COSTCO WHOLESALE CORP /NEW
Form 10-Q
June 07, 2018
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## UNITED STATES

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549
FORM 10-Q

## QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended May 13, 2018
or
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission file number 0-20355
Costco Wholesale Corporation
(Exact name of registrant as specified in its charter)
Washington 91-1223280
(State or other jurisdiction of incorporation or organization)
(I.R.S. Employer Identification No.)

999 Lake Drive, Issaquah, WA 98027
(Address of principal executive offices) (Zip Code)
(Registrant's telephone number, including area code): (425) 313-8100
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
( $\$ 232.405$ 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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Emerging growth company
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) 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
The number of shares outstanding of the issuer's common stock as of May 30,2018 was $438,541,544$.

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## PART I—FINANCIAL INFORMATION

Item 1-Financial Statements
COSTCO WHOLESALE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(amounts in millions, except par value and share data)
(unaudited)

|  | $\begin{aligned} & \text { May 13, } \\ & 2018 \end{aligned}$ | September 3, 2017 |
| :---: | :---: | :---: |
| ASSETS |  |  |
| CURRENT ASSETS |  |  |
| Cash and cash equivalents | \$5,877 | \$ 4,546 |
| Short-term investments | 1,167 | 1,233 |
| Receivables, net | 1,593 | 1,432 |
| Merchandise inventories | 10,626 | 9,834 |
| Other current assets | 430 | 272 |
| Total current assets | 19,693 | 17,317 |
| PROPERTY AND EQUIPMENT |  |  |
| Land | 6,093 | 5,690 |
| Buildings and improvements | 15,786 | 15,127 |
| Equipment and fixtures | 7,161 | 6,681 |
| Construction in progress | 1,070 | 843 |
|  | 30,110 | 28,341 |
| Less accumulated depreciation and amortization | (10,932) | (10,180 |
| Net property and equipment | 19,178 | 18,161 |
| OTHER ASSETS | 734 | 869 |
| TOTAL ASSETS | \$39,605 | \$ 36,347 |
| LIABILITIES AND EQUITY |  |  |
| CURRENT LIABILITIES |  |  |
| Accounts payable | \$ 10,705 | \$ 9,608 |
| Accrued salaries and benefits | 2,697 | 2,703 |
| Accrued member rewards | 1,041 | 961 |
| Deferred membership fees | 1,679 | 1,498 |
| Other current liabilities | 3,289 | 2,725 |
| Total current liabilities | 19,411 | 17,495 |
| LONG-TERM DEBT, excluding current portion | 6,492 | 6,573 |
| OTHER LIABILITIES | 1,255 | 1,200 |
| Total liabilities | 27,158 | 25,268 |
| COMMITMENTS AND CONTINGENCIES |  |  |
| EQUITY |  |  |
| Preferred stock $\$ .01$ par value; 100,000,000 shares authorized; no shares issued and outstanding | 0 | 0 |
| Common stock $\$ .01$ par value; 900,000,000 shares authorized; 438,602,000 and 437,204,000 shares issued and outstanding | 4 | 4 |
| Additional paid-in capital | 6,001 | 5,800 |
| Accumulated other comprehensive loss | (1,038 | (1,014 |

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| Retained earnings | 7,176 | 5,988 |
| :--- | :--- | :--- |
| Total Costco stockholders' equity | 12,143 | 10,778 |
| Noncontrolling interests | 304 | 301 |
| Total equity | 12,447 | 11,079 |
| TOTAL LIABILITIES AND EQUITY | $\$ 39,605$ | $\$ 36,347$ |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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## COSTCO WHOLESALE CORPORATION <br> CONDENSED CONSOLIDATED STATEMENTS OF INCOME <br> (amounts in millions, except per share data) <br> (unaudited)

