SCANSOURCE INC
Form 10-Q
May 07, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the Quarterly period ended March 31, 2014

Commission File Number: 000-26926

ScanSource, Inc.
(Exact name of registrant as specified in its charter)

SOUTH CAROLINA	57-0965380
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6 Logue Court
Greenville, South Carolina, 29615
(Address of principal executive offices)
(864) 288-2432
(Registrant's telephone number, including area code)

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 x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post to such files. Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x		Accelerated filer	¨
Non-accelerated filer	¨	(Do not check if a smaller reporting company)	Smaller reporting company	¨

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 5, 2014
Common Stock, no par value per share	28,518,432 shares

SCANSOURCE, INC.
INDEX TO FORM 10-Q
March 31, 2014

Table of Contents

FORWARD-LOOKING STATEMENTS

The forward-looking statements included in the "Management’s Discussion and Analysis of Financial Condition and Results of Operations" and "Quantitative and Qualitative Disclosures About Market Risk" and "Risk Factors" sections and elsewhere herein, which reflect our best judgment based on factors currently known, involve risks and uncertainties. Words such as "expects," "anticipates," "believes," "intends," "plans," "hopes," "forecasts" and variations of such words and similar expressions are intended to identify such forward-looking statements. Except as may be required by law, we expressly disclaim any obligation to update these forward-looking statements to reflect events or circumstances after the date of this Quarterly Report on Form 10-Q or to reflect the occurrence of unanticipated events. Actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors including, but not limited to, the factors discussed in such sections and, in particular, those set forth in the cautionary statements included in "Risk Factors" contained in our Annual Report on Form 10-K for the year ended June 30, 2013. The forward-looking information we have provided in this Quarterly Report on Form 10-Q pursuant to the safe harbor established under the Private Securities Litigation Reform Act of 1995, should be evaluated in the context of these factors.

Table of Contents

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
SCANSOURCE, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(In thousands, except share information)

	March 31, 2014	June 30, 2013
Assets		
Current assets:		
Cash and cash equivalents	$183,562	$148,164
Accounts receivable, less allowance of $26,825 at March 31, 2014 and $25,479 at June 30, 2013	419,889	435,028
Inventories	479,871	402,307
Prepaid expenses and other current assets	41,947	40,105
Deferred income taxes	15,876	16,456
Total current assets	1,141,145	1,042,060
Property and equipment, net	25,674	20,203
Goodwill	32,143	31,795
Other non-current assets, including net identifiable intangible assets	53,412	70,125
Total assets	$1,252,374	$1,164,183
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$375,892	$362,271
Accrued expenses and other current liabilities	62,756	59,983
Current portion of contingent consideration	5,718	3,732
Income taxes payable	2,289	1,696
Total current liabilities	446,655	427,682
Deferred income taxes	192	205
Long-term debt	5,429	5,429
Long-term portion of contingent consideration	5,018	8,813
Other long-term liabilities	22,294	26,098
Total liabilities	479,588	468,227
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, 28,513,120 and 27,971,809 shares issued and outstanding at March 31, 2014 and June 30, 2013, respectively	166,509	149,821
Retained earnings	623,791	569,107
Accumulated other comprehensive income (loss)	(17,514)	(22,972)
Total shareholders' equity	772,786	695,956
Total liabilities and shareholders' equity	$1,252,374	$1,164,183

June 30, 2013 amounts are derived from audited consolidated financial statements.

See accompanying notes to these condensed consolidated financial statements.

Table of Contents

SCANSOURCE, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED INCOME STATEMENTS (UNAUDITED)
(In thousands, except per share data)

	Quarter ended March 31,		Nine months ended March 31,	
	2014	2013	2014	2013
Net sales	$682,998	$682,965	$2,155,520	$2,164,286
Cost of goods sold	609,647	614,133	1,928,414	1,947,063
Gross profit	73,351	68,832	227,106	217,223
Selling, general and administrative expenses	46,705	47,937	143,541	144,392
Change in fair value of contingent consideration	981	100	2,218	1,396
Operating income	25,665	20,795	81,347	71,435
Interest expense	217	102	698	356
Interest income	(545)	(483)	(1,644)	(1,648)
Other (income) expense, net	13	(4)	65	34
Income before income taxes	25,980	21,180	82,228	72,693
Provision for income taxes	9,031	7,202	27,544	24,716
Net income	$16,949	$13,978	$54,684	$47,977
Per share data:				
Weighted-average shares outstanding, basic	28,502	27,847	28,275	27,725
Net income per common share, basic	$0.59	$0.50	$1.93	$1.73
Weighted-average shares outstanding, diluted	28,730	28,024	28,548	27,960
Net income per common share, diluted	$0.59	$0.50	$1.92	$1.72

See accompanying notes to these condensed consolidated financial statements.

