

COPART INC  
Form 10-Q  
December 10, 2013

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

**(Mark One)**

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**for the quarterly period ended October 31, 2013**

**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: 0-23255**

**COPART, INC.**

(Exact name of registrant as specified in its charter)

**14185 Dallas Parkway, Dallas, Texas 75254**

(Address of principal executive offices) (Zip Code)

**(972) 391-5000**

Registrant's telephone number, including area code

**N/A**

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

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(§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Number of shares of Common Stock outstanding as of December 10, 2013: 125,556,302

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**Copart, Inc.**

**Index to the Quarterly Report**

**October 31, 2013**

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**PART I FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**Copart, Inc.**  
**Condensed Consolidated Balance Sheets**  
**(in thousands, except share amounts)**  
**(Unaudited)**

See accompanying notes to condensed consolidated financial statements.

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**Copart, Inc.**  
**Condensed Consolidated Statements of Income**  
(in thousands, except per share amounts)  
(Unaudited)

	Three Months Ended October 31,	
	2013	2012
Service revenues and vehicle sales:		
Service revenues	\$226,363	\$195,179
Vehicle sales	53,520	43,687
Total service revenues and vehicle sales	279,883	238,866
Operating costs and expenses:		
Yard operations	125,956	97,119
Cost of vehicle sales	46,091	36,311
General and administrative	42,877	31,079
Total operating costs and expenses	214,924	164,509
Operating income	64,959	74,357
Other (expense) income:		
Interest expense	(2,286 )	(2,632 )
Interest income	149	156
Other income (expense), net	1,423	(293 )
Total other expense	(714 )	(2,769 )
Income before income taxes	64,245	71,588
Income taxes	22,823	25,743
Net income	\$41,422	\$45,845
Earnings per share-basic		
Basic net income per share	\$0.33	\$0.37
Weighted average common shares outstanding	125,460	124,302
Earnings per share-diluted		
Diluted net income per share	\$0.32	\$0.36
Diluted weighted average common shares outstanding	130,706	128,473

See accompanying notes to condensed consolidated financial statements.

**Copart, Inc.**  
**Condensed Consolidated Statements of Comprehensive Income**  
**(in thousands)**  
**(Unaudited)**

	Three Months Ended October 31,	
	2013	2012
Net income, as reported	\$ 41,422	\$ 45,845
Other comprehensive income:		
Unrealized gain on interest rate swaps, net of tax effects of \$(164) and \$(389)	301	692
Reclassification adjustment of interest rate swaps to net income, net of tax effects of \$208 and \$233	(378 )	(416 )
Foreign currency translation adjustments	14,558	7,062
Total comprehensive income	\$ 55,903	\$ 53,183
See accompanying notes to condensed consolidated financial statements.		

**Copart, Inc.**  
**Condensed Consolidated Statements of Cash Flows**  
**(in thousands)**  
**(Unaudited)**

See accompanying notes to condensed consolidated financial statements.

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**Copart, Inc.**  
**Notes to Condensed Consolidated Financial Statements**  
**October 31, 2013**  
**(Unaudited)**

**NOTE 1 - Description of Business and Summary of Significant Accounting Policies**

*Description of Business*

The Company provides vehicle sellers with a full range of services to process and sell vehicles over the Internet through the Company's Virtual Bidding Third Generation (VB3) Internet auction-style sales technology. Sellers are primarily insurance companies but also include banks and financial institutions, charities, car dealerships, fleet operators, and vehicle rental companies. The Company sells principally to licensed vehicle dismantlers, rebuilders, repair licensees, used vehicle dealers and exporters; however at certain locations the Company sells directly to the general public. The majority of vehicles sold on behalf of insurance companies are either damaged vehicles deemed a total loss or not economically repairable by the insurance companies or are recovered stolen vehicles for which an insurance settlement with the vehicle owner has already been made. The Company offers vehicle sellers a full range of services that expedite each stage of the vehicle sales process, minimize administrative and processing costs and maximize the ultimate sales price. In the United States and Canada (North America), the United Arab Emirates (U.A.E.) and Brazil, the Company sells vehicles primarily as an agent and derives revenue primarily from fees paid by vehicle sellers and vehicle buyers as well as related fees for services such as towing and storage. In the United Kingdom (U.K.), the Company operates both on a principal basis, purchasing the salvage vehicle outright from the insurance company and reselling the vehicle for its own account, and as an agent. In Germany and Spain, the Company derives revenue from sales listing fees for listing vehicles on behalf of insurance companies. Certain prior year amounts have been reclassified to conform to current year presentation.

*Principles of Consolidation*

The condensed consolidated financial statements of the Company include the accounts of the parent company and its wholly owned subsidiaries, including its foreign wholly owned subsidiaries. Significant intercompany transactions and balances have been eliminated in consolidation.

In the opinion of the management of the Company, the accompanying unaudited condensed consolidated financial statements contain all adjustments (which are normal recurring accruals) necessary to present fairly its financial position as of October 31, 2013 and July 31, 2013, its consolidated statement of income for the three months ended October 31, 2013 and 2012, its consolidated statement of comprehensive income for the three months ended October 31, 2013 and 2012, and its consolidated statement of cash flows for the three months ended October 31, 2013 and 2012. Interim results for the three months ended October 31, 2013 are not necessarily indicative of the results that may be expected for any future period, or for the entire year ending July 31, 2014. These condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the U.S. Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The interim condensed consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the fiscal year ended July 31, 2013.

*Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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. Estimates are used for, but not limited to, vehicle pooling costs,



self-insured reserves, allowance for doubtful accounts, income taxes, revenue recognition, stock-based compensation, purchase price allocations, long-lived asset and goodwill impairment calculations and contingencies. Actual results could differ from those estimates.

***Revenue Recognition***

The Company provides a portfolio of services to its sellers and buyers that facilitate the sale and delivery of a vehicle from seller to buyer. These services include the ability to use the Company's Internet sales technology and vehicle delivery, loading, title processing, preparation and storage. The Company evaluates multiple-element arrangements relative to its member and seller agreements.

The services provided to the seller of a vehicle involve disposing of a vehicle on the seller's behalf and, under most of the Company's current North American contracts, collecting the proceeds from the member. The Company applies Accounting Standard Update 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (ASU 2009-13)* for revenue recognition. Pre-sale services, including towing, title processing, preparation and storage, as well as sale fees and other enhancement services meet the criteria for separate units of accounting. The revenue associated with each service is recognized upon completion of the respective service, net of applicable rebates or allowances. For certain sellers who are charged a proportionate fee based on high bid of the vehicle, the revenue associated with the pre-sale services is recognized upon completion of the sale when the total arrangement is fixed and determinable. The estimated selling price of each service is determined based on management's best estimate and allotted based on the relative selling price method.

Vehicle sales, where vehicles are purchased and remarketed on the Company's own behalf, are recognized on the sale date, which is typically the point of high bid acceptance. Upon high bid acceptance, a legal binding contract is formed with the member, and the gross sales price is recorded as revenue.

The Company also provides a number of services to the buyer of the vehicle, charging a separate fee for each service. Each of these services has been assessed to determine whether the requirements have been met to separate them into units of accounting within a multiple-element arrangement. The Company has concluded that the sale and the post-sale services are separate units of accounting. The fees for sale services are recognized upon completion of the sale, and the fees for the post-sale services are recognized upon successful completion of those services using the relative selling price method.

The Company also charges members an annual registration fee for the right to participate in its vehicle sales program, which is recognized ratably over the term of the arrangement, and relist and late-payment fees, which are recognized upon receipt of payment by the member. No provision for returns has been established, as all sales are final with no right of return, although the Company provides for bad debt expense in the case of non-performance by its members or sellers.

The Company allocates arrangement consideration based upon management's best estimate of the selling price of the separate units of accounting contained within an arrangement containing multiple deliverables. Significant inputs in the Company's estimates of the selling price of separate units of accounting include market and pricing trends, pricing customization and practices, and profit objectives for the services.

### ***Vehicle Pooling Costs***

The Company defers in vehicle pooling costs certain yard operation expenses associated with vehicles consigned to and received by the Company, but not sold as of the end of the period. The Company quantifies the deferred costs using a calculation that includes the number of vehicles at its facilities at the beginning and end of the period, the number of vehicles sold during the period and an allocation of certain yard operation costs of the period. The primary expenses allocated and deferred are certain facility costs, labor, transportation and vehicle processing. If the allocation factors change, then yard operation expenses could increase or decrease correspondingly in the future. These costs are expensed as vehicles are sold in the subsequent periods on an average cost basis.

The Company applies the provisions of accounting guidance for subsequent measurement of inventory to our vehicle pooling costs. The provision requires that items such as idle facility expense, double freight and re-handling costs be recognized as current period charges regardless of whether they meet the criteria of "abnormal" as provided in the guidance. In addition, the guidance requires that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of production facilities.

### ***Foreign Currency Translation***

The Company records foreign currency translation adjustments from the process of translating the functional currency of the financial statements of its foreign subsidiaries into the U.S. dollar reporting currency. The Canadian dollar, the British pound, the U.A.E. dirham, the Brazilian real and the Euro are the functional currencies of the Company's foreign subsidiaries as they are the primary currencies within the economic environment in which each subsidiary operates. The original equity investment in the respective subsidiaries is translated at historical rates. Assets and liabilities of the respective subsidiary's operations are translated into U.S. dollars at period-end exchange rates, and revenues and expenses are translated into U.S. dollars at average exchange rates in effect during each reporting period. Adjustments resulting from the translation of each subsidiary's financial statements are reported in other comprehensive income.

The cumulative effects of foreign currency exchange rate fluctuations are as follows (in thousands):

### ***Income Taxes and Deferred Tax Assets***

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In accordance with the provisions of Accounting Standards Codification 740, Income Taxes (ASC 740), a two-step approach is applied to the recognition and measurement of uncertain tax positions taken or expected to be taken in a tax return. The first step is to determine if the weight of available evidence indicates that it is more likely than not that the tax position will be sustained in an audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. The Company recognizes interest and penalties related to uncertain tax positions in the provision for income taxes on its condensed consolidated statements of income.

### ***Fair Value of Financial Instruments***

The Company records its financial assets and liabilities at fair value in accordance with the framework for measuring fair value in U.S. generally accepted accounting principles. In accordance with ASC 820, *Fair Value Measurements and Disclosures*, as amended by Accounting Standards Update 2011-04, the Company considers fair value as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants under current market conditions. This framework establishes a fair value hierarchy that prioritizes the inputs used to measure fair value:

The amounts recorded for financial instruments in the Company's condensed consolidated financial statements, which included cash, accounts receivable, accounts payable and accrued liabilities approximate their fair values as of October 31, 2013 and July 31, 2013, due to the short-term nature of those instruments, and are classified within Level II of the fair value hierarchy. Cash equivalents are classified within Level II of the fair value hierarchy because they are valued using quoted market prices of the underlying investments. See *Note 3. Long-Term Debt* for fair value disclosures related to the Company's long-term debt.

### ***Derivatives and Hedging***

The Company has entered into two interest rate swaps to eliminate interest rate risk on the Company's variable rate Term Loan, and the swaps are designated as effective cash flow hedges under ASC 815, *Derivatives and Hedging* (see *Note 4. Derivatives and Hedging*). Each quarter, the Company measures hedge effectiveness using the "hypothetical derivative method" and records in earnings any hedge ineffectiveness with the effective portion of the hedges change in fair value recorded in other comprehensive income or loss.

### ***Assets Held for Sale***

The Company has removed certain assets from operations and offered them for sale. These assets, which include certain real estate, are reflected at their fair market value in the financial statements and are a Level II fair value measurement based on sales transactions of similar assets.



### ***Accounting for Acquisitions***

Accounting for acquisitions requires the Company to recognize and measure identifiable assets acquired and liabilities assumed in the acquired entity. The accounting for acquisitions involves significant judgments and estimates, including the fair value of certain forms of consideration, the fair value of acquired intangible assets, which involve projections of future revenues, cash flows and terminal value, which are then either discounted at an estimated discount rate or measured at an estimated royalty rate, and the fair value of other acquired assets and assumed liabilities, including potential contingencies, and the useful lives of the assets. The projections are developed using internal forecasts, available industry and market data and estimates of long-term rates of growth for the Company. Historical experience is additionally utilized, in which historical or current costs have approximated fair value for certain assets acquired.

### ***Segments and Other Geographic Reporting***

The Company's North American region and its United Kingdom region are considered two separate operating segments, which have been aggregated into one reportable segment because they share similar economic characteristics.

### **NOTE 2 - Cash and Cash Equivalents**

The Company considers all highly liquid investments purchased with original maturities of three months or less at the time of purchase to be cash equivalents. Cash and cash equivalents include cash held in checking and money market accounts. The Company periodically invests its excess cash in money market funds and U.S. Treasury Bills. The Company's cash and cash equivalents are placed with high credit quality financial institutions. The Company generally classifies its investment portfolio not otherwise qualifying as cash and cash equivalents as available-for-sale securities. Available-for-sale securities are reported at fair value, with unrealized gains and losses reported as a component of stockholders' equity and comprehensive income. Unrealized losses are charged against income when a decline in the fair market value of an individual security is determined to be other than temporary. Realized gains and losses on investments are included in interest income.

