PRICESMART INC
Form 10-Q
April 09, 2014

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

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended February 28, 2014
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 0-22793
PriceSmart, Inc.
(Exact name of registrant as specified in its charter)

Delaware	33-0628530
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

9740 Scranton Road, San Diego, CA 92121
(Address of principal executive offices)

(858) 404-8800
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer ý Accelerated filer ¨ Non-accelerated filer ¨ Smaller Reporting Company ¨

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

The registrant had 30,205,589 shares of its common stock, par value $0.0001 per share, outstanding at March 31, 2014.

PRICESMART, INC.

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PART I—FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PriceSmart, Inc.'s ("PriceSmart" or the "Company") unaudited consolidated balance sheet as of February 28, 2014 and the consolidated balance sheet as of August 31, 2013, the unaudited consolidated statements of income for the three and six months ended February 28, 2014 and 2013, the unaudited consolidated statements of comprehensive income for the three and six months ended ended February 28, 2014 and 2013, the unaudited consolidated statements of equity for the six months ended February 28, 2014 and 2013, and the unaudited consolidated statements of cash flows for the six months ended February 28, 2014 and 2013, are included herein. Also included herein are the notes to the unaudited consolidated financial statements.

PRICESMART, INC.
CONSOLIDATED BALANCE SHEETS
(AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA)

	February 28, 2014 (Unaudited)	August 31, 2013
ASSETS		
Current Assets:		
Cash and cash equivalents	$75,337	$121,874
Short-term restricted cash	2,328	5,984
Receivables, net of allowance for doubtful accounts of $6 and $0 as of February 28, 2014 and August 31, 2013, respectively	3,614	3,130
Merchandise inventories	236,471	217,413
Deferred tax assets – current	6,219	6,290
Prepaid expenses and other current assets (includes $891 and $0 as of February 28, 2014 and August 31, 2013, respectively, for the fair value of derivative instruments)	24,654	20,890
Total current assets	348,623	375,581
Long-term restricted cash	26,760	34,775
Property and equipment, net	374,335	338,478
Goodwill	36,321	36,364
Deferred tax assets – long term	12,942	12,871
Other non-current assets (includes $1,969 and $1,505 as of February 28, 2014 and August 31, 2013, respectively, for the fair value of derivative instruments)	26,477	19,866
Investment in unconsolidated affiliates	8,858	8,104
Total Assets	$834,316	$826,039
LIABILITIES AND EQUITY		
Current Liabilities:		
Accounts payable	$194,959	$199,425
Accrued salaries and benefits	15,048	17,862
Deferred membership income	18,042	16,528
Income taxes payable	8,431	8,059
Other accrued expenses	18,115	20,136
Dividends payable	10,593	—
Long-term debt, current portion	18,887	12,757
Deferred tax liability – current	138	111
Total current liabilities	284,213	274,878
Deferred tax liability – long-term	3,107	2,622
Long-term portion of deferred rent	4,672	4,440
Long-term income taxes payable, net of current portion	1,978	2,184
Long-term debt, net of current portion	41,308	60,263
Other long-term liabilities (includes $0 and $14 for the fair value of derivative instruments and $645 and $589 for the defined benefit plans as of February 28, 2014 and August 31, 2013, respectively)	645	603
Total liabilities	335,923	344,990
Equity:		
Common stock, $0.0001 par value, 45,000,000 shares authorized; 30,943,763 and 30,924,392 shares issued and 30,205,586 and 30,234,506 shares outstanding (net of treasury shares) as of February 28, 2014 and August 31, 2013, respectively	3	3

Preferred stock $.0001 par value; 2,000,000 shares authorized; no shares issued and outstanding as of February 28, 2014 and August 31, 2013	—	—
Additional paid-in capital	394,020	390,581
Tax benefit from stock-based compensation	9,361	8,016
Accumulated other comprehensive loss	(52,914)	(41,475)
Retained earnings	172,418	143,871
Less: treasury stock at cost; 738,177 and 689,886 shares as of February 28, 2014 and August 31, 2013, respectively	(24,495)	(19,947)
Total equity	498,393	481,049
Total Liabilities and Equity	$834,316	$826,039

See accompanying notes.