Table of Contents

SCANSOURCE, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(In thousands)

	Quarter ended March 31,		Nine months ended March 31,	
	2014	2013	2014	2013
Net income	$16,949	$13,978	$54,684	$47,977
Foreign currency translation adjustment	1,562	(3,107)	5,458	2,206
Comprehensive income	$18,511	$10,871	$60,142	$50,183

See accompanying notes to these condensed consolidated financial statements.

SCANSOURCE, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

	Nine months ended March 31, 2014	2013
Cash flows from operating activities:		
Net income	$54,684	$47,977
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	5,391	6,604
Amortization of debt issuance costs	238	259
Provision for doubtful accounts	5,469	8,312
Share-based compensation and restricted stock	3,807	4,565
Deferred income taxes	10,981	(4,028)
Excess tax benefits from share-based payment arrangements	(982)	(849)
Change in fair value of contingent consideration	2,218	1,396
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	13,340	32,061
Inventories	(74,461)	72,170
Prepaid expenses and other assets	(2,924)	(303)
Other non-current assets	3,790	3,658
Accounts payable	12,404	(94,951)
Accrued expenses and other liabilities	(2,817)	(2,696)
Income taxes payable	1,532	1,831
Net cash provided by (used in) operating activities	32,670	76,006
Cash flows from investing activities:		
Capital expenditures	(6,785)	(4,463)
Net cash provided by (used in) investing activities	(6,785)	(4,463)
Cash flows from financing activities:		
Borrowings (repayments) on short-term borrowings, net	—	(4,459)
Borrowings on revolving credit	—	515,262
Repayments on revolving credit	—	(515,877)
Debt issuance costs	(468)	—
Contingent consideration payments	(3,793)	(4,777)
Exercise of stock options	12,152	2,231
Excess tax benefits from share-based payment arrangements	982	849
Net cash provided by (used in) financing activities	8,873	(6,771)
Effect of exchange rate changes on cash and cash equivalents	640	(40)
Increase (decrease) in cash and cash equivalents	35,398	64,732
Cash and cash equivalents at beginning of period	148,164	29,173
Cash and cash equivalents at end of period	$183,562	$93,905

See accompanying notes to these condensed consolidated financial statements.

Table of Contents

SCANSOURCE, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(1) Business and Summary of Significant Accounting Policies

Business Description

ScanSource, Inc. is a leading international wholesale distributor of specialty technology products. ScanSource, Inc. and its subsidiaries ("the Company") provide value-added distribution services for technology manufacturers and sell to resellers in the following specialty technology markets: POS Barcode and Security through its Worldwide Barcode & Security segment and Communications through its Worldwide Communications & Services segment.

The Company operates in the United States, Canada, Latin America and Europe and uses centralized distribution centers for major geographic regions. The Company distributes to the United States and Canada from its Southaven, Mississippi distribution center; to Latin America principally from distribution centers located in Florida, Mexico and Brazil; and to Europe from its distribution center in Belgium.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of ScanSource, Inc. have been prepared by the Company’s management in accordance with United States generally accepted accounting principles ("US GAAP") 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 US GAAP for annual financial statements. The unaudited condensed consolidated financial statements included herein contain all adjustments (consisting of normal recurring and non-recurring adjustments) which are, in the opinion of management, necessary to present fairly the financial position as of March 31, 2014 and June 30, 2013, the results of operations for the quarters and nine months ended March 31, 2014 and 2013, the statements of comprehensive income for the quarters and nine months ended March 31, 2014 and 2013 and the statements of cash flows for the nine months ended March 31, 2014 and 2013. The results of operations for the quarters and nine months ended March 31, 2014 and 2013 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 Annual Report on Form 10-K for the fiscal year ended June 30, 2013.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation in the accompanying Condensed Consolidated Statements of Cash Flows. Such reclassifications have no effect on the cash flow from operating, investing and financing activities as previously reported.