### **NOTE 3 - Long-Term Debt**

On December 14, 2010, the Company entered into an Amended and Restated Credit Facility Agreement (Credit Facility), which supersedes the Company's previously disclosed credit agreement with Bank of America, N.A. (Bank of America). The Credit Facility is an unsecured credit agreement providing for (i) a \$100.0 million revolving credit facility, including a \$100.0 million alternative currency borrowing sublimit and a \$50.0 million letter of credit sublimit (Revolving Credit) and (ii) a term loan facility of \$400.0 million (Term Loan). On January 14, 2011, the full \$400.0 million provided under the Term Loan was borrowed. On September, 29, 2011, the Company amended the credit agreement increasing the amount of the Term Loan facility from \$400.0 million to \$500.0 million. On March 1, 2013, the Company amended the credit agreement to increase the net leverage ratio at which restrictive spending covenants are introduced from 1:1 to 1.5:1.

The Term Loan, which at October 31, 2013 had \$350.0 million outstanding, amortizes \$18.8 million each quarter beginning December 31, 2011, with all outstanding borrowings due on December 14, 2015. All amounts borrowed under the Term Loan may be prepaid without premium or penalty.

Amounts borrowed under the Credit Facility bear interest, subject to certain restrictions, at a fluctuating rate based on (i) the Eurocurrency Rate; (ii) the Federal Funds Rate; or (iii) the Prime Rate as described in the Credit Facility. The Company has entered into two interest rate swaps (see *Note 4. Derivatives and Hedging*) to exchange its variable interest rate payments commitment for fixed interest rate payments on the Term Loan balance, which at October 31, 2013, totaled \$350.0 million. A default interest rate applies on all obligations during an event of default under the

credit facility, at a rate per annum equal to 2.0% above the otherwise applicable interest rate. The Company's interest rate at October 31, 2013 is the 0.18% Eurocurrency Rate plus the 1.5% Applicable Rate. The Applicable Rate can fluctuate between 1.5% and 2.0% depending on the Company's consolidated net leverage ratio (as defined in the Credit Facility). The Credit Facility is guaranteed by the Company's material domestic subsidiaries. The carrying amount of the Credit Facility is comprised of borrowings under which interest accrues under a fluctuating interest rate structure. Accordingly, the carrying value approximates fair value at October 31, 2013 and is classified within Level II of the fair value hierarchy.

Amounts borrowed under the Revolving Credit may be repaid and reborrowed until the maturity date, which is December 14, 2015. The Credit Facility requires the Company to pay a commitment fee on the unused portion of the Revolving Credit. The commitment fee ranges from 0.075% to 0.125% per annum depending on the Company's leverage ratio. The Company had no outstanding borrowings under the Revolving Credit at the end of the period.

The Credit Facility contains customary representations and warranties and may place certain business operating restrictions on the Company relating to, among other things, indebtedness, liens and other encumbrances, investments, mergers and acquisitions, asset sales, dividends and distributions and redemptions of capital stock. In addition, the Credit Facility provides for the following financial covenants: (i) earnings before income tax, depreciation and amortization (EBITDA); (ii) leverage ratio; (iii) interest coverage ratio; and (iv) limitations on capital expenditures. The Credit Facility contains events of default that include, among others, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, cross-defaults to certain other indebtedness, bankruptcy and insolvency defaults, material judgments, invalidity of the loan documents and events constituting a change of control. The Company is in compliance with all covenants as of October 31, 2013.

#### **NOTE 4 - Derivatives and Hedging**

The Company has entered into two interest rate swaps to exchange its variable interest rate payments commitment for fixed interest rate payments on the Term Loan balance which, at October 31, 2013 totaled \$350.0 million. The first swap fixed the Company's interest rate at 85 basis points plus the one month LIBOR rate on the first \$275.0 million of its term debt. The second swap fixed the Company's interest rate at 69 basis points plus the one month LIBOR rate on the next \$75.0 million of its term debt.

The swaps are a designated effective cash flow hedge under ASC 815, *Derivatives and Hedging*, and are recorded in other liabilities at their fair value, which at October 31, 2013 is \$2.9 million. Each quarter, the Company measures hedge effectiveness using the "hypothetical derivative method" and records in earnings any hedge ineffectiveness with the effective portion of the hedge's change in fair value recorded in other comprehensive income or loss. The Company has reclassified \$0.6 million and \$0.7 million for the three months ended October 31, 2013 and 2012, respectively, out of other comprehensive income into interest expense.

The notional amount of the swap amortizes until all outstanding borrowings are due on the Term Loan on December 14, 2015 (see *Note 3. Long-Term Debt*). At October 31, 2013, the notional amount of the interest rate swaps was equal to the Term Loan balance, \$350.0 million. The notional amount of the two derivative transactions amortizes \$18.8 million per quarter through September 30, 2015 and \$200.0 million on December 14, 2015.

The hedge provided by the swaps could prove to be ineffective for a number of reasons, including early retirement of the Term Loan, as allowed under the Credit Facility, or in the event the counterparty to the interest rate swaps is determined in the future to not be creditworthy. The Company has no plans for early retirement of the Term Loan.

The interest rate swaps are classified within Level II of the fair value hierarchy as the derivatives are valued using observable inputs. The Company determines fair value of the derivative utilizing observable market data of swap rates and basis rates. These inputs are placed into a pricing model using a discounted cash flow methodology in order to calculate the mark-to-market value of the interest rate swap. As of October 31, 2013 and July 31, 2013, the Company's fair value of the interest rate swaps, a Level II financial instrument, were \$2.9 million and \$2.7 million, respectively, and are classified as other liabilities in the accompanying condensed consolidated balance sheet.

#### **NOTE 5 - Goodwill and Intangible Assets**

The following table sets forth amortizable intangible assets by major asset class as of the dates indicated (in thousands):

Aggregate amortization expense on amortizable intangible assets was \$1.1 million for the three months ended October 31, 2013 and 2012.





The change in the carrying amount of goodwill is as follows (in thousands):

#### NOTE 6 - Net Income Per Share

The table below reconciles basic weighted shares outstanding to diluted weighted average shares outstanding (in thousands):

	Three Months Ended October 31,	
	2013	2012
Basic weighted average shares outstanding	125,460	124,302
Effect of dilutive securities - stock options	5,246	4,171
Diluted weighted average shares outstanding	130,706	128,473

There were no material adjustments to net income required in calculating diluted net income per share. Excluded from the dilutive earnings per share calculation were 317,065 and 468,510 stock options for the three months ended October 31, 2013 and 2012, respectively, because their effect would have been anti-dilutive.

#### NOTE 7 - Stock-based Compensation

The Company recognizes compensation expense for stock option awards on a straight-line basis over the requisite service period of the award. The following is a summary of option activity for the Company's stock options for the three months ended October 31, 2013:

As required by ASC 718, the Company made an estimate of expected forfeitures and is recognizing compensation cost only for those equity awards expected to vest.

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for the 14,902,114 options that were in-the-money at October 31, 2013.

The table below sets forth the stock-based compensation recognized by the Company (in thousands):

	Three Months Ended October 31,		
	2013	2012	
General and administrative	\$4,232	\$	4,570
Yard operations	635	604	
	\$4,867	\$	5,174

## **NOTE 8 - Common Stock Repurchases**

On September 22, 2011, the Company's board of directors approved a 40 million share increase in the Company's stock repurchase program, bringing the total current authorization to 98 million shares. The repurchases may be effected through solicited or unsolicited transactions in the open market or in privately negotiated transactions. No time limit has been placed on the duration of the stock repurchase program. Subject to applicable securities laws, such repurchases will be made at such times and in such amounts as the Company deems appropriate and may be discontinued at any time. The Company did not repurchase its common stock during the three months ended October 31, 2013. The Company repurchased 500,000 shares of its common stock during the three months ended October 31, 2012, at a weighted average price of \$27.77 per share totaling \$13.9 million. The total number of shares repurchased under the program as of October 31, 2013 was 50,286,782 and 47,713,218 shares were available for repurchase under the program.

Additionally, on January 14, 2011, the Company completed a tender offer to purchase up to 21,052,630 shares of its common stock at a price of \$19.00 per share. Directors and executive officers of the Company were expressly prohibited from participating in the tender offer by our board of directors under the Company's Securities Trading Policy. In connection with the tender offer, the Company accepted for purchase 24,344,176 shares of its common stock. The shares accepted for purchase are comprised of the 21,052,630 shares the Company offered to purchase and an additional 3,291,546 shares purchased pursuant to the Company's right to purchase additional shares up to 2% of its outstanding shares. The shares purchased as a result of the tender offer are not part of the Company's repurchase program. The purchase of the shares of common stock was funded by the proceeds relating to the issuance of long-term debt. The impact on dilutive earnings per share of all repurchased shares on the weighted average number of common shares outstanding for the three months ended October 31, 2013 is less than \$0.01.

In the second quarter of fiscal 2013, certain executive officers exercised stock options through cashless exercises and in the first quarter of fiscal 2014, certain employees exercised stock options through cashless exercises. A portion of the options exercised were net settled in satisfaction of the exercise price and federal and state minimum statutory tax withholding requirements. The Company remitted \$0.6 million and \$0.08 million in fiscal year 2013 and fiscal year 2014, respectively, to the proper taxing authorities in satisfaction of the employees' minimum statutory withholding requirements. The exercises are summarized in the following table:

(1) Shares withheld for taxes are treated as a repurchase of shares for accounting purposes but do not count against the Company's stock repurchase program.

## **NOTE 9 - Income Taxes**

The Company applies the provisions of the accounting standard for uncertain tax positions to its income taxes. For benefits to be realized, a tax position must be more likely than not to be sustained upon examination. The amount recognized is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement.

As of October 31, 2013, the total gross unrecognized tax benefit was \$23.4 million, including interest and penalty.

As of October 31, 2013, the gross amounts of the Company's liabilities for unrecognized tax benefits were classified as long-term income taxes payable, in the accompanying condensed consolidated balance sheet. Over the next twelve months, the Company's existing positions will continue to generate an increase in liabilities for unrecognized tax benefits, as well as a likely decrease in liabilities as a result of the lapse of the applicable statute of limitations and the conclusion of income tax audits. The expected decrease in liabilities relating to unrecognized tax benefits will have a positive effect on the Company's consolidated results of operations and financial position when realized. The Company recognized interest and penalties related to uncertain tax positions in income tax expense. The amount of interest and penalties accrued for the three months ended October 31, 2013 was \$0.4 million.

The Company files income tax returns in the U.S. federal jurisdiction, various states, and foreign jurisdictions. The Company is currently under audit by the states of New York and South Carolina for fiscal years 2008 through 2012. The Company is no longer subject to U.S. federal and state income tax examination for fiscal years prior to 2010, excepting the jurisdictions currently under audit. At this time, the Company does not believe that the outcome of any examination will have a material impact on the Company's consolidated results of operations and financial position.

The Company has not provided for U.S. federal income and foreign withholding taxes from undistributed earnings of its foreign operations, because the Company intends to reinvest such earnings indefinitely in the operations and potential acquisitions related to its foreign operations. Upon distribution of those earnings in the form of dividends or otherwise, the Company would be subject to U.S. income taxes (subject to an adjustment for foreign tax credits). It is not practical to determine the income tax liability that might be incurred if these earnings were to be distributed. If these earnings were distributed, foreign tax credits may become available under current law to reduce or eliminate the resultant U.S. income tax liability.

#### **NOTE 10 - Recent Accounting Pronouncements**

There were no new accounting standards issued or effective during the three months ended October 31, 2013 that had or are expected to have a material impact on the Company's condensed consolidated results of operations and financial position.

#### **NOTE 11 - Legal Proceedings**

The Company is subject to threats of litigation and is involved in actual litigation and damage claims arising in the ordinary course of business, such as actions related to injuries, property damage, and handling or disposal of vehicles. The material pending legal proceedings to which the Company is a party to, or of which any of the Company's property is subject to, include the following matters:

On April 23, 2010, Deborah Hill filed suit against the Company in the Twentieth Judicial Circuit of Collier County, Florida, alleging negligent destruction of evidence in connection with a stored vehicle that suffered damage due to a fire at its facility in Florida where the vehicle was being stored. Relief sought is for compensatory damages, costs and interest allowed by law. On January 30, 2013, the Court granted the Company's motion for summary judgment, finding that the Company did not owe any duty to Ms. Hill to preserve her car as evidence. The summary judgment resolves Ms. Hill's claim against the Company in its entirety in favor of the Company. On February 22, 2013, Ms. Hill's attorneys filed an appeal of the summary judgment. Ms. Hill filed an initial brief, motion to supplement record on appeal, and a request for oral argument in August of 2013. In October 2013, the company filed our appeal brief setting forth our positional arguments. The Company believes the claim is without merit and intends to vigorously defend the appeal.