PRICESMART, INC.
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED—AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

	Three Months Ended February 28,		Six Months Ended February 28,	
	2014	2013	2014	2013
Revenues:				
Net warehouse club sales	$657,167	$591,855	$1,246,861	$1,115,454
Export sales	6,764	6,323	12,485	9,396
Membership income	9,481	8,326	18,749	15,999
Other income	962	906	1,880	1,847
Total revenues	674,374	607,410	1,279,975	1,142,696
Operating expenses:				
Cost of goods sold:				
Net warehouse club	561,652	504,725	1,065,939	949,669
Export	6,423	5,986	11,864	8,821
Selling, general and administrative:				
Warehouse club operations	53,203	48,213	104,975	94,055
General and administrative	13,277	11,888	24,461	23,046
Pre-opening expenses	340	147	814	886
Loss/(gain) on disposal of assets	104	47	188	104
Total operating expenses	634,999	571,006	1,208,241	1,076,581
Operating income	39,375	36,404	71,734	66,115
Other income (expense):				
Interest income	193	446	374	740
Interest expense	(886)	(1,306)	(1,924)	(2,524)
Other income (expense), net	712	(265)	1,023	(264)
Total other expense	19	(1,125)	(527)	(2,048)
Income before provision for income taxes and income (loss) of unconsolidated affiliates	39,394	35,279	71,207	64,067
Provision for income taxes	(11,116)	(10,393)	(21,501)	(19,172)
Income (loss) of unconsolidated affiliates	—	(4)	4	(8)
Net income	$28,278	$24,882	$49,710	$44,887
Net income per share available for distribution:				
Basic net income per share	$0.93	$0.82	$1.64	$1.48
Diluted net income per share	$0.93	$0.82	$1.64	$1.48
Shares used in per share computations:				
Basic	29,724	29,626	29,707	29,609
Diluted	29,736	29,636	29,719	29,620
Dividends per share	$0.70	$—	$0.70	$0.60

See accompanying notes.

PRICESMART, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED—AMOUNTS IN THOUSANDS)

	Three Months Ended February 28,		Six Months Ended February 28,	
	2014	2013	2014	2013
Net income	$28,278	$24,882	$49,710	$44,887
Other Comprehensive Income, net of tax:				
Foreign currency translation adjustments [1]	$(13,661)	$(1,614)	$(12,372)	$(3,010)
Defined benefit pension plan:				
Net gain (loss) arising during period	8	2	11	3
Total defined benefit pension plan	8	2	11	3
Unrealized gains/(losses) on change in fair value of interest rate swaps[2]	1,065	(410)	922	(615)
Other comprehensive income (loss)	(12,588)	(2,022)	(11,439)	(3,622)
Comprehensive income	$15,690	$22,860	$38,271	$41,265

(1) Translation adjustments arising in translating the financial statements of a foreign entity have no effect on the income taxes of that foreign entity. They may, however, affect: (a) the amount, measured in the parent entity's reporting currency, of withholding taxes assessed on dividends paid to the parent entity and (b) the amount of taxes assessed on the parent entity by the government of its country. The Company has determined that the reinvestment of earnings of its foreign subsidiaries are indefinite because of the long-term nature of the Company's foreign investment plans. Therefore, deferred taxes are not provided for on translation adjustments related to unremitted earnings of the Company's foreign subsidiaries.

(2) See Note 9 - Derivative Instruments and Hedging Activities.