Summary of Significant Accounting Policies

Except as described below, there have been no material changes to the Company’s significant accounting policies for the quarter and nine months ended March 31, 2014 from the information included in the notes to the Company’s consolidated financial statements included in the Annual Report on Form 10-K for the fiscal year ended June 30, 2013. For a discussion of the Company’s significant accounting policies, please see the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2013.

During the third quarter of fiscal 2014, the Company changed its annual goodwill impairment testing date from June 30 to April 30. This voluntary change is considered preferable as it better aligns the timing of the impairment test with management’s financial planning and budgeting process, and ensures the completion of the test prior to the end of the annual reporting period. This change does not accelerate, delay or avoid a potential impairment charge. The Company will complete its annual goodwill impairment test during the fourth quarter of fiscal 2014.

Table of Contents

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. The Company maintains some zero-balance, disbursement accounts at various financial institutions in which the Company does not maintain significant depository relationships. Due to the nature of the Company's banking relationships with these institutions, the Company does not have the right to offset most if not all outstanding checks written from these accounts against cash on hand, and the respective institutions are not legally obligated to honor the checks until sufficient funds are transferred to fund the checks. Checks released but not yet cleared from these accounts in the amounts of $53.2 million and $65.9 million are included in accounts payable as of March 31, 2014 and June 30, 2013, respectively.

Recent Accounting Pronouncements

There are currently no new accounting pronouncements that are expected to have a significant impact on the Company's financial position, results of operations and cash flows.

(2) 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.

	Quarter ended March 31,		Nine months ended March 31,	
	2014	2013	2014	2013
	(in thousands, except per share data)			
Numerator:				
Net Income	$16,949	$13,978	$54,684	$47,977
Denominator:				
Weighted-average shares, basic	28,502	27,847	28,275	27,725
Dilutive effect of share-based payments	228	177	273	235
Weighted-average shares, diluted	28,730	28,024	28,548	27,960
Net income per common share, basic	$0.59	$0.50	$1.93	$1.73
Net income per common share, diluted	$0.59	$0.50	$1.92	$1.72

For the quarter and nine months ended March 31, 2014, weighted average shares outstanding excluded from the computation of diluted earnings per share because their effect would be anti-dilutive were 275,635 and 203,384, respectively. For the quarter and nine months ended March 31, 2013, there were 1,119,940 and 1,097,610 weighted average shares outstanding excluded from the computation of diluted earnings per share because their effect would be anti-dilutive.

(3) Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) consists of the following:

	March 31, 2014	June 30, 2013
	(in thousands)	
Foreign currency translation adjustment	$(17,514)	$(22,972)
Accumulated other comprehensive income (loss)	$(17,514)	$(22,972)

For the quarter and nine months ended March 31, 2014, the tax effect of amounts in comprehensive income reflect a tax benefit of $0.2 million. For the quarter and nine months ended March 31, 2013, the tax effect of amounts in comprehensive income reflect a tax expense of $0.3 million and a tax benefit of $0.1 million, respectively.

Table of Contents

(4) Goodwill and Other Identifiable Intangible Assets

The changes in the carrying amount of goodwill for the nine months ended March 31, 2014, by reporting segment, are as follows:

	Barcode & Security Segment	Communications & Services Segment	Total
	(in thousands)		
Balance as of June 30, 2013	$16,329	$ 15,466	$31,795
Foreign currency translation adjustment	348	—	348
Balance as of March 31, 2014	$16,677	$ 15,466	$32,143

Included within other non-current assets in the Condensed Consolidated Balance Sheets are net identifiable intangible assets of $16.9 million and $19.8 million at March 31, 2014 and June 30, 2013, respectively. These amounts relate primarily to acquired intangible assets including customer relationships, non-compete agreements, and distributor agreements.