On April 16, 2013, Lexington Insurance Company, as subrogee of Thomas Properties Group, Inc., filed suit against the Company, Sandra Jean Rodriguez (an individual) and Balboa Insurance Company, Inc. The complaint alleges spoliation of evidence, negligence, and breach of bailment contract against the Company. The Company believes the suit is without merit and intends to vigorously defend the action.

In connection with its response to Hurricane Sandy, the Company entered into various short-term lease/license agreements with certain land owners in New York and New Jersey to marshal and store storm damaged vehicles until they were sold. In November and December 2012, various actions were commenced against the Company and land owners. In New York, actions were brought by the Town of Southampton, the County of Suffolk, the Town of Brookhaven, and the New York State Department of Environmental Conservation (the DEC), seeking declaratory and injunctive relief as well as civil penalties, in connection with alleged violations of local zoning, land use and environmental regulations. The claims by the various plaintiffs have been mitigated with the removal of vehicles from the various short-term storage locations in New York. The claims brought by the DEC have all been resolved through entering into consent orders, which included administrative payments in amounts that are not material to the Company, and restoration of premises, which the Company is undertaking. The Company is defending the other New York claims and believes it has bona fide legal defenses.

The Company provides for costs relating to these matters when a loss is probable and the amount can be reasonably estimated. The effect of the outcome of these matters on the Company's future consolidated results of operations and

cash flows cannot be predicted because any such effect depends on future results of operations and the amount and timing of the resolution of such matters. The Company believes that any ultimate liability will not have a material effect on our consolidated results of operations, financial position or cash flows. However, the amount of the liabilities associated with these claims, if any, cannot be determined with certainty. The Company maintains insurance which may or may not provide coverage for claims made against the Company. There is no assurance that there will be insurance coverage available when and if needed. Additionally, the insurance that the Company carries requires that the Company pay for costs and/or claims exposure up to the amount of the insurance deductibles negotiated when insurance is purchased.

### ***Governmental Proceedings***

The Georgia Department of Revenue, or DOR, conducted a sales and use tax audit of the Company's operations in Georgia for the period from January 1, 2007 through June 30, 2011. As a result of the audit, the DOR issued a notice of proposed assessment for uncollected sales taxes in which it asserted that the Company failed to remit sales taxes totaling \$73.8 million, including penalties and interest. In issuing the notice of proposed assessment, the DOR stated its policy position that sales for resale to non-U.S. registered resellers are subject to Georgia sales and use tax.

The Company has engaged a Georgia law firm and outside tax advisors to review the conduct of its business operations in Georgia, the notice of assessment, and the DOR's policy position. In particular, the Company's outside legal counsel has provided the Company an opinion that its sales for resale to non-U.S. registered resellers should not be subject to Georgia sales and use tax. In rendering its opinion, the Company's counsel noted that non-U.S. registered resellers are unable to comply strictly with technical requirements for a Georgia certificate of exemption but concluded that its sales for resale to non-U.S. registered resellers should not be subject to Georgia sales and use tax notwithstanding this technical inability to comply.

Based on the opinion from the Company's outside law firm and advice from outside tax advisors, the Company has adequately provided for the payment of this assessment in its consolidated financial statements. The Company believes it has strong defenses to the DOR's notice of proposed assessment and intends to defend this matter. The Company has filed a request for protest or administrative appeal with the State of Georgia. There can be no assurance, however, that this matter will be resolved in the Company's favor or that the Company will not ultimately be required to make a substantial payment to the Georgia DOR. The Company understands that Georgia law and DOR regulations are ambiguous on many of the points at issue in the audit, and litigating and defending the matter in Georgia could be expensive and time-consuming and result in substantial management distraction. If the matter were to be resolved in a manner adverse to the Company, it could have a material adverse effect on the Company's consolidated results of operations, financial position and cash flows.

### **NOTE 12 - Restructuring**

The Company relocated its corporate headquarters to Dallas, Texas in 2012. The restructuring-related costs are as follows (in thousands):

The movements in the severance accrual are as follows (in thousands):

The Company started transitioning its data center to a third party managed data center during the year ended July 31, 2013. The Company reviewed the useful life of certain assets related to its data centers and determined they should be revised from an average of 60 months to an average of 45 months to reflect the shorter useful lives of these assets. Additionally, facility depreciation related to the Company's IT operations, currently located in the Company's offices in Fairfield, CA, was accelerated as the department is relocating to the Dallas, TX corporate headquarters. These changes in estimate are accounted for on a prospective basis, resulting in increased depreciation expense over the revised useful lives. These changes will result in \$2.8 million in accelerated depreciation expense to be recorded in fiscal 2014. These changes resulted in \$1.7 million and \$0.7 million in additional depreciation in the three months ended October 31, 2013 and 2012, respectively.

**NOTE 13 - Acquisitions**

During the year ended July 31, 2013, the Company acquired 100% of the voting stock of Salvage Parent, Inc., which conducts business primarily as Quad City Salvage Auction, Crashed Toys, and Desert View Auto Auctions. Combined, these businesses operate at 39 locations in 14 states. The Company also acquired salvage vehicle auction businesses in Brazil and the U.A.E.; two auction platforms in Germany and Spain; as well as the assets of Gainesville Salvage Disposal and Auto Salvage Auction, Inc., salvage vehicle auction companies with locations in Gainesville, GA, and Davison and Ionia, MI, for a total purchase price of \$88.2 million.

These acquisitions were undertaken because of their strategic fit and have been accounted for using the purchase method in accordance with ASC 805, *Business Combinations*, which has resulted in the recognition of goodwill in the Company's consolidated financial statements. This goodwill arises because the purchase price reflects a number of factors including their future earnings and cash flow potential; the multiple to earnings, cash flow and other factors at which similar businesses have been purchased by other acquirers, the competitive nature of the process by which the Company acquired the businesses; and because of the complementary strategic fit and resulting synergies brought to existing operations. The goodwill arising from these acquisitions is within Level III of the fair value hierarchy as it is valued using unobservable inputs primarily from third party valuation specialists. Goodwill is not amortized for financial reporting purposes, and most of the balance is not amortized for tax purposes. Intangible assets acquired include covenants not to compete, supply contracts, customer relationships, trade names, licenses and databases and software with a useful life ranging from 3 to 8 years.

The purchase price allocation for Salvage Parent, Inc., and the acquired auction platform in Spain are not final for property and equipment, income taxes, liabilities and intangible assets acquired pending the final valuation by the Company's valuation specialists. During the three months ended October 31, 2013, the Company obtained new information related to the Company's liabilities and income taxes related to the acquisitions. The Company noted there was a pre-acquisition contingency related to a lack of documentation on the historical sales of Salvage Parent, Inc. that could expose the Company to additional liabilities. The Company notes the contingency could range from \$7.0 million to \$28.0 million. The Company has recorded its current estimate of the fair value of the potential exposure at \$14.0 million within accrued liabilities on the condensed consolidated balance sheet. The Company notes this is its best estimate based on the currently available information and continues to gather information relating to this exposure and it could materially change. Any changes to this pre-acquisition contingency recorded during the measurement period related to new information will be included in the final valuation and related amounts recognized. Subsequent to the end of the measurement period, any adjustments to this pre-acquisition contingency will be reflected in the Company's results of operations. During the three months ended October 31, 2013, goodwill was adjusted by the change in liability exposure, working capital adjustments and deferred taxes on acquired intangible assets. The Company believes the potential changes to its preliminary purchase price allocation will not have a material impact on the Company's consolidated financial position and results of operations.

The following table summarizes the preliminary purchase price allocation based on the estimated fair values of the assets acquired and liabilities assumed for these acquisitions (in thousands):

The acquisitions do not result in a significant change in the Company's consolidated results of operations individually nor in the aggregate; therefore pro forma financial information has not been presented. The operating results have been included in the Company's consolidated financial position and results of operations since the acquisition dates.



## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*This Quarterly Report on Form 10-Q, including the information incorporated by reference herein, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended, (the Exchange Act). All statements other than statements of historical facts are statements that could be deemed forward-looking statements. In some cases, you can identify forward-looking statements by terms such as "may," "will," "should," "expect," "plan," "intend," "forecast," "anticipate," "believe," "estimate," "predict," "potential," "continue" or the negative of these terms or other comparable terminology. The forward-looking statements contained in this Form 10-Q involve known and unknown risks, uncertainties and situations that may cause our or our industry's actual results, level of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these statements. These forward-looking statements are made in reliance upon the safe harbor provision of the Private Securities Litigation Reform Act of 1995. These factors include those listed in Part I, Item 1A. "Risk Factors" of this Form 10-Q and those discussed elsewhere in this Form 10-Q. We encourage investors to review these factors carefully together with the other matters referred to herein, as well as in the other documents we file with the Securities and Exchange Commission (the SEC). We may from time to time make additional written and oral forward-looking statements, including statements contained in our filings with the SEC. We do not undertake to update any forward-looking statement that may be made from time to time by us or on our behalf.*

*Although we believe that, based on information currently available to us and our management, the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on these forward-looking statements. In addition, historical information should not be considered an indicator of future performance.*

### Overview

We are a leading provider of online auctions and vehicle remarketing services in the United States (U.S.), Canada, the United Kingdom (U.K.), and Brazil. We also provide vehicle remarketing services in the United Arab Emirates (U.A.E.), Germany and Spain.

We provide vehicle sellers with a full range of services to process and sell vehicles primarily over the Internet through our Virtual Bidding Third Generation Internet auction-style sales technology, which we refer to as VB3. Vehicle sellers consist primarily of insurance companies, but also include banks and financial institutions, charities, car dealerships, fleet operators and vehicle rental companies. We sell the vehicles principally to licensed vehicle dismantlers, rebuilders, repair licensees, used vehicle dealers and exporters and, at certain locations, to the general public. The majority of the vehicles sold on behalf of insurance companies are either damaged vehicles deemed a total loss or not economically repairable by the insurance companies or are recovered stolen vehicles for which an insurance settlement with the vehicle owner has already been made. We offer vehicle sellers a full range of services that expedite each stage of the vehicle sales process, minimize administrative and processing costs and maximize the ultimate sales price.

In the U.S. and Canada (North America), Brazil and the U.A.E. we sell vehicles primarily as an agent and derive revenue primarily from fees paid by vehicle sellers and vehicle buyers as well as related fees for services such as towing and storage. In the U.K., we operate both on a principal basis, purchasing the salvage vehicles outright from the insurance companies and reselling the vehicles for our own account, and as an agent. In Germany and Spain, we derive revenue from sales listing fees for listing vehicles on behalf of many insurance companies.

Our revenues consist of sales transaction fees charged to vehicle sellers and vehicle buyers, transportation revenue, purchased vehicle revenues, and other remarketing services. Revenues from sellers are generally generated either on a

fixed fee contract basis where we collect a fixed amount for selling each vehicle regardless of the selling price of the vehicle or, under our Percentage Incentive Program, or PIP, where our fees are generally based on a predetermined percentage of the vehicle sales price. Under the consignment, or fixed fee program, we generally charge an additional fee for title processing and special preparation. Although sometimes included in the consignment fee, we may also charge additional fees for the cost of transporting the vehicle to our facility, storage of the vehicle, and other incidental costs. Under the consignment programs, only the fees associated with vehicle processing are recorded in revenue, not the actual sales price (gross proceeds). Sales transaction fees also include fees charged to vehicle buyers for purchasing vehicles, storage, loading and annual registration. Transportation revenue includes charges to sellers for towing vehicles under certain contracts and towing charges assessed to buyers for delivering vehicles. Purchased vehicle revenue includes the gross sales price of the vehicle which we have purchased or are otherwise considered to own and is primarily generated in the U.K.

Operating costs consist primarily of operating personnel (which includes yard management, clerical and yard employees), rent, contract vehicle towing, insurance, fuel, equipment maintenance and repair, and costs of vehicles sold under purchase contracts. Costs associated with general and administrative expenses consist primarily of executive management, accounting, data processing, sales personnel, human resources, professional fees, research and development and marketing expenses.

### **Acquisitions and New Operations**

We have experienced significant growth in facilities as we have acquired 51 facilities and opened one new facility since August 1, 2012 through October 31, 2013. All of these acquisitions have been accounted for using the purchase method of accounting.

As part of our overall expansion strategy of offering integrated services to vehicle sellers, we anticipate acquiring and developing facilities in new regions, as well as the regions currently served by our facilities. We believe that these acquisitions and openings strengthen our coverage as we have facilities located in North America, the U.K., the U.A.E., Germany, Spain, and Brazil, and are able to provide national coverage for our sellers.

The following table sets forth facilities that we have acquired or opened from August 1, 2012 through October 31, 2013:

\* Salvage Parent, Inc. conducts business primarily as Quad City Salvage Auction, Crashed Toys, and Desert View Auto Auctions. Combined, these businesses operate at 39 locations in 14 states.

The period-to-period comparability of our consolidated operating results and financial position is affected by business acquisitions, new openings, weather and product introductions during such periods. In particular, we have certain contracts inherited through our U.K. acquisitions that require us to act as a principal, purchasing vehicles from the insurance companies and reselling them for our own account. It is our intention, where possible, to migrate these contracts to the agency model in future periods. Changes in the amount of revenue derived in a period from principal transactions relative to total revenue will impact revenue growth and margin percentages.