PRICESMART, INC.
CONSOLIDATED STATEMENTS OF EQUITY
(UNAUDITED—AMOUNTS IN THOUSANDS)

	Common Stock		Additional Paid-in	Tax Benefit From Stock Based	Accumulated Other Compre-hensive	Retained	Treasury Stock		Total
	Shares	Amount	Capital	Compen-sation	Income(Loss)	Earnings	Shares	Amount	Equity
Balance at August 31, 2012	30,856	$ 3	$ 384,154	$ 6,680	$ (33,182)	$ 77,739	645	$ (16,480)	$ 418,914
Purchase of treasury stock	—	—	—	—	—	—	42	(3,235)	(3,235)
Issuance of restricted stock award	12	—	—	—	—	—	—	—	—
Forfeiture of restricted stock awards	(1)	—	—	—	—	—	—	—	—
Exercise of stock options	3	—	47	—	—	—	—	—	47
Stock-based compensation	—	—	3,491	829	—	—	—	—	4,320
Dividend paid to stockholders	—	—	—	—	—	(9,065)	—	—	(9,065)
Dividend payable to stockholders	—	—	—	—	—	(9,065)	—	—	(9,065)
Net income	—	—	—	—	—	44,887	—	—	44,887
Other comprehensive income (loss)	—	—	—	—	(3,622)	—	—	—	(3,622)
Balance at February 28, 2013	30,870	$ 3	$ 387,692	$ 7,509	$ (36,804)	$ 104,496	687	$ (19,715)	$ 443,181
Balance at August 31, 2013	30,924	$ 3	$ 390,581	$ 8,016	$ (41,475)	$ 143,871	690	$ (19,947)	$ 481,049
Purchase of treasury stock	—	—	—	—	—	—	48	(4,548)	(4,548)
Issuance of restricted stock award	16	—	—	—	—	—	—	—	—
Forfeiture of restricted stock awards	(1)	—	—	—	—	—	—	—	—
Exercise of stock options	5	—	118	—	—	—	—	—	118
Stock-based compensation	—	—	3,321	1,345	—	—	—	—	4,666
Dividend paid to stockholders	—	—	—	—	—	(10,570)	—	—	(10,570)

Dividend payable to stockholders	—	—	—	—	—	(10,593)	—	—	(10,593)
Net income	—	—	—	—	—	49,710	—	—	49,710
Other comprehensive income (loss)	—	—	—	—	(11,439)	—	—	—	(11,439)
Balance at February 28, 2014	30,944	$ 3	$ 394,020	$ 9,361	$ (52,914)	$ 172,418	738	$ (24,495)	$ 498,393

See accompanying notes.

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PRICESMART, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED—AMOUNTS IN THOUSANDS)

	Six Months Ended February 28,	
	2014	2013
Operating Activities:		
Net income	$49,710	$44,887
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	13,793	11,715
Allowance for doubtful accounts	6	—
Loss on sale of property and equipment	188	104
Deferred income taxes	1,857	2,031
Excess tax (benefit) on stock-based compensation	(1,345)	(829)
Equity in (gains)/losses of unconsolidated affiliates	(4)	8
Stock-based compensation	3,321	3,491
Change in operating assets and liabilities:		
Change in receivables, prepaid expenses and other current assets, accrued salaries and benefits, deferred membership income and other accruals	(12,839)	(4,853)
Merchandise inventories	(19,058)	(18,411)
Accounts payable	81	22,974
Net cash provided by operating activities	35,710	61,117
Investing Activities:		
Additions to property and equipment	(58,096)	(38,676)
Deposits for land purchase option agreements	(850)	—
Proceeds from disposal of property and equipment	42	61
Capital contributions to joint ventures	(750)	(550)
Net cash flows (used in) investing activities	(59,654)	(39,165)
Financing Activities:		
Proceeds from bank borrowings	—	3,979
Repayment of bank borrowings	(12,012)	(3,757)
Cash dividend payments	(10,570)	(9,065)
Release of restricted cash	8,000	2,000
Excess tax benefit on stock-based compensation	1,345	829
Purchase of treasury stock	(4,548)	(3,235)
Proceeds from exercise of stock options	118	47
Net cash (used in) financing activities	(17,667)	(9,202)
Effect of exchange rate changes on cash and cash equivalents	(4,926)	(2,796)
Net (decrease) increase in cash and cash equivalents	(46,537)	9,954
Cash and cash equivalents at beginning of period	121,874	91,248
Cash and cash equivalents at end of period	$75,337	$101,202
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest, net of amounts capitalized	$1,893	$2,357
Income taxes	$22,326	$18,090
Supplemental non-cash item:		
Dividends declared but not paid	$10,593	$9,065