## REVENUE

Net sales
Membership fees
Total revenue
OPERATING EXPENSES
Merchandise costs
Selling, general and administrative
Preopening expenses
Operating income
OTHER INCOME (EXPENSE)
Interest expense
Interest income and other, net
INCOME BEFORE INCOME TAXES
Provision for income taxes
Net income including noncontrolling interests
Net income attributable to noncontrolling interests
NET INCOME ATTRIBUTABLE TO COSTCO
NET INCOME PER COMMON SHARE ATTRIBUTABLE TO COSTCO:
Basic
Diluted
Shares used in calculation (000's):
Basic
Diluted
CASH DIVIDENDS DECLARED PER COMMON SHARE
$\left.\left.\begin{array}{llll}12 \text { Weeks Ended } \\ \text { May 13, } & \text { May } 7, \\ 2018 & 2017 & \begin{array}{l}\text { May } 13, \\ 2018\end{array} & \begin{array}{l}\text { May } 7, \\ 2017\end{array} \\ & & & \\ \$ 31,624 & \$ 28,216 & \$ 95,020 & \$ 84,815 \\ 737 & 644 & 2,145 & 1,910 \\ 32,361 & 28,860 & 97,165 & 86,725 \\ & & & \\ 28,131 & 24,970 & 84,481 & 75,185 \\ 3,155 & 2,907 & 9,613 & 8,827 \\ 8 & 15 & 37 & 52 \\ 1,067 & 968 & 3,034 & 2,661 \\ & & & \\ (37 & (21 & )(111 & )(81 \\ 41 & 18 & 70 & 40 \\ 1,071 & 965 & 2,993 & 2,620 \\ 309 & 259 & 867 & 838 \\ 762 & 706 & 2,126 & 1,782 \\ 12 & (6 & ) & (35\end{array}\right) \begin{array}{l}(22\end{array}\right)$

The accompanying notes are an integral part of these condensed consolidated financial statements.
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The accompanying notes are an integral part of these condensed consolidated financial statements.
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## COSTCO WHOLESALE CORPORATION <br> CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS <br> (amounts in millions) <br> (unaudited)

36 Weeks Ended May 13, May 7, 20182017
CASH FLOWS FROM OPERATING ACTIVITIES
Net income including noncontrolling interests
Adjustments to reconcile net income including noncontrolling interests to net cash provided by operating activities:
Depreciation and amortization $\quad 1,006 \quad 929$
Stock-based compensation
Other non-cash operating activities, net
Deferred income taxes
Changes in operating assets and liabilities:
Merchandise inventories
Accounts payable
Other operating assets and liabilities, net
Net cash provided by operating activities
CASH FLOWS FROM INVESTING ACTIVITIES
Purchases of short-term investments
Maturities and sales of short-term investments
Additions to property and equipment
Other investing activities, net
Net cash used in investing activities
431404
(3 ) (66 )
(21) 47
(828 ) (952 )

CASH FLOWS FROM FINANCING ACTIVITIES
Change in bank checks outstanding
(23 ) (243 )
Repayments of long-term debt
Tax withholdings on stock-based awards
(58 ) (1,100)
Repurchases of common stock (217 ) (202 )

Cash dividend payments
(238 ) (236 )
Other financing activities, net
Net cash used in financing activities
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS
Net change in cash and cash equivalents
CASH AND CASH EQUIVALENTS BEGINNING OF YEAR
(439 ) (396 )

CASH AND CASH EQUIVALENTS END OF PERIOD
(39 ) 36
$(1,014)(2,141)$
(23 ) (42 )
1,331 1,159
4,546 3,379
\$5,877 \$4,538
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:
Cash paid during the first thirty-six weeks of year for:
Interest (reduced by $\$ 11$ and $\$ 12$ for interest capitalized in 2018 and 2017, respectively) \$81 \$99
Income taxes, net \$779
\$529
SUPPLEMENTAL DISCLOSURE OF NON-CASH FINANCING ACTIVITIES:
Cash dividend declared, but not yet paid

