
Accounts receivable	$67.7	$ 59.7
Undrawn commitment on revolving credit facility	$100.0	$ 100.0

We manage our cash balances in order to fund our day-to-day operations. Accounts receivable primarily represent investment management fees that have been earned, but not yet received from our clients. We perform a review of our receivables on a monthly basis to assess collectability. As of June 30, 2017, none of our receivables were considered uncollectable.

In August 2012, we issued $200.0 million in unsecured notes and entered into the $100.0 million five-year revolving credit facility. The notes are comprised of three series, each with a balloon payment at maturity. The fixed interest rate on each series of unsecured notes is subject to a 100 basis point increase in the event Holdings receives a below-investment grade rating and any such increase will continue to apply until an investment grade rating is received. The $100.0 million revolving credit facility was unused as of and for the six months ended June 30, 2017. These borrowings contain various restrictive covenants. Our failure to comply with any of the covenants could result in an event of default under the agreements, giving our lenders the ability to accelerate repayment of our obligations. We were in compliance with all debt covenants as of June 30, 2017.

Unsecured notes of $60 million will mature, and the $100 million revolving credit facility is scheduled to terminate, on August 17, 2017. We have obtained commitments to refinance the $60 million of notes coming due and extend the revolving credit facility, in both cases subject to standard closing conditions.

Distributions and Dividends

Artisan Partners Holdings' distributions, including distributions to APAM for the three and six months ended June 30, 2017 and 2016, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2017	2016	2017	2016
	(unaudited, in millions)			
Holdings Partnership Distributions to Limited Partners	$38.2	$43.1	$54.8	$62.4
Holdings Partnership Distributions to APAM	$61.9	$50.8	$83.5	$73.2
Total Holdings Partnership Distributions	$100.1	$93.9	$138.3	$135.6

On July 27, 2017, we, acting as the general partner of Artisan Partners Holdings, declared a distribution of $39.3 million, payable by Artisan Partners Holdings to holders of its partnership units, including us.

APAM declared and paid the following dividends per share during the three and six months ended June 30, 2017 and 2016:

Type of Dividend Class of Stock

		For the Three Months Ended June 30,		For the Six Months Ended June 30,	
		2017	2016	2017	2016
Quarterly	Class A Common	$0.60	$0.60	$1.20	$1.20
Special Annual	Class A Common	$—	$—	$0.36	$0.40

On July 27, 2017, our board declared a quarterly dividend of $0.60 per share of Class A common stock payable on August 31, 2017 to shareholders of record as of August 17, 2017.

Subject to board approval each quarter, we currently expect to pay a quarterly dividend of $0.60 per share of Class A common stock during 2017. After the end of the year, our board expects to consider paying a special dividend that will take into consideration our annual adjusted earnings, business conditions and the amount of cash we want to retain at that time. Although we expect to pay dividends according to our dividend policy, we may not pay dividends according to our policy or at all.

Tax Receivable Agreements ("TRAs")

In addition to funding our normal operations, we will be required to fund amounts payable under the TRAs that we entered into in connection with the IPO, which resulted in the recognition of a $669.9 million liability as of June 30, 2017. The liability generally represents 85% of the tax benefits APAM expects to realize as a result of the merger of an entity into APAM as part of the IPO Reorganization, our purchase of partnership units from limited partners of Holdings and the exchange of partnership units (for shares of Class A common stock or other consideration). The estimated liability assumes no material changes in the relevant tax law and that APAM earns sufficient taxable income to realize all tax benefits subject to the TRAs. An increase or decrease in future tax rates will increase or decrease, respectively, the expected tax benefits APAM would realize and the amounts payable under the TRAs. Changes in the estimate of expected tax benefits APAM would realize and the amounts payable under the TRAs as a result of change in tax rates would be recorded in net income.

The liability will increase upon future purchases or exchanges of limited partnership units with the increase representing amounts payable under the TRAs equal to 85% of the estimated future tax benefits, if any, resulting from such purchases or exchanges. We intend to fund the payment of amounts due under the TRAs out of the reduced tax payments that APAM realizes in respect of the tax attributes to which the TRAs relate.

The actual increase in tax basis, as well as the amount and timing of any payments under these agreements, will vary depending upon a number of factors, including the timing of sales or exchanges by the holders of limited partnership units, the price of the Class A common stock at the time of such sales or exchanges, whether such sales or exchanges are taxable, the amount and timing of the taxable income APAM generates in the future and the tax rate then applicable and the portion of APAM's payments under the TRAs constituting imputed interest or depreciable basis or amortizable basis. In certain cases, payments under the TRAs may be accelerated and/or significantly exceed the actual benefits we realize in respect of the tax attributes subject to the TRAs. In such cases, we intend to fund those payments with cash on hand, although we may have to borrow funds depending on the amount and timing of the payments. We expect to make total payments of approximately $30 million in 2017 related to the TRAs, $22.8 million of which we paid in April 2017.

Cash Flows

	For the Six Months Ended June 30,	
	2017	2016
	(unaudited; in millions)	
Cash as of January 1	$156.8	$166.2
Net cash provided by operating activities	169.4	184.1
Net cash provided by (used in) investing activities	0.8	(3.9)
Net cash used in financing activities	(136.7)	(148.6)
Cash as of June 30	$190.3	$197.8

Operating activities provided net cash of $169.4 million and $184.1 million for the six months ended June 30, 2017 and 2016, respectively. The $14.7 million decrease in cash provided by operating activities was primarily due to $32.7 million of net operating cash flows used by consolidated investment products, partially offset by increased revenues and operating income resulting from an increase in average AUM. For the six months ended June 30, 2017, compared to the six months ended June 30, 2016, our operating income, excluding share-based and pre-offering related compensation expenses, increased $11.4 million.