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PRICESMART, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
February 28, 2014

NOTE 1 – COMPANY OVERVIEW AND BASIS OF PRESENTATION

PriceSmart, Inc.'s ("PriceSmart" or the "Company") business consists primarily of international membership shopping warehouse clubs similar to, but smaller in size than, warehouse clubs in the United States. As of February 28, 2014, the Company had 32 consolidated warehouse clubs in operation in 12 countries and one U.S. territory (six in Costa Rica, four each in Panama and Trinidad, three each in Colombia, Guatemala and in the Dominican Republic, two each in El Salvador and Honduras and one each in Aruba, Barbados, Jamaica, Nicaragua and the United States Virgin Islands), of which the Company owns 100% of the corresponding legal entities (see Note 2 - Summary of Significant Accounting Policies). During fiscal 2013, the Company opened its second and third clubs in Colombia. These clubs are in south and north Cali and opened in October 2012 and May 2013, respectively. On January 8, 2014, the Company acquired land in the southern area of Pereira, Colombia, upon which the Company plans to construct a new warehouse club that is currently planned to open in November 2014. On January 30, 2014, the Company acquired land in the city of Medellin, Colombia and leased land in the city of Bogota, Colombia, upon which the Company plans to construct new warehouse clubs. These warehouse clubs are currently planned to open before the end of calendar year 2014. Together with the three warehouse clubs currently operating in Colombia (one in Barranquilla and two in Cali), these three new clubs will bring the number of PriceSmart warehouse clubs operating in Colombia to six. In October 2013, the Company opened its sixth membership warehouse club in Costa Rica in La Union, Cartago. Additionally, in February 2013, the Company acquired land in Tegucigalpa, Honduras upon which it anticipates opening its third warehouse club in Honduras in May 2014. The Company continues to explore other potential sites for future warehouse clubs in Central America, the Caribbean and Colombia. The warehouse club sales and membership sign-ups experienced with the opening of the Barranquilla and Cali warehouse clubs have reinforced the Company's belief that Colombia could be a market for additional PriceSmart warehouse clubs in other Colombian cities.

Basis of Presentation - The interim consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q for interim financial reporting pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the fiscal year ended August 31, 2013 (the "2013 Form 10-K"). The interim consolidated financial statements include the accounts of PriceSmart, Inc., a Delaware corporation, and its subsidiaries. Inter-company transactions between the Company and its subsidiaries have been eliminated in consolidation.

In accordance with the Financial Accounting Standards Board's ("FASB") revised guidance establishing general accounting standards and disclosure of subsequent events, the Company has evaluated subsequent events through the date and time these financial statements were issued.

Reclassifications to consolidated statement of income recorded during fiscal year 2014 for fiscal year 2013 - The Company recorded asset disposal activity during fiscal year 2013 under other income (expense), net. This activity consisted mainly of normally scheduled asset replacement and upgrades involved in operating activities. The Company has determined that these costs represent operating expenses. Therefore, the Company has accordingly recorded such asset disposal activity as operating expenses under loss/(gain) on disposal of assets starting in fiscal year 2014. The Company has made reclassifications to the consolidated statement of income for fiscal year 2013 to conform to the presentation in fiscal year 2014. These reclassifications did not impact net income. The following tables summarize the impact of this reclassification (in thousands):

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PRICESMART, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	Fiscal Year 2013 Three Months Ended November 30, 2012	February 28, 2013	May 31, 2013	August 31, 2013	Total Fiscal Year 2013
Other income (expense), net – as previously reported	$(58)	$(312)	$(1,034)	$(439)	$(1,843)
Loss/(gain) on disposal of assets, other income (expense), net reclassified to Loss/(gain) on disposal of assets, total operating expenses	57	47	249	536	889
Other income (expense), net – as currently reported	$(1)	$(265)	$(785)	$97	$(954)