(5) Short-Term Borrowings and Long-Term Debt

Short-Term Borrowings

A subsidiary of the Company has a €6.0 million line of credit, which is secured by the assets of our European operations and is guaranteed by ScanSource, Inc. This agreement can be withdrawn by the lender with minimal notice. The subsidiary line of credit bears interest at the 30-day Euro Interbank Offered Rate ("EURIBOR") plus a spread ranging from 1.25% to 2.00% per annum. The spread in effect for the period ended March 31, 2014 was 1.25%. Additionally, the Company is assessed commitment fees ranging from 0.10% to 0.275% on non-utilized borrowing availability if outstanding balances are below €3.0 million. The interest rate spread and commitment fee rates are based on the Company's Leverage Ratio for its revolving credit facility, as defined below. There were no outstanding balances at March 31, 2014 and June 30, 2013.

Revolving Credit Facility

The Company has a $300 million multi-currency senior secured revolving credit facility that was scheduled to mature on October 11, 2016. On November 6, 2013, the Company entered into an amendment of this credit facility ("Amended Credit Agreement") with JPMorgan Chase Bank N.A., as administrative agent, and a syndicate of banks to extend its maturity to November 6, 2018. The Amended Credit Agreement allows for the issuance of up to $50 million for letters of credit and has a $150 million accordion feature that allows the Company to increase the availability to $450 million, subject to obtaining additional credit commitments for the lenders participating in the increase. The Company incurred debt issuance costs of $0.5 million in connection with the Amended Credit Agreement, which were capitalized to other assets on the Condensed Consolidated Balance Sheets and added to the unamortized debt issuance costs from the previous credit facility.

At the Company's option, loans denominated in U.S. dollars under the Amended Credit Agreement, other than swingline loans, bear interest at a rate equal to a spread over the London Interbank Offered Rate ("LIBOR") or alternate base rate depending upon the Company's ratio of total debt (excluding accounts payable and accrued liabilities), measured as of the end of the most recent quarter, to adjusted earnings before interest expense, taxes, depreciation and amortization ("EBITDA") for the most recently completed four quarters (the "Leverage Ratio"). The Leverage Ratio calculation excludes the Company's subsidiary in Brazil. This spread ranges from 1.00% to 2.25% for LIBOR-based loans and 0.00% to 1.25% for alternate base rate loans. The spread in effect for the period ended

March 31, 2014 was 1.00% for LIBOR-based loans and 0.00% for alternate base rate loans. Additionally, the Company is assessed commitment fees ranging from 0.175% to 0.40%, depending upon the Leverage Ratio, on non-utilized borrowing availability, excluding swingline loans. Borrowings are guaranteed by substantially all of the domestic assets of the Company as well as certain foreign subsidiaries determined to be material under the Amended Credit Agreement and a pledge of up to 65% of capital stock or other equity interest in each Guarantor as defined in the Amended Credit Agreement. The Company was in compliance with all covenants under the credit facility as of March 31, 2014. There were no outstanding balances at March 31, 2014 and June 30, 2013.

The average daily balance during the nine month period ended March 31, 2014 and 2013 was $0.0 million and $12.5 million, respectively.

Long-Term Debt

Table of Contents

On August 1, 2007, the Company entered into an agreement with the State of Mississippi to provide financing for the acquisition and installation of certain equipment to be utilized at the Company's Southaven, Mississippi distribution facility, through the issuance of an industrial development revenue bond. The bond matures on September 1, 2032 and accrues interest at the 30-day LIBOR rate plus a spread of 0.85%. The terms of the bond allow for payment of interest only for the first 10 years of the agreement, and then, starting on September 1, 2018 through 2032, principal and interest payments are due until the maturity date or the redemption of the bond. The agreement also provides the bondholder with a put option, exercisable only within 180 days of each fifth anniversary of the agreement, requiring the Company to pay back the bonds at 100% of the principal amount outstanding. As of March 31, 2014, the Company was in compliance with all covenants under this bond. The balance on the bond was $5.4 million as of March 31, 2014 and June 30, 2013 and is included in long-term debt. The interest rate at March 31, 2014 and June 30, 2013 was 1.01% and 1.04%, respectively.

Debt Issuance Costs

As of March 31, 2014, net debt issuance costs associated with the credit facility and bonds totaled $1.4 million and are being amortized on a straight-line basis through the maturity date of each respective debt instrument.

Table of Contents

(6) Derivatives and Hedging Activities

The Company's results of operations could be materially impacted by significant changes in foreign currency exchange rates and interest rates. These risks and the management of these risks are discussed in greater detail below. In an effort to manage the exposure to these risks, the Company periodically enters into various derivative instruments. The Company's accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments in accordance with US GAAP. The Company records all derivatives on the balance sheet at fair value. Derivatives that are not designated as hedging instruments or the ineffective portions of cash flow hedges are adjusted to fair value through earnings in other income and expense.