The accompanying notes are an integral part of these condensed consolidated financial statements.
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## COSTCO WHOLESALE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in millions, except share, per share, and warehouse count data)
(unaudited)
Note 1—Summary of Significant Accounting Policies
Description of Business
Costco Wholesale Corporation (Costco or the Company), a Washington corporation, and its subsidiaries operate membership warehouses and e-commerce websites based on the concept that offering its members low prices on a limited selection of nationally branded and private-label merchandise in a wide range of categories will produce high sales volumes and rapid inventory turnover. At May 13, 2018, Costco operated 749 warehouses worldwide: 519 United States (U.S.) locations (in 44 states, Washington, D.C., and Puerto Rico), 98 Canada locations, 38 Mexico locations, 28 United Kingdom (U.K.) locations, 26 Japan locations, 14 Korea locations, 13 Taiwan locations, nine Australia locations, two Spain locations, one Iceland location, and one France location. The Company operates e-commerce websites in the U.S., Canada, Mexico, U.K., Korea, and Taiwan.
Basis of Presentation
The condensed consolidated financial statements include the accounts of Costco, its wholly-owned subsidiaries, and subsidiaries in which it has a controlling interest. The Company reports noncontrolling interests in consolidated entities as a component of equity separate from the Company's equity. All material inter-company transactions between and among the Company and its consolidated subsidiaries have been eliminated in consolidation. The Company's net income excludes income attributable to the noncontrolling interest in Taiwan. During the first quarter of 2018 , Costco purchased its former joint venture partner's remaining equity interest in its Korean operations. Unless otherwise noted, references to net income relate to net income attributable to Costco.
These unaudited condensed 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 Securities and Exchange Commission (SEC). While these statements reflect all normal recurring adjustments that are, in the opinion of management, necessary for fair presentation of the results of the interim period, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (U.S. GAAP) for complete financial statements. Therefore, the interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company's Annual Report filed on Form 10-K for the fiscal year ended September 3, 2017.
Fiscal Year End
The Company operates on a $52 / 53$ week fiscal year basis, with the fiscal year ending on the Sunday closest to August 31. Fiscal 2018 is a 52-week year ending on September 2, 2018. References to the third quarters of 2018 and 2017 relate to the 12 -week fiscal quarters ended May 13, 2018, and May 7, 2017, respectively. References to the first thirty-six weeks of 2018 and 2017 relate to the thirty-six weeks ended May 13, 2018, and May 7, 2017, respectively. Use of Estimates
The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. Actual results and events could differ from those estimates and assumptions.

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Note 1—Summary of Significant Accounting Policies (Continued)

## Fair Value of Financial Instruments

The Company accounts for certain assets and liabilities at fair value. The carrying value of the Company's financial instruments, including cash and cash equivalents, receivables and accounts payable, approximate fair value due to their short-term nature or variable interest rates. See Notes 2, 3, and 4 for the carrying value and fair value of the Company's investments, derivative instruments, and fixed-rate debt, respectively.
Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is estimated by applying a fair value hierarchy, which requires maximizing the use of observable inputs when measuring fair value. The three levels of inputs are:
Level 1: Quoted market prices in active markets for identical assets or liabilities.
Level 2: Observable market-based inputs or unobservable inputs that are corroborated by market data.
Level 3: Significant unobservable inputs that are not corroborated by market data.
Current financial liabilities have fair values that approximate their carrying values. Long-term financial liabilities include the Company's long-term debt, which are recorded on the balance sheet at issuance price and adjusted for unamortized discounts or premiums and debt issuance costs, which are amortized to interest expense over the term of the loan. There have been no material changes to the valuation techniques utilized in the fair value measurement of assets and liabilities as disclosed in the Company's 2017 Form 10-K.
Merchandise Inventories
Merchandise inventories are stated at the lower of cost or market. U.S. merchandise inventories are valued by the cost method of accounting, using the last-in, first-out (LIFO) basis. The Company believes the LIFO method more fairly presents the results of operations by more closely matching current costs with current revenues. The Company records adjustments quarterly, if necessary, for the projected annual effect of inflation or deflation, and these estimates are adjusted at fiscal year-end, after actual inflation rates and inventory levels have been determined. Canadian and Other International merchandise inventories are predominantly valued using the cost and retail inventory methods, respectively, using the first-in, first-out (FIFO) basis.
As of May 13, 2018, and September 3, 2017, U.S. merchandise inventories valued at LIFO approximated FIFO after considering the lower of cost or market principle.
Derivatives
The Company is exposed to foreign-currency exchange-rate fluctuations in the normal course of business. It manages these fluctuations, in part, through the use of forward foreign-exchange contracts, seeking to economically hedge the impact of fluctuations of foreign exchange on known future expenditures denominated in a non-functional foreign currency. The contracts relate primarily to U.S. dollar merchandise inventory expenditures made by the Company's international subsidiaries, whose functional currency is not the U.S. dollar. These contracts do not qualify for derivative hedge accounting. The Company seeks to mitigate risk with the use of these contracts and does not intend to engage in speculative transactions. Some of these contracts contain credit-risk-related contingent features that require settlement of outstanding contracts upon certain triggering events. At May 13, 2018, and September 3, 2017, the aggregate fair value amounts of derivative instruments in a net liability position and the amount needed to settle the instruments immediately if the credit-risk-related contingent features were triggered were immaterial. The aggregate notional amounts of unsettled forward foreign-exchange contracts were $\$ 663$ and $\$ 637$ at May 13, 2018, and September 3, 2017, respectively. 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 that this practice is effective. The contracts are limited to less than one year in duration. See Note 3 for information on the fair value of unsettled forward foreign-exchange contracts as of May 13, 2018, and September 3, 2017.
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## Note 1—Summary of Significant Accounting Policies (Continued)