	Three Months Ended November 30, 2012	February 28, 2013	May 31, 2013	August 31, 2013	Total Fiscal Year 2013
Composition of beginning balance of other income (expense) – as previously reported:					
Gain/(loss) on sale	$(57)	$(47)	$(249)	$(536)	$(889)
Currency gain/(loss)	(1)	(265)	(785)	97	(954)
Total	$(58)	$(312)	$(1,034)	$(439)	$(1,843)
Composition of ending balance of other income (expense) – as currently reported:					
Gain/(loss) on sale	$—	$—	$—	$—	$—
Currency gain/(loss)	(1)	(265)	(785)	97	(954)
Total	$(1)	$(265)	$(785)	$97	$(954)

2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation – The interim consolidated financial statements of the Company included herein include the assets, liabilities and results of operations of the Company's wholly owned subsidiaries and the Company's investment in, and the Company's share of the income (loss) of, joint ventures recorded under the equity method. All significant inter-company accounts and transactions have been eliminated in consolidation. The interim consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the SEC, and reflect all adjustments (consisting of normal recurring adjustments) that are, in the opinion of management, necessary to fairly present the financial position, results of operations, and cash flows for the periods presented. The results for interim periods are not necessarily indicative of the results for the full year. As of February 28, 2014, all of the Company's subsidiaries were wholly owned. Additionally, the Company's ownership interest in real estate development joint ventures as of February 28, 2014 is listed below:

Real Estate Development Joint Ventures	Countries	Ownership		Basis of Presentation
GolfPark Plaza, S.A.	Panama	50.0	%	Equity[1]
Price Plaza Alajuela PPA, S.A.	Costa Rica	50.0	%	Equity[1]

(1) Joint venture interests are recorded as investment in unconsolidated affiliates on the consolidated balance sheets.

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PRICESMART, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Use of Estimates – The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Variable Interest Entities – The Company reviews and determines at the start of each arrangement, or subsequently if a reconsideration event occurs, whether any of its investments in joint ventures are a Variable Interest Entity ("VIE") and whether it must consolidate a VIE and/or disclose information about its involvement in a VIE. The Company has determined that the joint ventures for GolfPark Plaza (Panama) and Price Plaza Alajuela (Costa Rica) are VIEs. The Company has determined that it is not the primary beneficiary of the VIEs and, therefore, has accounted for these entities under the equity method.

Cash and Cash Equivalents – Cash and cash equivalents represent cash and short-term investments with maturities of three months or less when purchased and proceeds due from credit and debit card transactions, which are generally settled within a few days of the underlying transaction.

Restricted Cash – The changes in restricted cash are disclosed within the consolidated statement of cash flows based on the nature of the restriction. The following table summarizes the restricted cash reported by the Company (in thousands):

	February 28, 2014	August 31, 2013
Short-term restricted cash:		
Restricted cash for Honduras loan	$ 1,200	$ 1,200
Restricted cash in Honduras for purchase of property	200	3,148
Restricted cash for land purchase option agreements	850	1,599
Other short-term restricted cash (1)	78	37
Total short-term restricted cash	$ 2,328	$ 5,984
Long-term restricted cash:		
Restricted cash for Honduras loan	$ 1,720	$ 1,720
Restricted cash for Colombia bank loans	24,000	32,000
Other long-term restricted cash (1)	1,040	1,055
Total long-term restricted cash	$ 26,760	$ 34,775
Total restricted cash	$ 29,088	$ 40,759

(1) Other short-term and long-term restricted cash consists mainly of cash deposits held within banking institutions in compliance with federal regulatory requirements in Costa Rica and Panama.