Foreign Currency – The Company conducts a portion of its business internationally in a variety of foreign currencies. The exposure to market risk for changes in foreign currency exchange rates arises from foreign currency-denominated assets and liabilities, and transactions arising from non-functional currency financing or trading activities. The Company's objective is to preserve the economic value of non-functional currency-denominated cash flows. The Company attempts to hedge transaction exposures with natural offsets to the fullest extent possible and, once these opportunities have been exhausted, through forward contracts or other hedging instruments with third parties. These contracts will periodically hedge the exchange of various currencies, including the U.S. dollar, euro, British pound, Canadian dollar, Mexican peso and Brazilian real. While the Company utilizes foreign exchange contracts to hedge foreign currency exposure, the Company's foreign exchange policy prohibits the use of derivative financial instruments for speculative purposes.

The Company had contracts outstanding with notional amounts of $62.5 million and $81.3 million for the exchange of foreign currencies as of March 31, 2014 and June 30, 2013, respectively. To date, the Company has chosen not to designate these derivatives as hedging instruments, and accordingly, these instruments are adjusted to fair value through earnings in other income and expense. Summarized financial information related to these derivative contracts and changes in the underlying value of the foreign currency exposures are as follows:

	Quarter ended March 31,		Nine months ended March 31,	
	2014	2013	2014	2013
	(in thousands)			
Net foreign exchange derivative contract (gains) losses	$114	$(2,092)	$2,511	$(759)
Net foreign currency transactional and re-measurement (gains) losses	(57)	2,237	(2,185)	1,087
Net foreign currency (gains) losses	$57	$145	$326	$328

Net foreign exchange gains and losses consist of foreign currency transactional and functional currency re-measurements, offset by net foreign currency exchange contract gains and losses and are included in other income and expense. Foreign exchange gains and losses are generated as the result of fluctuations in the value of the British pound versus the euro, the U.S. dollar versus the euro, the U.S. dollar versus the Brazilian real and other currencies versus the U.S. dollar.

The Company used the following derivative instruments, located on its Condensed Consolidated Balance Sheets, for the risk management purposes detailed above:

	As of March 31, 2014	
	Fair Value of Derivatives Designated as Hedge Instruments	Fair Value of Derivatives Not Designated as Hedge Instruments
	(in thousands)	

Derivative assets:[a]		
Foreign exchange contracts	$—	$ 23
Derivative liabilities:[b]		
Foreign exchange contracts	$—	$ 61

(a) All derivative assets are recorded as prepaid expenses and other current assets in the Condensed Consolidated Balance Sheets.

(b) All derivative liabilities are recorded as accrued expenses and other current liabilities in the Condensed Consolidated Balance Sheets.

Table of Contents

(7) Fair Value of Financial Instruments

Accounting guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Under this guidance, the Company is required to classify certain assets and liabilities based on the fair value hierarchy, which groups fair value measured assets and liabilities based upon the following levels of inputs:

- Level 1 – Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 – Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability; and
- Level 3 – Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

The assets and liabilities maintained by the Company that are required to be measured at fair value on a recurring basis include the Company's various debt instruments, deferred compensation plan investments, outstanding foreign exchange forward contracts and contingent consideration owed to the previous owners of Brasil Distribuidora de Tecnologias Especiais LTDA ("CDC" or "ScanSource Brasil"). The carrying value of debt is considered to approximate fair value, as the Company's debt instruments are indexed to LIBOR or the alternate base rate using the market approach (Level 2 criteria).