In addition to growth through business acquisitions, we seek to increase revenues and profitability by, among other things, (i) acquiring and developing additional vehicle storage facilities in key markets; (ii) pursuing national and regional vehicle seller agreements; (iii) expanding our service offerings to sellers and members; and (iv) expanding the application of VB3 into new markets. In addition, we implement our pricing structure and auction procedures and attempt to introduce cost efficiencies at each of our acquired facilities by implementing our operational procedures, integrating our management information systems and redeploying personnel, when necessary.

## Critical Accounting Policies and Estimates

The preparation of condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to vehicle pooling costs, self-insured reserves, allowance for doubtful accounts, income taxes, revenue recognition, stock-based compensation, purchase price allocations, long-lived asset impairment calculations and contingencies. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Management has discussed the selection of critical accounting policies and estimates with the Audit Committee of the Board of Directors and the Audit Committee has reviewed our disclosure relating to critical accounting policies and estimates in this Quarterly Report on Form 10-Q. Our significant accounting policies are described in the Notes to Condensed Consolidated Financial Statements - *Note 1. Description of Business and Summary of Significant Accounting Policies*. The following is a summary of the more significant judgments and estimates included in our critical accounting policies used in the preparation of our condensed consolidated financial statements. We discuss, where appropriate, sensitivity to change based on other outcomes reasonably likely to occur.

### Revenue Recognition

We provide a portfolio of services to our sellers and buyers that facilitate the sale and delivery of a vehicle from seller to buyer. These services include the ability to use our Internet sales technology and vehicle delivery, loading, title processing, preparation and storage. We evaluate multiple-element arrangements relative to our member and seller agreements.

The services we provide to the seller of a vehicle involve disposing of a vehicle on the seller's behalf and, under most of our current North American contracts, collecting the proceeds from the member. Pre-sale services, including towing, title processing, preparation and storage, as well as sale fees and other enhancement service fees meet the criteria for separate units of accounting. The revenue associated with each service is recognized upon completion of the respective service, net of applicable rebates or allowances. For certain sellers who are charged a proportionate fee based on high bid of the vehicle, the revenue associated with the pre-sale services are recognized upon completion of the sale when the total arrangement is fixed and determinable. The selling price of each service is determined based on management's best estimate and allotted based on the relative selling price method.

Vehicle sales, where vehicles are purchased and remarketed on our own behalf, are recognized on the sale date, which is typically the point of high bid acceptance. Upon high bid acceptance, a legal binding contract is formed with the member, and we record the gross sales price as revenue.

We also provide a number of services to the buyer of the vehicle, charging a separate fee for each service. Each of these services has been assessed to determine whether we have met the requirements to separate them into units of accounting within a multiple-element arrangement. We have concluded that the sale and the post-sale services are separate units of accounting.

The fees for sale services are recognized upon completion of the sale, and the fees for the post-sale services are recognized upon successful completion of those services using the relative selling price method.

We also charge members an annual registration fee for the right to participate in our vehicle sales program, which is recognized ratably over the term of the arrangement, and relist and late-payment fees, which are recognized upon receipt of payment by the member. No provision for returns has been established, as all sales are final with no right of

return, although we provide for bad debt expense in the case of non-performance by our members or sellers.

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards for multiple deliverables revenue arrangements to:

- (i) provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the arrangement consideration should be allocated;
- (ii) require an entity to allocate consideration in an arrangement using its best estimate of selling prices (BSP) of deliverables if a vendor does not have vendor-specific objective evidence of selling price (VSOE) or third-party evidence of selling price (TPE); and
- (iii) eliminate the use of the residual method and require an entity to allocate arrangement consideration using the relative selling price method.

We allocate arrangement consideration based on the relative estimated selling prices of the separate units of accounting containing multiple deliverables. Estimated selling prices are determined using management's best estimate. Significant inputs in our estimates of the selling price of separate units of accounting include market and pricing trends, pricing customization and practices, and profit objectives for the services.

### **Fair Value of Financial Instruments**

We record our financial assets and liabilities at fair value in accordance with the framework for measuring fair value in U.S. generally accepted accounting principles. In accordance with ASC 820, *Fair Value Measurements and Disclosures*, as amended by Accounting Standards Update 2011-04, we consider fair value as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants under current market conditions. This framework establishes a fair value hierarchy that prioritizes the inputs used to measure fair value:

The amounts recorded for financial instruments in our condensed consolidated financial statements, which included cash, accounts receivable, accounts payable and accrued liabilities approximate their fair values as of October 31, 2013 and July 31, 2013, due to the short-term nature of those instruments, and are classified within Level II of the fair value hierarchy. Cash equivalents are classified within Level II of the fair value hierarchy because they are valued using quoted market prices of the underlying investments. See *Note 3. Long-Term Debt* for fair value disclosures related to our long-term debt.

### **Vehicle Pooling Costs**

We defer in vehicle pooling costs certain yard operation expenses associated with vehicles consigned to and received by us, but not sold as of the balance sheet date. We quantify the deferred costs using a calculation that includes the number of vehicles at our facilities at the beginning and end of the period, the number of vehicles sold during the period and an allocation of certain yard operation expenses of the period. The primary expenses allocated and deferred are certain facility costs, labor, and vehicle processing. If our allocation factors change, then yard operation expenses could increase or decrease correspondingly in the future. These costs are expensed as vehicles are sold in subsequent periods on an average cost basis. Given the fixed cost nature of our business there is not a direct correlation in an increase in expenses or units processed on vehicle pooling costs.

We apply the provisions of accounting guidance for subsequent measurement of inventory to our vehicle pooling costs. The provision requires that items such as idle facility expense, double freight and re-handling costs be recognized as current period charges regardless of whether they meet the criteria of "so abnormal" as provided in the guidance. In addition, the guidance requires that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of production facilities.

### **Derivatives and Hedging**

We have entered into two interest rate swaps to eliminate interest rate risk on our variable rate Term Loan, and the swaps are designated as effective cash flow hedges under ASC 815, *Derivatives and Hedging*, (see *Note 4. Derivatives and Hedging*). Each quarter, we measure hedge effectiveness using the "hypothetical derivative method" and record in earnings any hedge ineffectiveness with the effective portion of the hedges' change in fair value recorded in other comprehensive income or loss.

### **Capitalized Software Costs**

We capitalize system development costs and website development costs related to our enterprise computing services during the application development stage. Costs related to preliminary project activities and post implementation

activities are expensed as incurred. Internal-use software is amortized on a straight line basis over its estimated useful life, generally three years. Management evaluates the useful lives of these assets on an annual basis and tests for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets. Total gross capitalized software as of October 31, 2013 and July 31, 2013 was \$77.3 million and \$74.3 million, respectively. Accumulated amortization expense related to software for October 31, 2013 and July 31, 2013 totaled \$31.0 million and \$28.6 million, respectively.

### **Allowance for Doubtful Accounts**

We maintain an allowance for doubtful accounts in order to provide for estimated losses resulting from disputed amounts billed to sellers or members and the inability of our sellers or members to make required payments. If billing disputes exceed expectations and/or if the financial condition of our sellers or members were to deteriorate, additional allowances may be required. The allowance is calculated by taking both seller and buyer accounts receivables written off during the previous 12 month period as a percentage of the total accounts receivable balance, i.e. total write-offs/total accounts receivable (write-off percentage). We note that a one percentage point deviation in the write-off percentage would have resulted in an increase or decrease to the allowance for doubtful accounts balance of \$1.5 million.

### **Valuation of Goodwill**

We evaluate the impairment of goodwill for our operating segments annually (or on an interim basis if certain indicators are present) by comparing the fair value of the operating segment to its carrying value. Future adverse changes in market conditions or poor operating results of the operating segments could result in an inability to recover the carrying value of the investment, thereby requiring impairment charges in the future.

### **Income Taxes and Deferred Tax Assets**

We account for income tax exposures as required under ASC 740, *Income Taxes*. We are subject to income taxes in the U.S., Canada, the U.K., Brazil, Spain and Germany. In arriving at a provision of income taxes, we first calculate taxes payable in accordance with the prevailing tax laws in the jurisdictions in which we operate; we then analyze the timing differences between the financial reporting and tax basis of our assets and liabilities, such as various accruals, depreciation and amortization. The tax effects of the timing difference are presented as deferred tax assets and liabilities in the condensed consolidated balance sheet. We assess the probability that the deferred tax assets will be realized based on our ability to generate future taxable income. In the event that it is more likely than not the full benefit would not be realized from the deferred tax assets we carry on our condensed consolidated balance sheet, we record a valuation allowance to reduce the carrying value of the deferred tax assets to the amount expected to be realized. As of October 31, 2013, we have \$1.6 million of valuation allowance arising from both our U.S. and foreign operations. To the extent we establish a valuation allowance or change the amount of valuation allowance in a period, we reflect the change with a corresponding increase or decrease in our income tax provision in the condensed consolidated statements of income.

Historically, our income taxes have been sufficiently provided to cover our actual income tax liabilities among the jurisdictions in which we operate. Nonetheless, our future effective tax rate could still be adversely affected by several factors, including (i) the geographical allocation of our future earnings; (ii) the change in tax laws or our interpretation of tax laws; (iii) the changes in governing regulations and accounting principles; (iv) the changes in the valuation of our deferred tax assets and liabilities; and (v) the outcome of the income tax examinations. As a result, we routinely assess the possibilities of material changes resulting from the aforementioned factors to determine the adequacy of our income tax provision.

Based on our results for the three months ended October 31, 2013, a one percentage point change in our provision for income taxes as a percentage of income before taxes would have resulted in an increase or decrease in the provision of \$0.6 million.

We apply the provision of ASC 740, which contains a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon settlement.



Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest settlement of any particular position, could require the use of cash. In addition, we are subject to the continuous examination of our income tax returns by various taxing authorities, including the Internal Revenue Service and U.S. states. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

### **Long-lived Asset Valuation, Including Intangible Assets**

We evaluate long-lived assets, including property and equipment and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the use of the asset. If the estimated undiscounted cash flows change in the future, we may be required to reduce the carrying amount of an asset.

### **Stock-based Compensation**

We account for our stock-based awards to employees and non-employees using the fair value method. Compensation cost related to stock-based payment transactions are recognized based on the fair value of the equity or liability instruments issued. Determining the fair value of options using the Black-Scholes Merton option pricing model, or other currently accepted option valuation models, requires highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated fair value on the measurement date. If actual results are not consistent with our assumptions and judgments used in estimating the key assumptions, we may be required to record additional compensation or income tax expense, which could have a material impact on our consolidated results of operations and financial position.

### **Retained Insurance Liabilities**

We are partially self-insured for certain losses related to medical, general liability, workers' compensation and auto liability. Our insurance policies are subject to a \$250,000 deductible per claim, with the exception of our medical policy which is \$225,000 per claim. In addition, each of our policies contains an aggregate stop loss which limits our ultimate exposure. Our liability represents an estimate of the ultimate cost of claims incurred as of the balance sheet date. The estimated liability is not discounted and is established based upon analysis of historical data and actuarial estimates. The primary estimates used in the actuarial analysis include total payroll and revenue. Our estimates have not materially fluctuated from actual results. While we believe these estimates are reasonable based on the information currently available, if actual trends, including the severity of claims and medical cost inflation, differ from our estimates, our consolidated results of operations, financial position or cash flows could be impacted. The process of determining our insurance reserves requires estimates with various assumptions, each of which can positively or negatively impact those balances. The total amount reserved for all policies is \$5.3 million as of October 31, 2013. If the total number of participants in the medical plan changed by 10% we estimate that our medical expense would change by \$1.1 million and our medical accrual would change by \$0.4 million. If our total payroll changed by 10% we estimate that our workers' compensation expense and our accrual for workers' compensation expenses would change by less than \$0.1 million. A 10% change in revenue would change our insurance premium for the general liability and umbrella policy by less than \$0.1 million.

### **Accounting for Acquisitions**

Accounting for acquisitions requires us to recognize and measure identifiable assets acquired and liabilities assumed in the acquired entity. The accounting for acquisitions involves significant judgments and estimates, including the fair value of acquired intangible assets, which involve projections of future revenues, cash flows and terminal value, which are then either discounted at an estimated discount rate or measured at an estimated royalty rate, and the fair value of other acquired assets and assumed liabilities, including potential contingencies, and the useful lives of the assets. The projections are developed using internal forecasts, available industry and market data, estimates of long-term rates of growth for our business. Historical experience is additionally utilized, in which historical or current costs have approximated fair value for certain assets acquired.

### **Segment Reporting**

Our North American and U.K. regions are considered two separate operating segments, which have been aggregated into one reportable segment because they share similar economic characteristics.

**Recently Issued Accounting Standards**

For a description of the new accounting standards that affect us, refer to the Notes to Condensed Consolidated Financial Statements - *Note 10. Recent Accounting Pronouncements*.