Investing activities consist primarily of acquiring and selling property and equipment, leasehold improvements and the purchase and sale of available-for-sale securities. Investing activities generated net cash of $0.8 million and used net cash of $3.9 million for the six months ended June 30, 2017 and 2016, respectively. The $4.7 million increase in net cash provided by investing activities was primarily due to $3.1 million of net sales of investment securities and a $1.6 million decrease in acquisition of property and equipment and leasehold improvements during the six months ended June 30, 2017.

Financing activities consist primarily of partnership distributions to non-controlling interests, dividend payments to holders of our Class A common stock, proceeds from the issuance of Class A common stock in follow-on offerings, and payments to purchase Holdings partnership units. Financing activities used net cash of $136.7 million and $148.6 million for the six months ended June 30, 2017 and 2016, respectively. The $11.9 million decrease in net cash used by financing activities was primarily the result of $12.7 million of contributions from non-controlling interests in our consolidated investment products, and a $7.7 million decrease in distributions to limited partners, partially offset by a $5.7 million increase in dividends paid.

Table of Contents

Certain Contractual Obligations

As of June 30, 2017, there have been no material changes to our contractual obligations outside the ordinary course of business from those listed in the “Certain Contractual Obligations” table and related notes to the table in our Annual Report on Form 10-K for the year ended December 31, 2016, filed with the SEC on February 21, 2017, except for increases in the TRA liability. As previously discussed in this report, the TRA liability increased from $586.2 million at December 31, 2016, to $669.9 million at June 30, 2017. Amounts payable under the TRAs will increase upon exchanges of Holdings units for our Class A common stock or sales of Holdings units to us, with the increase representing 85% of the estimated future tax benefits, if any, resulting from such exchanges or sales. The actual amount and timing of payments associated with our existing payable under the TRAs or future exchanges or sales, and associated tax benefits, will vary depending upon a number of factors as described under “Liquidity and Capital Resources.” As a result, the timing of payments by period is currently unknown. We expect to make total payments of approximately $30 million in 2017 related to the TRAs, $22.8 million of which we paid in April 2017.

Off-Balance Sheet Arrangements

As of June 30, 2017, we did not have any off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on our financial condition, results of operations, liquidity or capital resources.

Critical Accounting Policies and Estimates

There have been no updates to our critical accounting policies from those disclosed in Management’s Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the year ended December 31, 2016.

New or Revised Accounting Standards

See Part I, Item 1, Unaudited Consolidated Financial Statements - Note 2, “Summary of Significant Accounting Policies.”

Item 3. Qualitative and Quantitative Disclosures Regarding Market Risk

There have been no material changes in our Quantitative and Qualitative Disclosures Regarding Market Risk from those previously reported in our Form 10-K for the year ended December 31, 2016.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act, that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow for timely decisions regarding required disclosure.

Our management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) at June 30, 2017. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective.

Changes in Internal Control over Financial Reporting

There have been no changes in internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2017, that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

Table of Contents

Part II — Other Information

Item 1. Legal Proceedings

In the normal course of business, we may be subject to various legal and administrative proceedings. Currently, there are no legal or administrative proceedings that management believes may have a material effect on our consolidated financial position, cash flows or results of operations.

Item 1A. Risk Factors

For a discussion of our potential risks and uncertainties, see the information under the heading "Risk Factors" in our latest annual report on Form 10-K, which is accessible on the SEC's website at www.sec.gov.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Unregistered Sales of Equity Securities

As described in Note 8, "Stockholders' Equity", to the Unaudited Consolidated Financial Statements included in Part I of this report, upon termination of employment with Artisan, an employee-partner's unvested Class B common units are forfeited. Generally, the employee-partner's vested Class B common units are exchanged for Class E common units; the employee-partner's shares of APAM Class B common stock are canceled; and APAM issues the former employee-partner a number of shares of APAM Class C common stock equal to the former employee-partner's number of Class E common units. Class E common units are exchangeable for Class A common stock subject to the same restrictions and limitations on exchange applicable to the other common units of Holdings. There were no such issuances during the three months ended June 30, 2017.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit No.	Description
31.1	Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Company's Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Company's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following Extensible Business Reporting Language (XBRL) documents are collectively included herewith as Exhibit 101: (i) the Unaudited Condensed Consolidated Statements of Financial Condition as of June 30, 2017 and December 31, 2016; (ii) the Unaudited Consolidated Statements of Operations for the three and six months ended June 30, 2017 and 2016; (iii) the Unaudited Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2017 and 2016; (iv) the Unaudited Consolidated Statements of Changes in Stockholders' Equity for the six months ended June 30, 2017 and 2016; (v) the Unaudited Consolidated Statements of Cash Flows for the six months ended June 30, 2017 and 2016 (vi) the Notes to Unaudited Consolidated Financial Statements as of and for the three months ended June 30, 2017 and 2016

Table of Contents

SIGNATURES

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

Artisan Partners Asset Management Inc.

Dated: August 2, 2017
By:
/s/ Eric R. Colson
Eric R. Colson
President, Chief Executive Officer and Chairman of the Board
(principal executive officer)

/s/ Charles J. Daley, Jr.
Charles J. Daley, Jr.
Executive Vice President, Chief Financial Officer and Treasurer
(principal financial and accounting officer)

38