The unrealized gains or losses recognized in interest income and other, net in the accompanying condensed consolidated statements of income relating to the net changes in the fair value of unsettled forward foreign-exchange contracts was a net gain of $\$ 24$ in the third quarter of 2018 and immaterial in the third quarter of 2017. The net changes in fair value of unsettled forward foreign-exchange contracts during the first thirty-six weeks of 2018 and 2017 were immaterial.
The Company is exposed to fluctuations in prices for the energy it consumes, particularly electricity and natural gas, which it seeks to partially mitigate through the use of fixed-price contracts for certain of its warehouses and other facilities, primarily in the U.S. and Canada. The Company also enters into variable-priced contracts on an index basis for some purchases of natural gas and fuel for its gas stations. These contracts meet the characteristics of derivative instruments, but generally qualify for the "normal purchases or normal sales" exception under authoritative guidance and require no mark-to-market adjustment.

## Foreign Currency

The Company recognizes foreign-currency transaction gains and losses related to revaluing or settling monetary assets and liabilities denominated in currencies other than the functional currency in interest income and other, net in the accompanying condensed consolidated statements of income. Generally, these include the U.S. dollar cash and cash equivalents and the U.S. dollar payables of consolidated subsidiaries revalued to their functional currency. Also included are realized foreign-currency gains or losses from settlements of forward foreign-exchange contracts. The net changes related to these items were immaterial in the third quarter and first thirty-six weeks of 2018 and 2017. Stock Repurchase Programs
Repurchased shares of common stock are retired, in accordance with the Washington Business Corporation Act. The par value of repurchased shares is deducted from common stock and the excess repurchase price over par value is deducted by allocation to additional paid-in capital and retained earnings. The amount allocated to additional paid-in capital is the current value of additional paid-in capital per share outstanding and is applied to the number of shares repurchased. Any remaining amount is allocated to retained earnings. See Note 5 for additional information.
Recent Accounting Pronouncements Adopted
In March 2016, the Financial Accounting Standards Board (FASB) issued guidance intended to simplify accounting for share-based payment transactions. The guidance relates to income taxes, forfeitures, and minimum statutory tax withholding requirements. The new standard was effective for fiscal years and interim periods within those years beginning after December 15, 2016, with early adoption permitted. The Company adopted this guidance at the beginning of its first quarter of fiscal year 2018. As a result, in the first thirty-six weeks of 2018 the Company recognized an excess tax benefit of $\$ 33$ as part of its income tax provision in the accompanying condensed consolidated statements of income. Previously these amounts were reflected in equity. Additionally, these amounts are now reflected as cash flows from operations instead of cash flows from financing activities in the consolidated statements of cash flows on a prospective basis. Adoption of this guidance did not have a material impact on the consolidated balance sheets, consolidated statements of cash flows, or related disclosures.
Recent Accounting Pronouncements Not Yet Adopted
In May 2014, the FASB issued guidance on the recognition of revenue from contracts with customers. The guidance converges the requirements for reporting revenue and requires disclosures sufficient to describe the nature, amount, timing, and uncertainty of revenue and cash flows. The new standard is effective for fiscal years and interim periods within those years beginning after December 15, 2017. The Company plans to adopt this guidance at the beginning of its first quarter of fiscal 2019, using the modified retrospective approach through a cumulative effect adjustment to retained earnings.