## Results of Operations

### Three Months Ended October 31, 2013 Compared to Three Months Ended October 31, 2012

**Revenues.** The following sets forth revenue by class of revenue (in thousands, except percentages):

**Service Revenues.** Service revenues were \$226.4 million during the three months ended October 31, 2013 compared to \$195.2 million for the same period last year, an increase of \$31.2 million, or 16.0%. The growth came from (i) the acquisition of Salvage Parent, Inc. which closed on May 30, 2013 and represented \$12.2 million; (ii) our international expansion during the prior fiscal year into Germany, Spain, the U.A.E. and Brazil which represented \$4.1 million; (iii) growth in the U.K. of \$0.5 million driven by increased volume as we increased our market share in the U.K.; and, (iv) growth in North America of \$14.4 million. The growth in North America was driven primarily by increased volume as revenue per car remained relatively flat. The increase in volume came from what we believe to be a general increase in the overall salvage market as we believe there has been an increase in salvage frequency. Salvage frequency is the percentage of cars involved in accidents which the insurance companies salvage rather than repair. Trends in salvage frequency are driven by the relationship between repairs costs, used car values and auction returns. The increase in salvage frequency was driven, we believe, by the decline in used cars values relative to repair costs. Used car values are determined by many factors including the used car supply, which is tied directly to new car sales, and the average age of cars on the road continued to grow from 9.6 to 11.4 years in 2013. New cars sales grew on a year over year basis increasing the supply of used cars. Additionally, the average age of a car on the road continued to grow. These factors, among others, had led to a general decline in used car values. During the same period the average cost to repair a car increased by 10%. The factors that influence repair costs, used car pricing and auction returns are many and varied and we cannot predict their movements. Accordingly, we cannot predict future trends in salvage frequency.

**Vehicle Sales.** We have certain contracts with insurance companies in which we act as a principal, purchasing vehicles and reselling them for our own account. We also purchase vehicles in the open market, primarily from individuals and resell them for our own account. Vehicle sales revenues were \$53.5 million during the three months ended October 31, 2013 compared to \$43.7 million for the same period last year, an increase of \$9.8 million, or 22.4%. The increase came from (i) the acquisition of Salvage Parent, Inc. which represented \$4.9 million; (ii) growth in the U.K. of \$2.1 million driven primarily by increased open market purchase activity from the general public; (iii) growth in North America of \$1.2 million driven primarily by increased volume; and (iv) our international expansion during the prior fiscal year which represented \$1.6 million.

**Yard Operation Expenses.** Yard operation expenses, excluding depreciation and amortization, were \$115.9 million during the three months ended October 31, 2013 compared to \$88.0 million for the same period last year. Compared to the same period last year, yard operation expense grew by \$27.9 million, or 31.7%. The growth came from (i) our international expansion during the prior fiscal year into Germany, Spain, the U.A.E. and Brazil which represented \$1.6 million; (ii) the acquisition of Salvage Parent, Inc. which represented \$9.0 million; (iii) growth in the U.K. of \$1.7 million driven by increased volume associated with salvage market share gains; and (iv) growth in North America of \$15.6 million. The growth in North America was driven by increases in both the costs to process each car and in volume which were \$10.6 million and \$4.9 million, respectively. The increase in volume came from what we believe to be a general increase the in overall salvage market as we believe there has been an increase in salvage frequency, which is the percentage of cars involved in accidents that the insurance companies salvage rather than repair. There was an increase in the normal cost to process each car driven by growth in normal subhaul, labor, equipment and titling costs as well as charges associated with severance and lease termination costs of \$0.5 million primarily associated with the integration of the Salvage Parent, Inc. acquisition. We expect these integration costs to continue for the next two quarters.

Included in yard operation costs were depreciation and amortization expenses which were \$10.1 million and \$9.1 million for the three months ended October 31, 2013 and 2012, respectively. The increase in yard operation

depreciation and amortization expense is due primarily to accelerated depreciation from the shorter useful lives of our data center assets of \$1.7 million and \$0.7 million for the three months ended October 31, 2013 and 2012, respectively.

**Cost of Vehicle Sales.** The cost of vehicle sales were \$46.1 million during the three months ended October 31, 2013 compared to \$36.3 million for the same period last year, an increase of \$9.8 million, or 27.0%. The increase came from (i) the acquisition of Salvage Parent, Inc. which represented \$4.6 million; (ii) growth in the U.K. and North America of \$3.7 million and driven primarily by increased volume from insurance sellers in the U.K. and increased open market purchase activity from the general public in both the U.K. and in North America; and (iii) our international expansion during the prior fiscal year into Germany, Spain, the U.A.E. and Brazil which represented \$1.5 million.

**General and Administrative Expenses.** General and administrative expenses, excluding depreciation and amortization, were \$38.5 million for the three months ended October 31, 2013 compared to \$27.3 million for the same period last year, an increase of \$11.2 million or 41.0%. The growth came from (i) the acquisition of Salvage Parent, Inc. which closed on May 30, 2013 and represents \$4.6 million; (ii) our international expansion during the prior fiscal year into Germany, Spain, the U.A.E. and Brazil representing \$2.0 million; and (iii) growth in North America of \$4.6 million. The growth in North America was driven primarily by increased costs associated with new product development, the rollout of a new worldwide ERP operating platform, the transition costs associated with the outsourcing of our IT infrastructure and support and the overall growth in labor costs, professional services and facilities costs associated with domestic and international expansion. Included in the current quarter's costs are \$2.6 million in relocation and employment and lease termination costs associated with restructuring activities and the integration of the Salvage Parent, Inc. acquisition as well as \$1.5 million in technology transition costs. We expect the integration costs to continue for the next two quarters. We expect to incur incremental technology transition costs throughout fiscal 2015.

Included in general and administrative costs were depreciation and amortization expenses which were \$4.4 million and \$3.7 million for the three months ended October 31, 2013 and 2012, respectively.

**Other (Expense) Income.** Total other expense was \$0.7 million during the three months ended October 31, 2013 compared to \$2.8 million for the same period last year. Interest expense decreased \$0.3 million as a result of principal payments of long-term debt, which is further described in the Notes to Condensed Consolidated Financial Statements - *Note 3. Long-Term Debt*, which is incorporated herein by reference. Other income primarily includes the income from the rent of certain real property, foreign exchange rate gains and losses, and gains and losses from the disposal of assets, and will fluctuate based on the nature of those activities during the period. Other income was \$1.4 million and an expense of \$0.3 million during the three months ended October 31, 2013 and 2012, respectively.

**Income Taxes.** Our effective income tax rates for the three months ended October 31, 2013 and 2012 were 35.5% and 36.0%, respectively. The change in tax rates was primarily driven by the release of excess liability relating to unrecognized tax benefits.

### **Liquidity and Capital Resources**

Our primary source of working capital is net income. Accordingly, factors affecting net income are the principal factors affecting the generation of working capital. Those primary factors: (i) seasonality; (ii) market wins and losses; (iii) supplier mix; (iv) accident frequency; (v) salvage frequency; (vi) change in market share of our existing suppliers; (vii) commodity pricing; (viii) used car pricing; (ix) foreign currency exchange rates; (x) product mix; and (xi) contract mix to the extent appropriate, are discussed in the Results of Operations and Risk Factors sections of this Quarterly Report on Form 10-Q.

Potential internal sources of additional working capital are the sale of assets or the issuance of equity through option exercises and shares issued under our Employee Stock Purchase Plan. A potential external source of additional working capital is the issuance of debt and equity. However, with respect to the issuance of equity or debt, we cannot predict if these sources will be available in the future and, if available, if they can be issued under terms commercially acceptable to us.

Historically, we have financed our growth through cash generated from operations, public offerings of common stock, the equity issued in conjunction with certain acquisitions and debt financing. Our primary source of cash generated by operations is from the collection of sellers' fees, members' fees and reimbursable advances from the proceeds of vehicle sales. Our business is seasonal as inclement weather during the winter months increases the frequency of accidents and, consequently, the number of cars deemed as totaled by the insurance companies. During the winter months, most of our facilities process 10% to 30% more vehicles than at other times of the year. This increased volume requires the increased use of our cash to pay out advances and handling costs of the additional business.

As of October 31, 2013, we had working capital of \$63.0 million, including cash and cash equivalents of \$77.1 million. Cash equivalents consisted of bank deposits and funds invested in money market accounts, which bear interest at a variable rate. Cash and cash equivalents increased by \$13.4 million from July 31, 2013 to October 31, 2013.

We believe that our currently available cash and cash equivalents and cash generated from operations will be sufficient to satisfy our operating and working capital requirements for at least the next 12 months. However, if we experience significant growth in the future, we may be required to raise additional cash through the issuance of new debt or additional equity.

As of October 31, 2013, \$36.0 million of the \$77.1 million of cash and cash equivalents was held by our foreign subsidiaries. If these funds are needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside of the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

### ***Operating Activities***

Net cash provided by operating activities decreased by \$7.6 million to \$67.7 million during the three months ended October 31, 2013, when compared to the three months ended October 31, 2012, due to changes in operating assets and liabilities. In particular, we experienced significant increases in our prepaid and other current and long-term assets due to contracted prepayments which were offset by lower growth in accounts receivable.

### ***Investing Activities***

Net cash used in investing activities decreased by \$37.6 million to \$20.7 million during the three months ended October 31, 2013, when compared to the three months ended October 31, 2012. The \$26.3 million decrease in capital expenditures was due primarily to significant land acquisitions during the three months ended October 31, 2012, related to our first facility in Brazil. Additionally in the three months ended October 31, 2012 there was an \$11.2 million investment in escrow related to purchases of property related to our expansion into Brazil, which closed during the remainder of fiscal 2013.

### ***Financing Activities***

Net cash used in financing activities increased by \$8.4 million to \$35.0 million during the three months ended October 31, 2013, when compared to the same period in the prior year principally due to a \$16.3 million change in bank overdraft, decreased proceeds of \$4.1 million from the exercises of stock options and a \$1.8 million reduction in tax benefits from stock-based compensation during the three months ended October 31, 2013. This was offset by reductions in the repurchases of common stock as we repurchased \$13.8 million less common stock during the three months ended October 31, 2013 (See *Note 8. Common Stock Repurchases*).

### ***Credit Facility***

On December 14, 2010, we entered into an Amended and Restated Credit Facility Agreement (Credit Facility), which supersedes our previously disclosed credit agreement with Bank of America, N.A. (Bank of America). The Credit Facility is an unsecured credit agreement providing for (i) a \$100.0 million revolving credit facility, including a \$100.0 million alternative currency borrowing sublimit and a \$50.0 million letter of credit sublimit (Revolving Credit) and (ii) a term loan facility of \$400.0 million (Term Loan). On January 14, 2011, the full \$400.0 million provided under the Term Loan was borrowed. On September 29, 2011, we amended the credit agreement increasing the amount of the Term Loan facility from \$400.0 million to \$500.0 million. On March 1, 2013, we amended the credit agreement to increase the net leverage ratio at which restrictive spending covenants are introduced from 1:1 to 1.5:1.

The Term Loan, which at October 31, 2013 had \$350.0 million outstanding, amortizes \$18.8 million each quarter beginning December 31, 2011, with all outstanding borrowings due on December 14, 2015. All amounts borrowed under the Term Loan may be prepaid without premium or penalty.



Amounts borrowed under the Credit Facility bear interest, subject to certain restrictions, at a fluctuating rate based on (i) the Eurocurrency Rate; (ii) the Federal Funds Rate; or (iii) the Prime Rate as described in the Credit Facility. We have entered into two interest rate swaps (see *Note 4. Derivatives and Hedging*) to exchange our variable interest rate payments commitment for fixed interest rate payments on the Term Loan balance, which at October 31, 2013 totaled \$350.0 million. A default interest rate applies on all obligations during an event of default under the credit facility, at a rate per annum equal to 2.0% above the otherwise applicable interest rate. Our interest rate at October 31, 2013 is the 0.18% Eurocurrency Rate plus the 1.5% Applicable Rate. The Applicable Rate can fluctuate between 1.5% and 2.0% depending on our consolidated net leverage ratio (as defined in the Credit Facility). The Credit Facility is guaranteed by our material domestic subsidiaries. The carrying amount of the Credit Facility is comprised of borrowings under which interest accrues under a fluctuating interest rate structure. Accordingly, the carrying value approximates fair value at October 31, 2013 and is classified within Level II of the fair value hierarchy.

Amounts borrowed under the Revolving Credit may be repaid and reborrowed until the maturity date, which is December 14, 2015. The Credit Facility requires us to pay a commitment fee on the unused portion of the Revolving Credit. The commitment fee ranges from 0.075% to 0.125% per annum depending on our leverage ratio. We had no outstanding borrowings under the Revolving Credit at the end of the period.

The Credit Facility contains customary representations and warranties and may place certain business operating restrictions on us relating to, among other things, indebtedness, liens and other encumbrances, investments, mergers and acquisitions, asset sales, dividends and distributions and redemptions of capital stock. In addition, the Credit Facility provides for the following financial covenants: (i) earnings before income tax, depreciation and amortization (EBITDA); (ii) leverage ratio; (iii) interest coverage ratio; and (iv) limitations on capital expenditures. The Credit Facility contains events of default that include, among others, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, cross-defaults to certain other indebtedness, bankruptcy and insolvency defaults, material judgments, invalidity of the loan documents and events constituting a change of control. We are in compliance with all covenants as of October 31, 2013.