The following table summarizes the valuation of the Company's remaining assets and liabilities measured at fair value on a recurring basis as of March 31, 2014:

	Total	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
	(in thousands)			
Assets:				
Deferred compensation plan investments, current and non-current portion	$15,403	$15,403	$—	$—
Forward foreign currency exchange contracts	23	—	23	—
Total assets at fair value	$15,426	$15,403	$23	$—
Liabilities:				
Deferred compensation plan investments, current and non-current portion	$15,403	$15,403	$—	$—
Forward foreign currency exchange contracts	61	—	61	—
Liability for contingent consideration, current and non-current portion	10,736	—	—	10,736
Total liabilities at fair value	$26,200	$15,403	$61	$10,736

The following table summarizes the valuation of the Company's remaining assets and liabilities measured at fair value on a recurring basis as of June 30, 2013:

	Total	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)

	(in thousands)			
Assets:				
Deferred compensation plan investments, current and non-current portion	$ 13,752	$ 13,752	$ —	$ —
Forward foreign currency exchange contracts	308	—	308	—
Total assets at fair value	$ 14,060	$ 13,752	$ 308	$ —
Liabilities:				
Deferred compensation plan investments, current and non-current portion	$ 13,752	$ 13,752	$ —	$ —
Forward foreign currency exchange contracts	34	—	34	—
Liability for contingent consideration, current and non-current portion	12,545	—	—	12,545
Total liabilities at fair value	$ 26,331	$ 13,752	$ 34	$ 12,545

Table of Contents

The investments in the deferred compensation plan are held in a rabbi trust and include mutual funds and cash equivalents for payment of non-qualified benefits for certain retired, terminated or active employees. These investments are recorded to prepaid expenses and other current assets or other non-current assets depending on their corresponding, anticipated distributions to recipients, which are reported in accrued expenses and other current liabilities or other long-term non-current liabilities, respectively.

Foreign currency forward contracts are measured using the market approach on a recurring basis considering foreign currency spot rates and forward rates quoted by banks or foreign currency dealers (Level 2). See Note 6 - Derivatives and Hedging Activities. Foreign currency contracts are classified in the consolidated balance sheet in prepaid expenses and other current assets or accrued expenses and other current liabilities, depending on the respective contracts' favorable or unfavorable positions.

The Company recorded a contingent consideration liability at the acquisition date of CDC representing the amounts payable to former CDC shareholders, as outlined under the terms of the Share Purchase and Sale Agreement, based upon the achievement of projected earnings, net of specific pro forma adjustments. The current and non-current portions of this obligation are reported separately on the Condensed Consolidated Balance Sheets. The fair value of contingent consideration (Level 3) is determined using a discounted cash flow model. Subsequent changes in the fair value of the contingent consideration liability are recorded to the change in fair value of contingent consideration line item in the Condensed Consolidated Income Statements. Fluctuations due to foreign currency translation are captured in other comprehensive income through the changes in foreign currency translation adjustments line item as seen in Note 3 - Accumulated Other Comprehensive Income.

The table below provides a summary of the changes in fair value of the Company's contingent consideration (Level 3) for the CDC earnout for the quarters and nine months ended March 31, 2014 and 2013:

	Contingent consideration for the quarter ended March 31,		Contingent consideration for the nine months ended March 31,	
	2014	2013	2014	2013
	(in thousands)			
Fair value at beginning of period	$9,547	$13,090	$12,545	$16,653
Payments	(147)	(61)	(3,793)	(4,777)
Change in fair value of contingent consideration	981	100	2,218	1,396
Foreign currency translation adjustment	355	192	(234)	49
Fair value at end of period	$10,736	$13,321	$10,736	$13,321

The fair value of the liability for the contingent consideration recognized at March 31, 2014 was $10.7 million of which $5.7 million is classified as current. The fair values of amounts owed are recorded in current portion of contingent consideration and long-term portion of contingent consideration in the Company's Condensed Consolidated Balance Sheets. The U.S. dollar amounts of actual disbursements made in connection with future earnout payments are subject to change as the liability is denominated in Brazilian reais and subject to foreign exchange fluctuation risk. The Company will revalue the contingent consideration liability at each reporting date through the last payment, with changes in the fair value of the contingent consideration reflected in the change in fair value of contingent consideration line item on the Company's Condensed Consolidated Income Statements that is included in the calculation of operating income. The fair value of the contingent consideration liability associated with future earnout payments is based on several factors, including:

- estimated future results, net of pro forma adjustments set forth in the Share Purchase and Sale Agreement;
- the probability of achieving these results; and

- a discount rate reflective of the Company’s creditworthiness and market risk premium associated with the Brazilian market.