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Note 1—Summary of Significant Accounting Policies (Continued)
The Company has substantially completed its assessment of the new standard and it does not believe the impacts to be material to the Company's consolidated financial statements. The Company continues to evaluate the disclosure requirements related to the new standard.
In February 2016, the FASB issued guidance on leases, which will require recognition on the balance sheet for the rights and obligations created by leases with terms greater than twelve months. The standard is effective for fiscal years and interim periods within those years beginning after December 15, 2018, with early adoption permitted. The Company plans to adopt this guidance at the beginning of its first quarter of fiscal 2020. While the Company continues to evaluate this standard and the effect on related disclosures, the primary effect of adoption will be to require recording right-of-use assets and corresponding lease obligations for current operating leases. The adoption is expected to have a material impact on the Company's consolidated balance sheets, but not on the consolidated statements of income or consolidated statements of cash flows.
Note 2-Investments
The Company's investments were as follows:
$\begin{array}{lll}\text { May 13, 2018: } & \text { Cost } & \text { Unrealized Recorded } \\ & \text { Basis } & \text { Loss, Net Basis }\end{array}$
Available-for-sale:
Government and agency securities \$914 \$ (17 ) \$897
Held-to-maturity:
Certificates of deposit 270270
Total short-term investments
\$1,184 \$ (17 ) \$ 1,167
September 3, 2017: Cost Unrealized Recorded
Available-for-sale:
Government and agency securities \$947 \$ 0 \$ 947
$\begin{array}{lllll}\text { Mortgage-backed securities } & 1 & 0 & 1\end{array}$
Total available-for-sale $948 \quad 0 \quad 948$
Held-to-maturity:
Certificates of deposit 285285
Total short-term investments $\quad \$ 1,233 \$ 0 \quad \$ 1,233$
At May 13, 2018, and September 3, 2017, available-for-sale securities with continuous unrealized-loss positions were immaterial. There were no sales of available-for-sale securities during the third quarter of 2018. Proceeds from sales of available-for-sale securities were $\$ 121$ during the third quarter of 2017. Proceeds from sales of available-for-sale securities were $\$ 39$ and $\$ 187$ during the first thirty-six weeks of 2018 and 2017, respectively. Gross unrealized and realized gains or losses for the quarter and first thirty-six weeks of 2018 and 2017 were immaterial.

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Note 2—Investments (Continued)

The maturities of available-for-sale and held-to-maturity securities at May 13, 2018, were as follows:

|  | Available-For-Sale |  | Held-To-Maturity |  |
| :--- | :--- | :--- | :--- | :--- |
|  | Cost BasisFair Value | Hel |  |  |
|  | $\$ 207$ | $\$ 206$ | $\$$ | 270 |
| Due in one year or less | 687 | 672 | 0 |  |
| Due after one year through five years | 20 | 19 | 0 |  |
| Due after five years | $\$ 914$ | $\$ 897$ | $\$$ | 270 |

Note 3-Fair Value Measurement
Assets and Liabilities Measured at Fair Value on a Recurring Basis
The tables below present information regarding financial assets and financial liabilities that are measured at fair value on a recurring basis and indicate the level within the hierarchy reflecting the valuation techniques utilized to determine fair value.
May 13, 2018: Level 1 Level 2
Money market mutual funds ${ }^{(1)} \quad \$ \quad 8 \quad \$ 0$
Investment in government and agency securities ${ }^{(2)} \quad 0 \quad 907$
Forward foreign-exchange contracts, in asset position ${ }^{(3)} \quad 0 \quad 10$
Forward foreign-exchange contracts, in (liability) position ${ }^{(3)} 0 \quad$ (3 )
Total \$ 8 $\quad \$ 914$

| September 3, 2017: | Level 1 | Level |  |
| :--- | :--- | :--- | :--- |
| Money market mutual funds |  |  |  |
| (1) | $\$$ | 7 | $\$ 0$ |
| Investment in government and agency securities ${ }^{(2)}$ | 0 |  | 947 |
| Investment in mortgage-backed securities | 0 |  | 1 |
| Forward foreign-exchange contracts, in asset position $^{(3)}$ | 0 |  | 2 |
| ${\text { Forward foreign-exchange contracts, in (liability) } \text { position }^{(3)}}^{2}$ | 0 |  | $(8)$ |
| Total | $\$$ | 7 | $\$ 942$ |

(1) Included in cash and cash equivalents in the accompanying condensed consolidated balance sheets.