### **Off-Balance Sheet Arrangements**

As of October 31, 2013, we did not have any off-balance sheet arrangements as defined in Item 303(a)(4) of Regulation S-K promulgated under the Exchange Act.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our principal exposures to financial market risk are interest rate risk, foreign currency risk and translation risk. We do not hold or issue financial instruments for trading purposes.

#### **Interest Income Risk**

The primary objective of our investment activities is to preserve principal while secondarily maximizing yields without significantly increasing risk. To achieve this objective in the current uncertain global financial markets, as of October 31, 2013, all of our total cash and cash equivalents were held in bank deposits and money market funds. As the interest rates on a material portion of our cash and cash equivalents are variable, a change in interest rates earned on our investment portfolio would impact interest income along with cash flows, but would not materially impact the fair market value of the related underlying instruments. As of October 31, 2013, we held no direct investments in auction rate securities, collateralized debt obligations, structured investment vehicles or mortgaged-backed securities. Based on the average cash balance held during the nine months ended October 31, 2013, a 10% change in our interest yield would not materially affect our operating results.

#### **Interest Expense Risk**

Our total borrowings under the Credit Facility were \$350.0 million as of October 31, 2013. Amounts borrowed under the Credit Facility bear interest, subject to certain restrictions, at a fluctuating rate based on (i) the Eurocurrency Rate, (ii) the Federal Funds Rate or (iii) the Prime Rate as described in the Credit Facility. A default interest rate applies on all obligations during an event of default under the Credit Facility, at a rate per annum equal to 2.0% above the otherwise applicable interest rate.

We have entered into two interest rate swaps to exchange our variable interest rate payments commitment for fixed interest rate payments on the Term Loan balance to mitigate the interest expense risk.

#### **Foreign Currency and Translation Exposure**

Fluctuations in the foreign currencies create volatility in our reported results of operations because we are required to consolidate the results of operations of our foreign currency denominated subsidiaries. International net revenues result from transactions by our Canadian, U.K., U.A.E., Brazilian, Spain, and German operations and are typically denominated in the local currency of each country. These operations also incur a majority of their expenses in the local currency, the Canadian dollar, the British pound, the U.A.E. dirham, the Brazilian real and the Euro. Our international operations are subject to risks associated with foreign exchange rate volatility. Accordingly, our future results could be materially adversely impacted by changes in these or other factors. A hypothetical uniform 10% strengthening or weakening in the value of the U.S. dollar relative to the Canadian dollar, British pound, U.A.E. dirham, Brazilian real or Euro in which our revenues and profits are denominated would result in a decrease/increase to revenue of \$5.9 million for the three months ended October 31, 2013.

Fluctuations in the foreign currencies create volatility in our reported consolidated financial position because we are required to remeasure substantially all assets and liabilities held by our foreign subsidiaries at the current exchange rate at the close of the accounting period. At October 31, 2013, the cumulative effect of foreign exchange rate fluctuations on our consolidated financial position was a net translation loss of \$30.9 million. This loss is recognized as an adjustment to stockholders' equity through accumulated other comprehensive income. A 10% strengthening or weakening in the value of the U.S. dollar relative to the Canadian dollar, British pound, U.A.E. dirham, Brazilian real or Euro will not have a material effect on our consolidated financial position.

We do not hedge our exposure to translation risks arising from fluctuations in foreign currency exchange rates.



## ITEM 4. CONTROLS AND PROCEDURES

### (a) Evaluation of Disclosure Controls and Procedures

We conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), or Disclosure Controls, as of the end of the period covered by this Quarterly Report on Form 10-Q. This evaluation, or Controls Evaluation, was performed under the supervision and with the participation of management, including our Chief Executive Officer (our CEO) and our Chief Financial Officer (our CFO). Disclosure Controls are controls and procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure Controls include, without limitation, controls and procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to our management, including our CEO and CFO, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. Our Disclosure Controls include some, but not all, components of our internal control over financial reporting.

Based upon the Controls Evaluation, our CEO and CFO have concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our Disclosure Controls were effective to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is accumulated and communicated to management, including the CEO and CFO, to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission.

### (b) Changes in Internal Controls

There have not been any changes in our internal control over financial reporting during the most recent fiscal quarter that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The information set forth above under *Note 11. Legal Proceedings* contained in the "Notes to Condensed Consolidated Financial Statements" is incorporated herein by reference.

### ITEM 1A. RISK FACTORS

Set forth below and elsewhere in this Quarterly Report on Form 10-Q and in other documents we file with the SEC are descriptions of the risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in "Part I, Item 1A, Risk Factors" of our Annual Report on Form 10-K for the fiscal year ended July 31, 2013.

**We depend on a limited number of major vehicle sellers for a substantial portion of our revenues. The loss of one or more of these major sellers could adversely affect our consolidated results of operations and financial position, and an inability to increase our sources of vehicle supply could adversely affect our growth rates.**

No single customer accounted for more than 10% of our revenue during the three months ended October 31, 2013. Historically, a limited number of vehicle sellers have collectively accounted for a substantial portion of our revenues. Seller arrangements are either written or oral agreements typically subject to cancellation by either party upon 30 to

90 days notice. Vehicle sellers have terminated agreements with us in the past in particular markets, which has affected the pricing for sales services in those markets. There can be no assurance that our existing agreements will not be cancelled. Furthermore, there can be no assurance that we will be able to enter into future agreements with vehicle sellers or that we will be able to retain our existing supply of salvage vehicles. A reduction in vehicles from a significant vehicle seller or any material changes in the terms of an arrangement with a significant vehicle seller could have a material adverse effect on our consolidated results of operations and financial position. In addition, a failure to increase our sources of vehicle supply could adversely affect our earnings and revenue growth rates.

**Our expansion into markets outside North America, including recent expansions in Europe, Brazil and the Middle East, expose us to risks arising from operating in international markets. Any failure to successfully integrate businesses acquired outside of North America into our operations could have an adverse effect on our consolidated results of operations, financial position or cash flows.**

We first expanded our operations outside North America in 2007 with a significant acquisition in the United Kingdom (the U.K.), and we continue to evaluate acquisitions and other opportunities outside North America. In August 2012, we announced our acquisition of a company in the United Arab Emirates (the U.A.E.), in November 2012, we announced our acquisitions of companies in Brazil and Germany and in June 2013, we announced our acquisition of a company in Spain. Acquisitions or other strategies to expand our operations outside North America pose substantial risks and uncertainties that could have an adverse effect on our future operating results. In particular, we may not be successful in realizing anticipated synergies from these acquisitions, or we may experience unanticipated costs or expenses integrating the acquired operations into our existing business. We have and may continue to incur substantial expenses establishing new yards or operations in international markets. Among other things, we will ultimately deploy our proprietary auction technologies at all of our foreign operations and we cannot predict whether this deployment will be successful or will result in increases in the revenues or operating efficiencies of any acquired companies relative to their historic operating performance. Integration of our respective operations, including information technology integration and integration of financial and administrative functions, may not proceed as we anticipate and could result in unanticipated costs or expenses (including unanticipated capital expenditures) that could have an adverse effect on our future operating results. We cannot provide any assurances that we will achieve our business and financial objectives in connection with these acquisitions or our strategic decision to expand our operations internationally.

As we continue to expand our business internationally, we will need to develop policies and procedures to manage our business on a global scale. Operationally, acquired businesses typically depend on key seller relationships, and our failure to maintain those relationships would have an adverse effect on our consolidated results of operations and could have an adverse effect on our future operating results.

In addition, we anticipate our international operations will subject us to a variety of risks associated with operating on an international basis, including:

the difficulty of managing and staffing foreign offices and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;

the need to localize our product offerings, particularly the need to implement our online auction platform in foreign countries;

tariffs and trade barriers and other regulatory or contractual limitations on our ability to operate in certain foreign markets;

exposure to foreign currency exchange rate risk, which may have an adverse impact on our revenues and revenue growth rates;

adapting to different business cultures and market structures, particularly where we seek to implement our auction model in markets where insurers have historically not played a substantial role in the disposition of salvage vehicles; and

repatriation of funds currently held in foreign jurisdictions to the U.S. may result in higher effective tax rates.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks successfully could harm our international operations and have an adverse effect on our operating results.

In addition, certain acquisitions in the U.K. may be reviewed by the Office of Fair Trade (OFT) and/or Competition Commission (U.K. Regulators). If an inquiry is made by U.K. Regulators, we may be required to demonstrate that our acquisitions will not result, or be expected to result, in a substantial lessening of competition in a U.K. market. Although we believe that there will not be a substantial lessening of competition in a U.K. market, based on our

analysis of the relevant U.K. markets, there can be no assurance that the U.K. Regulators will agree with us if they decide to make an inquiry. If the U.K. Regulators determine that by our acquisitions of certain assets, there is or likely will be a substantial lessening of competition in a U.K. market, we could be required to divest some portion of our U.K. assets. In the event of a divestiture order by the U.K. Regulators, the assets disposed may be sold for substantially less than their carrying value. Accordingly, any divestiture could have a material adverse effect on our operating results in the period of the divestiture.



**Our operations and acquisitions in certain foreign areas expose us to political, regulatory, economic and reputational risks.**

Although we have implemented policies, procedures and training designed to ensure compliance with anti-bribery laws, trade controls and economic sanctions, and similar regulations, our employees or agents may take actions in violation of our policies. We may incur costs or other penalties in the event that any such violations occur, which could have an adverse effect on our business and reputation.

In addition, some of our recent acquisitions have required us to integrate non-U.S. companies which had not, until our acquisition, been subject to U.S. law. In many countries outside of the United States, particularly in those with developing economies, it may be common for persons to engage in business practices prohibited by laws and regulations applicable to us, such as the U.S. Foreign Corrupt Practices Act (FCPA) or similar local anti-bribery laws. These laws generally prohibit companies and their employees or agents from making improper payments to government officials for the purpose of obtaining or retaining business. Failure by us and our subsidiaries to comply with these laws could subject us to civil and criminal penalties that could have a material adverse effect on our consolidated operating results and financial position.

**We face risks associated with the implementation of our salvage auction model in markets that may not operate on the same terms as the North American market. For example, certain markets operate on a principal rather than agent basis, which may have an adverse impact on our gross margin percentages and expose us to inventory risks that we do not experience in North America.**

Some of our target markets outside North America operate in a manner substantially different than our historic market in North America. For example, new markets may operate either wholly or partially on the principal model, in which the vehicle is purchased then resold for our own account, rather than the agency model employed in North America, in which we act as a sales agent for the legal owner of vehicles. Consequently, new acquisitions may have an adverse impact on our consolidated gross margin percentages. Further, operating on a principal basis exposes us to inventory risks, including losses from theft, damage, and obsolescence. In addition, our business in North America and the U.K. has been established and grown based largely on our ability to build relationships with insurance carriers. In other markets, insurers have traditionally been less involved in the disposition of salvage vehicles. As we expand into markets outside North America and the U.K., we cannot predict whether markets will readily adapt to our strategy of online auctions of automobiles sourced principally through vehicle insurers. Any failure of new markets to adopt our business model could adversely affect our consolidated results of operations and financial position.

**If the implementation of our new Enterprise Resource Planning (ERP) system is not executed efficiently and effectively, our business, financial position, and our consolidated operating results could be adversely affected.**

We are in the process of converting our primary management information system to a new standard ERP system, which will occur in phases through 2014 and 2015. In the event this conversion of our primary management information system is not executed efficiently and effectively, the conversion may cause interruptions in our primary management information systems, which may make our website and services unavailable. This type of interruption could prevent us from processing vehicles for our sellers and may prevent us from selling vehicles through our Internet bidding platform, VB3, which would adversely affect our consolidated results of operations and financial position.

In addition, our information and technology systems are vulnerable to damage or interruption from computer viruses, network failures, computer and telecommunications failures, infiltration by unauthorized persons and security breaches, usage errors by our employees, power outages and catastrophic events such as fires, tornadoes, floods, hurricanes and earthquakes. Although we have not been the victim of cyber attacks or other cyber incidents that have had a material impact on our consolidated operating results or financial position, we have from time to time experienced cyber security breaches such as computer viruses and similar information technology violations in the

ordinary course of business. We have implemented various measures to manage our risks related to system and network disruptions. If these systems are compromised, become inoperable for extended periods of time or cease to function properly, we may have to make a significant investment to fix or replace them and our ability to provide many of our electronic and online solutions to our customers may be impaired, which would have a material adverse effect on our consolidated operating results and financial position.

**Implementation of our online auction model in new markets may not result in the same synergies and benefits that we achieved when we implemented the model in North America and the U.K.**

We believe that the implementation of our proprietary auction technologies across our operations over the last decade had a favorable impact on our results of operations by increasing the size and geographic scope of our buyer base, increasing the average selling price for vehicles sold through our sales, and lowering expenses associated with vehicle sales. We implemented our online system across all of our North American and U.K. salvage yards beginning in fiscal 2004 and fiscal 2008, respectively, and experienced increases in revenues and average selling prices as well as improved operating efficiencies in both markets. In considering new markets, we consider the potential synergies from the implementation of our model based in large part on our experience in North America and the U.K. We cannot predict whether these synergies will also be realized in new markets.