A change in any of these unobservable inputs can significantly change the fair value of the contingent consideration. The change in fair value of the contingent consideration recognized in the Condensed Consolidated Income Statements contributed losses of $1.0 million and $2.2 million for the quarter and nine months ended March 31, 2014, respectively. The change this quarter and year to date is largely driven by the recurring amortization of the unrecognized fair value discount and better than expected operating results. In addition, volatility in the foreign exchange between the Brazilian real and the U.S. dollar has driven changes in the translation of this Brazilian real denominated liability. Although there is no contractual limit, total future undiscounted contingent consideration payments are anticipated to range up to $13.2 million, based on the Company’s best estimate as the earnout is based on a multiple of adjusted earnings.

Table of Contents

(8) Segment Information

The Company is a leading distributor of specialty technology products, providing value-added distribution sales to resellers in specialty technology markets. The Company has two reportable segments, based on product and service type.

Historically, the Company's reporting units coincided with its geographic operating segments of North America and International. In the fourth quarter of fiscal 2013, the Company reorganized its management structure and reporting segments to globally leverage the Company's leadership in specific technology markets, changing from a geographic to a technology focus. As part of this new structure, the Company formed two operating segments with a global technology focus: Worldwide Barcode & Security ("Barcode/Security") and Worldwide Communications & Services ("Communications/Services"). Each operating segment is managed around its global technology focus and is supported by its centralized infrastructure, including distribution centers and back office operations. Each operating segment has its own management team led by a president and includes regional presidents within the operating group who manage the various functions within each segment. Decisions and planning for the Company as a whole are made at the corporate level by analyzing results from the operating segments. The principal measure of segment performance is considered to be operating income. These technology business segments replace the geographic segments previously used, and the Company has retrospectively reclassified the condensed consolidated financial statements to conform to the new presentation.

Worldwide Barcode & Security Segment

The Barcode/Security distribution segment focuses on automatic identification and data capture ("AIDC"), point-of-sale ("POS"), and electronic physical security technologies. We have business units within this segment for sales and merchandising functions, including ScanSource POS and Barcode business units in North America, Latin America, and Europe and the ScanSource Security business unit in North America. We see adjacencies among these technologies in helping our resellers develop solutions, such as with networking products. AIDC and POS products interface with computer systems used to automate the collection, processing and communication of information for commercial and industrial applications, including retail sales, distribution, shipping, inventory control, materials handling, warehouse management and health care applications. Electronic physical security products include identification, access control, video surveillance, intrusion-related and wireless infrastructure products.

Worldwide Communications & Services Segment

The Communications/Services distribution segment focuses on communications technologies and services. We have business units within this segment for sales and merchandising functions, including the ScanSource Catalyst business unit in North America, ScanSource Communications business units in North America and Europe, and the ScanSource Services Group business unit in North America. ScanSource Catalyst and ScanSource Communications business units market voice, video conferencing, data networking and converged communications solutions. The ScanSource Services Group business unit delivers value-added support programs and services, including education and training, network assessments, custom configuration, implementation and marketing.

Table of Contents

	Quarter ended March 31,		Nine months ended March 31,	
	2014	2013	2014	2013
	(In thousands)			
Sales:				
Worldwide Barcode & Security	$455,822	$438,191	$1,382,672	$1,383,453
Worldwide Communications & Services	227,176	244,774	772,848	780,833
	$682,998	$682,965	$2,155,520	$2,164,286
Depreciation and amortization:				
Worldwide Barcode & Security	$1,024	$1,415	$3,159	$4,274
Worldwide Communications & Services	719	773	2,232	2,330
	$1,743	$2,188	$5,391	$6,604
Operating income:				
Worldwide Barcode & Security	$13,820	$10,413	$38,734	$36,326
Worldwide Communications & Services	11,845	10,382	42,613	35,109
	$25,665	$20,795	$81,347	$71,435
Capital expenditures:				
Worldwide Barcode & Security	$204	$181	$507	$324
Worldwide Communications & Services	130	211	249	877
Corporate	6,029	868	6,029	3,262
	$6,363	$1,260	$6,785	$4,463
Sales by Geography Category:				
North America	$508,751	$519,502	$1,637,308	$1,647,115
International	184,225	174,571	553,318	562,093
Less intercompany sales	(9,978)	(11,108)	(35,106)	(44,922)
	$682,998	$682,965	$2,155,520	$2,164,286

	March 31, 2014	June 30, 2013
	(in thousands)	
Assets:		