PRICESMART, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Value Added Tax Receivable - The Company pays Value Added Tax (“VAT”) or similar taxes (“input VAT”) within the normal course of its business in most of the countries it operates in on merchandise and/or services it acquires. The Company also collects VAT or similar taxes on behalf of the government (“output taxes”) for merchandise and/or services it sells. If the output VAT exceeds the input VAT, then the difference is remitted to the government, usually on a monthly basis. If the input VAT exceeds the output VAT, this creates a VAT receivable. The Company either requests a refund of this VAT receivable or applies the balance to expected future VAT payables. In some countries where the Company operates, the governments have implemented additional collection procedures, such as requiring credit card processors to remit a portion of sales processed via credit card directly to the government. These procedures alter the natural offset of input and output VAT and generally leaves the Company with a net VAT receivable, forcing the Company to process significant refund claims on a recurring basis. These refund processes can take anywhere from several months to several years to complete.

In most countries where the Company operates, the VAT refund process is defined and structured with regular refunds or offsets. However, in one country the government has alleged that there is no defined process in the law to allow them to refund this VAT receivable. The Company together with its tax and legal advisers is currently appealing this interpretation in court and based on recent favorable jurisprudence on this matter, expects to prevail. Additionally, the government has recently begun an audit to verify the amount of this receivable as a required precursor to any refund. Therefore, the Company has not placed any type of allowance on the recoverability of this VAT receivable. The balance of the VAT receivable in this country was $4.7 million and $4.3 million as of February 28, 2014 and August 31, 2013, respectively.

The Company's policy for classification and presentation of VAT receivables is as follows:

•Short-term VAT receivables, recorded as Other current assets: This classification is used for any countries where the Company's subsidiary has generally demonstrated the ability to recover the VAT receivable within one year. The Company also classifies as short-term any approved refunds or credit notes to the extent that the Company expects to receive the refund or use the credit notes within one year.

•Long-term VAT receivables, recorded as Other non-current assets: This classification is used for amounts not approved for refund or credit in countries where the Company's subsidiary has not demonstrated the ability to obtain refunds within one year and/or for amounts which are subject to outstanding disputes. An allowance is provided against VAT balances in dispute when the Company does not expect to eventually prevail in its recovery. The following table summarizes the VAT receivables reported by the Company (in thousands):

	February 28, 2014	August 31, 2013
Prepaid expenses and other current assets	$ 5,304	$ 5,458
Other non-current assets	$ 16,610	$ 12,875

Lease Accounting – Certain of the Company's operating leases where the Company is the lessee (see Revenue Recognition Policy for lessor accounting) provide for minimum annual payments that increase over the expected life of the lease. The aggregate minimum annual payments are expensed on the straight-line basis beginning when the Company takes possession of the property and extending over the expected term of the related lease including renewal options when the exercise of the option is reasonably assured as an economic penalty may be incurred if the option is not exercised. The amount by which straight-line rent exceeds actual lease payment requirements in the early years of the leases is accrued as deferred rent and reduced in later years when the actual cash payment requirements exceed the straight-line expense. The Company also accounts in its straight-line computation for the effect of any “rental holidays” and lessor-paid tenant improvements. In addition to the minimum annual payments, in certain locations, the Company pays additional contingent rent based on a contractually stipulated percentage of sales.

Merchandise Inventories - Merchandise inventories, which include merchandise for resale, are valued at the lower of cost (average cost) or market. The Company provides for estimated inventory losses and obsolescence between physical inventory counts on the basis of a percentage of sales. The provision is adjusted periodically to reflect the trend of actual physical inventory count results, with physical inventories occurring primarily in the second and fourth fiscal quarters. In addition, the Company may be required to take markdowns below the carrying cost of certain inventory to expedite the sale of such merchandise.

PRICESMART, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Fair Value Measurements – The Company measures the fair value for all financial and nonfinancial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements on a recurring or nonrecurring basis. The fair value of an asset is the price at which the asset could be sold in an orderly transaction between unrelated, knowledgeable and willing parties able to engage in the transaction. A liability's fair value is defined as the amount that would be paid to transfer the liability to a new obligor in a transaction between such parties, not the amount that would be paid to settle the liability with the creditor.