**Failure to have sufficient capacity to accept additional cars at one or more of our storage facilities could adversely affect our relationships with insurance companies or other sellers of vehicles.**

Capacity at our storage facilities varies from period to period and from region to region. For example, following adverse weather conditions in a particular area, our yards in that area may fill and limit our ability to accept additional salvage vehicles while we process existing inventories. For example, Hurricanes Katrina, Rita and Sandy had, in certain quarters, an adverse effect on our operating results, in part because of yard capacity constraints in the Gulf Coast area and in the northeastern coast of the United States, respectively. We regularly evaluate our capacity in all our markets and, where appropriate, seek to increase capacity through the acquisition of additional land and yards. We may not be able to reach agreements to purchase independent storage facilities in markets where we have limited excess capacity, and zoning restrictions or difficulties obtaining use permits may limit our ability to expand our capacity through acquisitions of new land. Failure to have sufficient capacity at one or more of our yards could adversely affect our relationships with insurance companies or other sellers of vehicles, which could have an adverse effect on our consolidated results of operations and financial position.

**Because the growth of our business has been due in large part to acquisitions and development of new facilities, the rate of growth of our business and revenues may decline if we are not able to successfully complete acquisitions and develop new facilities.**

We seek to increase our sales and profitability through the acquisition of additional facilities and the development of new facilities. For example, in fiscal 2013, we acquired five new facilities in Sao Paulo, Brazil, one facility in the U.A.E., one facility in Ettlingen, Germany, one facility in Cordoba, Spain, and 44 facilities in North America. Furthermore, promising acquisitions are difficult to identify and complete for a number of reasons, including competition among prospective buyers, the availability of affordable financing in the capital markets and the need to satisfy applicable closing conditions and obtain antitrust and other regulatory approvals on acceptable terms. There can be no assurance that we will be able to:

continue to acquire additional facilities on favorable terms;  
expand existing facilities in no-growth regulatory environments;  
increase revenues and profitability at acquired and new facilities;  
maintain the historical revenue and earnings growth rates we have been able to obtain through facility openings and strategic acquisitions; or  
create new vehicle storage facilities that meet our current revenue and profitability requirements.

In addition, certain of the acquisition agreements by which we have acquired companies require the former owners to indemnify us against certain liabilities related to the operation of the company before we acquired it. In most of these agreements, however, the liability of the former owners is limited and certain former owners may be unable to meet their indemnification responsibilities. We cannot assure that these indemnification provisions will protect us fully or at all, and as a result we may face unexpected liabilities that adversely affect our financial statements. Any failure to continue to successfully identify and complete acquisitions and develop new facilities could have a material adverse

effect on our consolidated results of operations and financial position.

**As we continue to expand our operations, our failure to manage growth could harm our business and adversely affect our consolidated results of operations and financial position.**

Our ability to manage growth depends not only on our ability to successfully integrate new facilities, but also on our ability to:

hire, train and manage additional qualified personnel;  
establish new relationships or expand existing relationships with vehicle sellers;

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identify and acquire or lease suitable premises on competitive terms;  
secure adequate capital; and  
maintain the supply of vehicles from vehicle sellers.

Our inability to control or manage these growth factors effectively could have a material adverse effect on our consolidated results of operations, and financial position.

**Our annual and quarterly performance may fluctuate, causing the price of our stock to decline.**

Our revenues and operating results have fluctuated in the past and can be expected to continue to fluctuate in the future on a quarterly and annual basis as a result of a number of factors, many of which are beyond our control. Factors that may affect our operating results include, but are not limited to, the following:

fluctuations in the market value of salvage and used vehicles;  
the impact of foreign exchange gain and loss as a result of international operations;  
our ability to successfully integrate our newly acquired operations in international markets and any additional markets we may enter;  
the availability of salvage vehicles;  
variations in vehicle accident rates;  
member participation in the Internet bidding process;  
delays or changes in state title processing;  
changes in international, state or federal laws or regulations affecting salvage vehicles;  
changes in local laws affecting who may purchase salvage vehicles;  
our ability to integrate and manage our acquisitions successfully;  
the timing and size of our new facility openings;  
the announcement of new vehicle supply agreements by us or our competitors;  
the severity of weather and seasonality of weather patterns;  
the amount and timing of operating costs and capital expenditures relating to the maintenance and expansion of our business, operations and infrastructure;  
the availability and cost of general business insurance;  
labor costs and collective bargaining;  
changes in the current levels of out of state and foreign demand for salvage vehicles;  
the introduction of a similar Internet product by a competitor;  
the ability to obtain necessary permits to operate; and  
the impact of our conversion to a new ERP system, if the conversion is not executed efficiently and effectively.

Due to the foregoing factors, our operating results in one or more future periods can be expected to fluctuate. As a result, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as any indication of future performance. In the event such fluctuations result in our financial performance being below the expectations of public market analysts and investors, the price of our common stock could decline substantially.

**Our Internet-based sales model has increased the relative importance of intellectual property assets to our business, and any inability to protect those rights could have a material adverse effect on our business, financial position, or results of operations.**

Our intellectual property rights include patents relating to our auction technologies as well as trademarks, trade secrets, copyrights and other intellectual property rights. In addition, we may enter into agreements with third parties regarding the license or other use of our intellectual property in foreign jurisdictions. Effective intellectual property protection may not be available in every country in which our products and services are distributed, deployed, or made available. We seek to maintain certain intellectual property rights as trade secrets. The secrecy could be compromised by third parties, or intentionally or accidentally by our employees, which would cause us to lose the competitive advantage resulting from those trade secrets. Any significant impairment of our intellectual property rights, or any inability to protect our intellectual property rights, could have a material adverse effect on our consolidated results of operations, and financial position.

**We have in the past been and may in the future be subject to intellectual property rights claims, which are costly to defend, could require us to pay damages, and could limit our ability to use certain technologies in the future.**

Litigation based on allegations of infringement or other violations of intellectual property rights are common among companies who rely heavily on intellectual property rights. Our reliance on intellectual property rights has increased significantly in recent years as we have implemented our auction-style sales technologies across our business and ceased conducting live auctions. As we face increasing competition, the possibility of intellectual property rights claims against us grows. Litigation and any other intellectual property claims, whether with or without merit, can be time-consuming, expensive to litigate and settle, and can divert management resources and attention from our core business. An adverse determination in current or future litigation could prevent us from offering our products and services in the manner currently conducted. We may also have to pay damages or seek a license for the technology, which may not be available on reasonable terms and which may significantly increase our operating expenses, if it is available for us to license at all. We could also be required to develop alternative non-infringing technology, which could require significant effort and expense.

**If we experience problems with our subhauers and trucking fleet operations, our business could be harmed.**

We rely solely upon independent subhauers to pick up and deliver vehicles to and from our North American and Brazilian storage facilities. We also utilize, to a lesser extent, independent subhauers in the U.K. Our failure to pick up and deliver vehicles in a timely and accurate manner could harm our reputation and brand, which could have a material adverse effect on our business. Further, an increase in fuel cost may lead to increased prices charged by our independent subhauers, which may significantly increase our cost. We may not be able to pass these costs on to our sellers or buyers.

In addition to using independent subhauers, in the U.K. we utilize a fleet of company trucks to pick up and deliver vehicles from our U.K. storage facilities. In connection therewith, we are subject to the risks associated with providing trucking services, including inclement weather, disruptions in transportation infrastructure, availability and price of fuel, any of which could result in an increase in our operating expenses and reduction in our net income.

**We are partially self-insured for certain losses and if our estimates of the cost of future claims differ from actual trends, our results of operations could be harmed.**

We are partially self-insured for certain losses related to medical insurance, general liability, workers' compensation and auto liability. Our liability represents an estimate of the ultimate cost of claims incurred as of the balance sheet date. The estimated liability is not discounted and is established based upon analysis of historical data and actuarial estimates. Further, we utilize independent actuaries to assist us in establishing the proper amount of reserves for

anticipated payouts associated with these self-insured exposures. While we believe these estimates are reasonable based on the information currently available, if actual trends, including the severity of claims and medical cost inflation, differ from our estimates, our results of operations could be impacted.

**Our executive officers, directors and their affiliates hold a large percentage of our stock and their interests may differ from other stockholders.**

Our executive officers, directors and their affiliates beneficially own, in the aggregate, 20% of our common stock as of October 31, 2013. If they were to act together, these stockholders would have significant influence over most matters requiring approval by stockholders, including the election of directors, any amendments to our certificate of incorporation and certain significant corporate transactions, including potential merger or acquisition transactions. In addition, without the consent of these stockholders, we could be delayed or prevented from entering into transactions that could be beneficial to us or our other investors. These stockholders may take these actions even if they are opposed by our other investors.

**We have certain provisions in our certificate of incorporation and bylaws, which may have an anti-takeover effect or that may delay, defer or prevent acquisition bids for us that a stockholder might consider favorable and limit attempts by our stockholders to replace or remove our current management.**

Our board of directors is authorized to create and issue from time to time, without stockholder approval, up to an aggregate of 5,000,000 shares of undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval, and which may include rights superior to the rights of the holders of common stock. In addition, our bylaws establish advance notice requirements for nominations for elections to our board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings. These anti-takeover provisions and other provisions under Delaware law could discourage, delay or prevent a transaction involving a change in control of our company, even if doing so would benefit our stockholders. These provisions could also discourage proxy contests and make it more difficult for stockholders to elect directors of their choosing and cause us to take other corporate actions the stockholders desire.

**If we lose key management or are unable to attract and retain the talent required for our business, we may not be able to successfully manage our business or achieve our objectives.**

Our future success depends in large part upon the leadership and performance of our executive management team, all of whom are employed on an at-will basis and none of whom are subject to any agreements not to compete. If we lose the service of one or more of our executive officers or key employees, in particular Willis J. Johnson, our Chairman; A. Jayson Adair, our Chief Executive Officer; and Vincent W. Mitz, our President, or if one or more of them decides to join a competitor or otherwise compete directly or indirectly with us, we may not be able to successfully manage our business or achieve our business objectives.

**Our cash investments are subject to numerous risks.**

We may invest our excess cash in securities or money market funds backed by securities, which may include U.S. treasuries, other federal, state and municipal debt, bonds, preferred stock, commercial paper, insurance contracts and other securities both privately and publicly traded. All securities are subject to risk, including fluctuations in interest rates, credit risk, market risk and systemic economic risk. Changes or movements in any of these risk factors may result in a loss or impairment to our invested cash and may have a material effect on our consolidated results of operations and financial position.

**The impairment of capitalized development costs could adversely affect our consolidated results of operations and financial condition.**

We capitalize certain costs associated with the development of new software products, new software for internal use and major software enhancements to existing software. These costs are amortized over the estimated useful life of the software beginning with its introduction or roll-out. If, at any time, it is determined that capitalized software provides a reduced economic benefit, the unamortized portion of the capitalized development costs will be expensed, in part or in full, as an impairment, which may have a material impact on our consolidated results of operations and financial position.

**New member programs could impact our operating results.**

We have or will initiate programs to open our auctions to the general public. These programs include the Registered Broker program through which the public can purchase vehicles through a registered member and the Market Maker program through which registered members can open Copart storefronts with Internet kiosks enabling the general public to search our inventory and purchase vehicles. Initiating programs that allow access to our online auctions to the general public may involve material expenditures and we cannot predict what future benefit, if any, will be derived.



**Factors such as mild weather conditions can have an adverse effect on our revenues and operating results as well as our revenue and earnings growth rates by reducing the available supply of salvage vehicles. Conversely, extreme weather conditions can result in an oversupply of salvage vehicles that requires us to incur abnormal expenses to respond to market demands.**

Mild weather conditions tend to result in a decrease in the available supply of salvage vehicles because traffic accidents decrease and fewer automobiles are damaged. Accordingly, mild weather can have an adverse effect on our salvage vehicle inventories, which would be expected to have an adverse effect on our revenue and operating results and related growth rates. Conversely, our inventories will tend to increase in poor weather such as a harsh winter or as a result of adverse weather-related conditions such as flooding. During periods of mild weather conditions, our ability to increase our revenues and improve our operating results and related growth will be increasingly dependent on our ability to obtain additional vehicle sellers and to compete more effectively in the market, each of which is subject to the other risks and uncertainties described in these sections. In addition, extreme weather conditions, although they increase the available supply of salvage cars, can have an adverse effect on our operating results. For example, during the fiscal year ended July 31, 2006 and during fiscal year 2013, we recognized

substantial additional costs associated with the impact of Hurricanes Katrina and Rita in Gulf Coast states and Hurricane Sandy in the northeastern coast of the United States, respectively. These additional costs, characterized as "abnormal" under ASC 330, *Inventory*, and included the additional subhauling, payroll, equipment and facilities expenses directly related to the operating conditions created by the hurricanes. In the event that we were to again experience extremely adverse weather or other anomalous conditions that result in an abnormally high number of salvage vehicles in one or more of our markets, those conditions could have an adverse effect on our future operating results.