At May 13, 2018, $\$ 10$ and $\$ 897$ were included in cash and cash equivalents and short-term investments, respectively, in the accompanying condensed consolidated balance sheets. At September 3, 2017, there were no
securities included in cash and cash equivalents and $\$ 947$ included in short-term investments in the accompanying condensed consolidated balance sheets.
The asset and the liability values are included in other current assets and other current liabilities, respectively, in
(3)the accompanying condensed consolidated balance sheets. See Note 1 for additional information on derivative instruments.
During and at the periods ended May 13, 2018, and September 3, 2017, the Company did not hold any Level 3 financial assets or liabilities that were measured at fair value on a recurring basis. There were no transfers in or out of Level 1 or 2 during the third quarter or first thirty-six weeks of 2018 or 2017.
Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis
Assets and liabilities recognized and disclosed at fair value on a nonrecurring basis include items such as financial assets recorded at amortized cost and long-lived nonfinancial assets. These assets are measured at fair value if determined to be impaired. There were no fair value adjustments to these items during the third quarter or first thirty-six weeks of 2018 or 2017.

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Note 4—Debt
The carrying value of the Company's long-term debt consisted of the following:
May 13, September 3, 20182017
1.70\% Senior Notes due December 2019 \$ 1,198 \$ 1,198
1.75\% Senior Notes due February 2020499498
2.15\% Senior Notes due May 2021995994
2.25\% Senior Notes due February 2022498497
2.30\% Senior Notes due May 2022794793
2.75\% Senior Notes due May 2024992991
3.00\% Senior Notes due May 2027986986

Other long-term debt $649 \quad 702$
Total long-term debt 6,611 6,659
Less current portion $119 \quad 86$
Long-term debt, excluding current portion $\$ 6,492$ \$ 6,573
The estimated fair value of Senior Notes is valued using Level 2 inputs. Other long-term debt consists primarily of promissory notes and term loans issued by the Company's Japan subsidiary and are valued primarily using Level 3 inputs. The fair value of the Company's long-term debt, including the current portion, was approximately $\$ 6,493$ and $\$ 6,753$ at May 13, 2018, and September 3, 2017, respectively.
Note 5-Equity and Comprehensive Income
Dividends
The Company's current quarterly dividend rate is $\$ 0.57$ per share, compared to $\$ 0.50$ per share in the third quarter of 2017. On April 24, 2018, the Board of Directors declared a quarterly cash dividend in the amount of $\$ 0.57$ per share, which was paid on May 25, 2018.
Stock Repurchase Programs
Stock repurchase activity during the third quarter and first thirty-six weeks of 2018 and 2017 is summarized below:

|  | Shares <br> Repurchased <br> $(000 ' s)$ | Average <br> Price <br> per | Total <br> Share |
| :--- | :--- | :--- | :--- |
|  | Cost |  |  |

These amounts may differ from the stock repurchase balances in the accompanying condensed consolidated statements of cash flows due to changes in unsettled stock repurchases at the end of a quarter. The remaining amount available for stock repurchases under our approved plan, which expires in April 2019, was \$2,516 at May 13, 2018. Purchases are made from time-to-time, as conditions warrant, in the open market or in block purchases and pursuant to plans under SEC Rule 10b5-1.

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Note 5-Equity and Comprehensive Income (Continued)
Components of Equity and Comprehensive Income
The following tables show the changes in equity attributable to Costco and the noncontrolling interests of consolidated subsidiaries:

Equity at September 3, 2017
Attributable Noncontrolling Total

Comprehensive income:
Net income
2,091 $35 \quad 2,126$

Foreign-currency translation adjustment and other, net
Comprehensive income
Stock-based compensation
to Costco Interests Equity
\$ 10,778 \$ 301 \$11,079

Release of vested restricted stock units (RSUs), including tax effects
Repurchases of common stock

| $(24$ | $)$ | 2 |
| :--- | :--- | :--- |
| 2,067 | 37 | $(22$ |
| 2,104 |  |  |

Cash dividends declared and other
$434 \quad 0 \quad 434$

Equity at May 13, 2018
(217 ) 0 (217 )
(233 ) 0 (233 )
(686 ) (34 ) (720 )
\$ 12,143 \$ 304 \$12,447

| Attributable | Noncontrolling Total <br> to Costco | Interests | Equity |
| :--- | :--- | :--- | :--- |
| \$ 12,079 | $\$$ | 253 | $\$ 12,332$ |