The Company has established a three-tier fair value hierarchy, which prioritizes the inputs used in measuring and revaluing fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions. The Company was not required to revalue any assets or liabilities utilizing Level 1 or Level 3 inputs at the balance sheet dates. The Company's Level 2 assets and liabilities revalued at the balance sheet dates, on a recurring basis, primarily included cash flow hedges (interest rate swaps and cross-currency interest rate swaps) and forward foreign exchange contracts. In addition, the Company utilizes Level 2 inputs in determining the fair value of long-term debt. The Company has elected not to revalue long-term debt because this debt will be settled at the carrying value and not at the fair market value. The Company did not make any significant transfers in and out of Level 1 and Level 2 fair value tiers during the periods reported on herein.

Nonfinancial assets and liabilities are revalued and recognized at fair value subsequent to initial recognition when there is evidence of impairment. For the periods reported, no impairment of such nonfinancial assets was recorded.

The disclosure of fair value of certain financial assets and liabilities recorded at cost is as follows:

Cash and cash equivalents: The carrying value approximates fair value due to the short maturity of these instruments.

Short-term restricted cash: The carrying value approximates fair value due to the short maturity of these instruments.

Long-term restricted cash: Long-term restricted cash primarily consists of auto renewable 3-12 month certificates of deposit, which are held as collateral on our long-term debt. The carrying value approximates fair value due to the short maturity of the underlying certificates of deposit.

Accounts receivable: The carrying value approximates fair value due to the short maturity of these accounts.

Short-term debt: The carrying value approximates fair value due to the short maturity of these instruments.

Long-term debt: The fair value of debt is generally measured using a discounted cash flow analysis based on current market interest rates for similar types of financial instruments. These inputs are not quoted prices in active markets but they are either directly or indirectly observable; therefore, they are classified as Level 2 inputs. The carrying value and fair value of the Company's debt as of February 28, 2014 and August 31, 2013 is as follows (in thousands):

	February 28, 2014		August 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value

Long-term debt, including current portion	$60,195	$60,710	$73,020	$72,576

Derivatives Instruments and Hedging Activities - The Company uses derivative financial instruments for hedging and non-trading purposes to manage its exposure to changes in interest and currency exchange rates. In using derivative financial instruments for the purpose of hedging the Company's exposure to interest and currency exchange rate risks, the contractual terms of a hedged instrument closely mirror those of the hedged item, providing a high degree of risk reduction and correlation. Contracts that are effective at meeting the risk reduction and correlation criteria (effective hedge) are recorded using hedge accounting. If a derivative financial instrument is an effective hedge, changes in the fair value of the instrument will be offset in accumulated other comprehensive income (loss) until the hedged item completes its contractual term. If any portion of the hedge is deemed

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ineffective, the change in fair value of the hedged assets or liabilities will be immediately recognized in earnings during the period. Instruments that do not meet the criteria for hedge accounting, or contracts for which the Company has not elected hedge accounting, are valued at fair value with unrealized gains or losses reported in earnings during the period of the change. Valuation techniques utilized in the fair value measurement of assets and liabilities presented on the Company's consolidated balance sheets were not changed from previous practice during the reporting period.