**Macroeconomic factors such as high fuel prices, declines in commodity prices, and declines in used car prices may have an adverse effect on our revenues and operating results as well as our earnings growth rates.**

Macroeconomic factors that affect oil prices and the automobile and commodity markets can have adverse effects on our revenues, revenue growth rates (if any), and operating results. Significant increases in the cost of fuel could lead to a reduction in miles driven per car and a reduction in accident rates. A material reduction in accident rates could have a material impact on revenue growth. In addition, under our percentage incentive program contracts, or PIP, the cost of towing the vehicle to one of our facilities is included in the PIP fee. We may incur increased fees, which we may not be able to pass on to our vehicle sellers. A material increase in tow rates could have a material impact on our operating results. Volatility in fuel, commodity, and used car prices could have a material adverse effect on our revenues and revenue growth rates in future periods.

**The salvage vehicle sales industry is highly competitive and we may not be able to compete successfully.**

We face significant competition for the supply of salvage vehicles and for the buyers of those vehicles. We believe our principal competitors include other auction and vehicle remarketing service companies with whom we compete directly in obtaining vehicles from insurance companies and other sellers, and large vehicle dismantlers, who may buy salvage vehicles directly from insurance companies, bypassing the salvage sales process. Many of the insurance companies have established relationships with competitive remarketing companies and large dismantlers. Certain of our competitors may have greater financial resources than us. Due to the limited number of vehicle sellers, particularly in the U.K., the absence of long-term contractual commitments between us and our sellers and the increasingly competitive market environment, there can be no assurance that our competitors will not gain market share at our expense.

We may also encounter significant competition for local, regional and national supply agreements with vehicle sellers. There can be no assurance that the existence of other local, regional or national contracts entered into by our competitors will not have a material adverse effect on our business or our expansion plans. Furthermore, we are likely to face competition from major competitors in the acquisition of vehicle storage facilities, which could significantly increase the cost of such acquisitions and thereby materially impede our expansion objectives or have a material adverse effect on our consolidated results of operations. These potential new competitors may include consolidators of automobile dismantling businesses, organized salvage vehicle buying groups, automobile manufacturers, automobile auctioneers and software companies. While most vehicle sellers have abandoned or reduced efforts to sell salvage vehicles directly without the use of service providers such as us, there can be no assurance that this trend will continue, which could adversely affect our market share, consolidated results of operations and financial position. Additionally, existing or new competitors may be significantly larger and have greater financial and marketing resources than us; therefore, there can be no assurance that we will be able to compete successfully in the future.

**Government regulation of the salvage vehicle sales industry may impair our operations, increase our costs of doing business and create potential liability.**

Participants in the salvage vehicle sales industry are subject to, and may be required to expend funds to ensure compliance with a variety of governmental, regulatory and administrative rules, regulations, land use ordinances, licensure requirements and procedures, including those governing vehicle registration, the environment, zoning and

land use. Failure to comply with present or future regulations or changes in interpretations of existing regulations may result in impairment of our operations and the imposition of penalties and other liabilities. At various times, we may be involved in disputes with local governmental officials regarding the development and/or operation of our business facilities. We believe that we are in compliance in all material respects with applicable regulatory requirements. We may be subject to similar types of regulations by federal, national, international, provincial, state, and local governmental agencies in new markets. In addition, new regulatory requirements or changes in existing requirements may delay or increase the cost of opening new facilities, may limit our base of salvage vehicle buyers and may decrease demand for our vehicles.

**Changes in laws affecting the importation of salvage vehicles may have an adverse effect on our business and financial condition.**

Our Internet-based auction-style model has allowed us to offer our products and services to international markets and has increased our international buyer base. As a result, foreign importers of salvage vehicles now represent a significant part of our total buyer base. Changes in laws and regulations that restrict the importation of salvage vehicles into foreign countries may reduce the demand for salvage vehicles and impact our ability to maintain or increase our international buyer base. For example, in March 2008, a decree issued by the president of Mexico became effective that placed restrictions on the types of vehicles that can be imported into Mexico from the United States. The adoption of similar laws or regulations in other jurisdictions that have the effect of reducing or curtailing our activities abroad could have a material adverse effect on our consolidated results of operations and financial position by reducing the demand for our products and services.

**The operation of our storage facilities poses certain environmental risks, which could adversely affect our consolidated financial position, results of operations or cash flows.**

Our operations are subject to federal, state, national, provincial and local laws and regulations regarding the protection of the environment in the countries which we have storage facilities. In the salvage vehicle remarketing industry, large numbers of wrecked vehicles are stored at storage facilities and, during that time, spills of fuel, motor oil and other fluids may occur, resulting in soil, surface water or groundwater contamination. In addition, certain of our facilities generate and/or store petroleum products and other hazardous materials, including waste solvents and used oil. In the U.K., we provide vehicle de-pollution and crushing services for End-of-Life program vehicles. We could incur substantial expenditures for preventative, investigative or remedial action and could be exposed to liability arising from our operations, contamination by previous users of certain of our acquired facilities, or the disposal of our waste at off-site locations. Environmental laws and regulations could become more stringent over time and there can be no assurance that we or our operations will not be subject to significant costs in the future. Although we have obtained indemnification for pre-existing environmental liabilities from many of the persons and entities from whom we have acquired facilities, there can be no assurance that such indemnifications will be adequate. Any such expenditures or liabilities could have a material adverse effect on our consolidated results of operations and financial position.

**Adverse U.S. and international economic conditions may negatively affect our business, operating results, or financial condition.**

The capital and credit markets have historically experienced extreme volatility and disruption, which has in the past and may in the future lead to economic downturns in the U.S. and abroad. As a result of any economic downturn, the number of miles driven may decrease, which may lead to fewer accident claims, a reduction of vehicle repairs, and fewer salvage vehicles. Increases in unemployment, as a result of any economic downturn, may lead to an increase in the number of uninsured motorists. Uninsured motorists are responsible for disposition of their vehicle if involved in an accident, which disposition generally is either the repair or disposal of the vehicle. In the situation where the owner of the wrecked vehicle, and not an insurance company, is responsible for its disposition, we believe it is more likely that vehicle will be repaired or, if disposed, disposed through channels other than us. Adverse credit markets may also affect the ability of members to secure financing to purchase salvaged vehicles which may adversely affect demand. In addition, if the banking system or the financial markets deteriorate or remain volatile our credit facility may be affected. These adverse economic conditions and events may have a negative effect on our business, consolidated results of operations and financial position.

**If we determine that our goodwill has become impaired, we could incur significant charges that would have a material adverse effect on our consolidated results of operations.**

Goodwill represents the excess of cost over the fair market value of assets acquired in business combinations. In recent periods, the amount of goodwill on our consolidated balance sheet has increased substantially, principally as a

result of a series of acquisitions we have made in North America, Brazil, Germany, the U.A.E., and Spain in fiscal 2013. As of October 31, 2013, the amount of goodwill on our consolidated balance sheet subject to future impairment testing was \$281.4 million.

Pursuant to ASC 350, *Intangibles Goodwill and Other*, we are required to annually test goodwill and intangible assets with indefinite lives to determine if impairment has occurred. Additionally, interim reviews must be performed whenever events or changes in circumstances indicate that impairment may have occurred. If the testing performed indicates that impairment has occurred, we are required to record a non-cash impairment charge for the difference between the carrying value of the goodwill or other intangible assets and the implied fair value of the goodwill or other intangible assets in the period the determination is made. The testing of goodwill and other intangible assets for impairment requires us to make significant estimates about our future performance and cash flows, as well as other assumptions. These estimates can be affected by numerous factors, including changes in the definition of a business segment in which we operate; changes in economic, industry or market conditions; changes in business operations; changes in competition; or potential changes in the share price of our

common stock and market capitalization. Changes in these factors, or changes in actual performance compared with estimates of our future performance, could affect the fair value of goodwill or other intangible assets, which may result in an impairment charge. For example, continued deterioration in worldwide economic conditions could affect these assumptions and lead us to determine that goodwill impairment is required with respect to our acquisitions in North America, the U.K., Brazil, Germany, the U.A.E. or Spain. We cannot accurately predict the amount or timing of any impairment of assets. Should the value of our goodwill or other intangible assets become impaired, it could have a material adverse effect on our consolidated results of operations and could result in our incurring net losses in future periods.

**An adverse outcome of a pending Georgia sales tax audit could have a material adverse effect on our consolidated results of operations and financial condition.**

The Georgia Department of Revenue, or DOR, conducted a sales and use tax audit of our operations in Georgia for the period from January 1, 2007 through June 30, 2011. As a result of the audit, the DOR issued a notice of proposed assessment for uncollected sales taxes in which it asserted that we failed to remit sales taxes totaling \$73.8 million, including penalties and interest. In issuing the notice of proposed assessment, the DOR stated its policy position that sales for resale to non-U.S. registered resellers are subject to Georgia sales and use tax.

We have engaged a Georgia law firm and outside tax advisors to review the conduct of our business operations in Georgia, the notice of assessment, and the DOR's policy position. In particular, our outside legal counsel has provided us with an opinion that our sales for resale to non-U.S. registered resellers should not be subject to Georgia sales and use tax. In rendering its opinion, our counsel noted that non-U.S. registered resellers are unable to comply strictly with technical requirements for a Georgia certificate of exemption but concluded that our sales for resale to non-U.S. registered resellers should not be subject to Georgia sales and use tax notwithstanding this technical inability to comply.

Based on the opinion from our outside law firm and advice from outside tax advisors, we have adequately provided for the payment of this assessment in our consolidated financial statements. We believe we have strong defenses to the DOR's notice of proposed assessment and intend to defend this matter. We have filed a request for protest or administrative appeal with the State of Georgia. There can be no assurance, however, that this matter will be resolved in our favor or that we will not ultimately be required to make a substantial payment to the Georgia DOR. We understand that Georgia law and DOR regulations are ambiguous on many of the points at issue in the audit, and litigating and defending the matter in Georgia could be expensive and time-consuming and result in substantial management distraction. If the matter were to be resolved in a manner adverse to us, it could have a material adverse effect on our consolidated results of operations and financial position.

**New accounting pronouncements or new interpretations of existing standards could require us to make adjustments to accounting policies that could adversely affect the consolidated financial statements.**

The Financial Accounting Standards Board, the Public Company Accounting Oversight Board, and the SEC, from time to time issue new pronouncements or new interpretations of existing accounting standards that require changes to our accounting policies and procedures. To date, we do not believe any new pronouncements or interpretations have had a material adverse effect on our consolidated results of operations and financial position, but future pronouncements or interpretations could require a change or changes in our policies or procedures.

**Fluctuations in foreign currency exchange rates could result in declines in our reported revenues and earnings.**

Our reported revenues and earnings are subject to fluctuations in currency exchange rates. We do not engage in foreign currency hedging arrangements and, consequently, foreign currency fluctuations may adversely affect our revenues and earnings. Should we choose to engage in hedging activities in the future we cannot be assured our hedges will be effective or that the costs of the hedges will exceed their benefits. Fluctuations in the rate of exchange

between the U.S. dollar and foreign currencies, primarily the British pound, Canadian dollar, U.A.E. dirham, Brazilian real, and the Euro could adversely affect our consolidated results of operations and financial position.

**If the interest rate swaps entered into in connection with our credit facility prove ineffective, it could result in volatility in our operating results, including potential losses, which could have a material adverse effect on our results of operations and cash flows.**

We entered into two interest rate swaps to exchange our variable interest rate payment commitments for fixed interest rate payments on the Term Loan. The notional amount of the two derivative transactions amortizes \$18.8 million per quarter until September 30, 2015 and \$200 million on December 14, 2015. The first swap agreement fixed our interest rate with respect to a notional amount of \$275.0 million of our Term Loan, at 85 basis points plus the Applicable Rate as outlined in our Credit Facility Agreement. The second swap agreement fixed our interest rate with respect to a notional amount of \$75.0 million of our Term Loan, at 69 basis points plus the Applicable Rate as outlined in our Credit Facility Agreement. The Applicable Rate on our Credit Facility can fluctuate between 1.5% and 2.0% depending on our consolidated net leverage ratio (as defined in the Credit Facility) and at October 31, 2013 was 1.5%.

We recorded the swaps at fair value, and are currently designated as an effective cash flow hedge under ASC 815, *Derivatives and Hedging*. Each quarter, we measure hedge effectiveness using the "hypothetical derivative method" and record in earnings any gains or losses resulting from hedge ineffectiveness. The hedge provided by our swaps could prove to be ineffective for a number of reasons, including early retirement of the Term Loan, as is allowed under the Credit Facility, or in the event the counterparty to the interest rate swaps are determined in the future to not be creditworthy. Any determination that the hedge created by the swaps is ineffective could have a material adverse effect on our results of operations and cash flows and result in volatility in our operating results. In addition, any changes in relevant accounting standards relating to the swaps, especially ASC 815, *Derivatives and Hedging*, could materially increase earnings volatility.



The following table sets forth information concerning the number of shares of our common stock purchased by us during the three months ended October 31, 2013.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.