Cash Flow Instruments. The Company is a party to receive floating interest rate, pay fixed-rate interest rate swaps to hedge the interest rate risk of certain U.S. denominated debt within its international subsidiaries whose functional currency is other than the U.S dollar. The swaps are designated as cash flow hedges of interest expense risk. These instruments are considered effective hedges and are recorded using hedge accounting. The Company is also a party to receive variable interest rate, pay fixed interest rate cross-currency interest rate swaps to hedge the interest rate and currency exposure associated with the expected payments of principal and interest of U.S. denominated debt within its international subsidiaries whose functional currency is other than the U.S dollar. The swaps are designated as cash flow hedges of the currency risk related to payments on the U.S. denominated debt. These instruments are also considered to be effective hedges and are recorded using hedge accounting. Under cash flow hedging, the effective portion of the fair value of the derivative, calculated as the net present value of the future cash flows, is deferred on the consolidated balance sheets in accumulated other comprehensive loss. If any portion of an interest rate swap is determined to be an ineffective hedge, the gains or losses from changes in fair value would be recorded directly in the consolidated statements of income. For cash flow hedges that were previously considered effective and are now considered ineffective hedges, amounts previously recorded in accumulated other comprehensive gain or loss are released to earnings in the same period that the hedged transaction has been determined to be ineffective and impacts consolidated earnings. See Note 9 - Derivative Instruments and Hedging Activities for information on the fair value of interest rate swaps and cross-currency interest rate swaps as of February 28, 2014 and August 31, 2013.

Fair Value Instruments. The Company is exposed to foreign-currency exchange-rate fluctuations in the normal course of business. The Company is also exposed to foreign-currency exchange-rate fluctuations on U.S. dollar denominated liabilities within its international subsidiaries whose functional currency is other than the U.S. dollar. The Company manages these fluctuations, in part, through the use of non-deliverable forward foreign-exchange contracts that are intended to offset changes in cash flow attributable to currency exchange movements. The contracts are intended primarily to economically address exposure to U.S. dollar merchandise inventory expenditures made by the Company's international subsidiaries whose functional currency is other than the U.S. dollar. Currently, these contracts are treated for accounting purposes as fair value instruments and do not qualify for derivative hedge accounting. As a result, these contracts are valued at fair value with unrealized gains or losses reported in earnings during the period of the change. The Company seeks to mitigate foreign-currency exchange-rate risk with the use of these contracts and does not intend to engage in speculative transactions. These contracts do not contain any credit-risk-related contingent features.

The Company seeks to manage counterparty risk associated with these contracts by limiting transactions to counterparties with which the Company has an established banking relationship. There can be no assurance, however, that this practice effectively mitigates counterparty risk. The contracts are limited to less than one year in duration. See Note 9 - Derivative Instruments and Hedging Activities for information on the fair value of open, unsettled forward foreign-exchange contracts as of February 28, 2014 and August 31, 2013.

The following table summarizes financial assets and liabilities measured and recorded at fair value on a recurring basis in the Company's consolidated balance sheet as of February 28, 2014 and August 31, 2013 (in thousands) for derivatives that qualify for hedge accounting:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Assets and Liabilities as of February 28, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Prepaid expenses and other current assets (Cross-currency interest rate swaps)	$—	$ 891	$—	$ 891
Other non-current assets - (Cross-currency interest rate swaps)	—	1,969	—	1,969
Other long-term liabilities – (Interest rate swaps)	—	—	—	—
Other long-term liabilities – (Cross-currency interest rate swaps)	—	—	—	—
Total	$—	$ 2,860	$—	$ 2,860

Assets and Liabilities as of August 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Prepaid expenses and other current assets (Cross-currency interest rate swaps)	$—	$—	$—	$—
Other non-current assets - (Cross-currency interest rate swaps)	—	1,505	—	1,505
Other long-term liabilities – (Interest rate swaps)	—	(14)	—	(14)
Other long-term liabilities – (Cross-currency interest rate swaps)	—	—	—	—
Total	$—	$ 1,491	$—	$ 1,491

The following table summarizes financial assets and liabilities measured and recorded at fair value on a recurring basis in the Company's consolidated balance sheet as of February 28, 2014 and August 31, 2013 (in thousands) for derivatives that do not qualify for hedge accounting:

Assets and Liabilities as of February 28, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Prepaid expenses and other current assets (Foreign currency forward contracts)	$—	$ 1	$—	$ 1

Other accrued expenses (Foreign currency forward contracts)	—	(55)	—	(55)
Net fair value of derivatives designated as hedging instruments that do not qualify for hedge accounting	$ &#82			