Equity at August 28, 2016
\$ 12,079 \$ 253 \$12,332
Comprehensive income:

| Net income | 1,760 | 22 | 1,782 |  |
| :--- | :--- | :--- | :--- | :--- |
| Foreign-currency translation adjustment and other, net | $(222$ | $)$ | 12 | $(210$ |
| Comprehensive income | 1,538 | 34 | 1,572 |  |
| Stock-based compensation | 404 | 0 | 404 |  |
| Release of vested RSUs, including tax effects | $(165$ | $)$ | 0 | $(165$ |
| Repurchases of common stock | $(233$ | $)$ | 0 | $(233)$ |
| Cash dividends declared and other | $(3,725$ | $)$ | 0 | $(3,725)$ |
| Equity at May 7, 2017 | $\$ 9,898$ | $\$ 287$ | $\$ 10,185$ |  |

Note 6-Stock-Based Compensation
The Seventh Restated 2002 Stock Incentive Plan authorized the issuance of 23,500,000 shares ( $13,429,000$ RSUs) of common stock for future grants in addition to the shares authorized under the previous plan. The Company issues new shares of common stock upon vesting of RSUs. Shares for vested RSUs are generally delivered to participants annually, net of shares withheld for statutory taxes.

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Note 6-Stock-Based Compensation (Continued)
Summary of Restricted Stock Unit Activity
At May 13, 2018, 8,262,000 shares were available to be granted as RSUs and the following awards were outstanding: 7,305,000 time-based RSUs that vest upon continued employment over specified periods of time;
127,000 performance-based RSUs, granted to executive officers of the Company, for which the performance targets have been met. The awards vest upon continued employment over specified periods of time; and
205,000 performance-based RSUs, granted to executive officers of the Company, subject to achievement of performance targets for fiscal 2018, as determined by the Compensation Committee of the Board of Directors after the end of the fiscal year. These awards are included in the table below and the Company has recognized compensation expense for these awards as it is currently deemed probable that the targets will be achieved.
The following table summarizes RSU transactions during the first thirty-six weeks of 2018:
Number of Weighted-Average
Units Grant Date Fair
(in 000's) Value
Outstanding at September 3, 2017 8,199 \$ 128.15
$\begin{array}{lll}\text { Granted } & 3,722 & 156.19\end{array}$
Vested and delivered $\quad(4,080) 129.49$
Forfeited (204 ) 138.42
Outstanding at May 13, 2018 7,637 \$ 140.83
The remaining unrecognized compensation cost related to non-vested RSUs at May 13, 2018, was $\$ 819$, and the weighted-average period over which this cost will be recognized is 1.7 years.
Summary of Stock-Based Compensation
The following table summarizes stock-based compensation expense and the related tax benefits under the Company's plans:

| 12 Weeks | 36 Weeks |  |
| :--- | :--- | :--- |
| Ended | Ended |  |
| May 1BIay 7, | May 13May 7, |  |
| 2018 | 2017 | 2018 |
| 2017 |  |  |
| $\$ 85$ | $\$ 82$ | $\$ 431$ |

(1)For 2018, the tax benefit reflects the reduction in the U.S. federal statutory income tax rate from $35 \%$ to $21 \%$.

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Note 7-Income Taxes
In December 2017, the Tax Cuts and Jobs Act (the " 2017 Tax Act") was signed into law. Except for certain provisions, the 2017 Tax Act is effective for tax years beginning on or after January 1, 2018. The Company is a fiscal-year taxpayer, so most provisions will become effective for fiscal 2019, including limitations on the Company's ability to claim foreign tax credits, repeal of the domestic manufacturing deduction, and limitations on certain business deductions. Provisions with significant impacts that were effective starting in the second quarter of fiscal 2018 and throughout the remainder of fiscal 2018 include: a decrease in the U.S. federal income tax rate, remeasurement of certain net deferred tax liabilities, and a transition tax on deemed repatriation of certain foreign earnings. The decrease in the U.S. federal statutory income tax rate to $21 \%$ will result in a blended rate for the Company of $25.6 \%$ for fiscal 2018.

During the first thirty-six weeks of 2018, the Company recognized net tax benefits of $\$ 131$ related to the 2017 Tax Act, including the impact of lowering the U.S. federal corporate rate. This benefit also included discrete tax expense of $\$ 142$ for the estimated tax on deemed repatriation of foreign earnings, and $\$ 43$ for the reduction in foreign tax credits and other immaterial items, largely offset by a tax benefit of $\$ 160$ for the provisional remeasurement of certain deferred tax liabilities. These items were predominantly recorded in the second quarter as provisional amounts to reflect the Company's current interpretations and estimates that it believes are reasonable. As the Company continues to evaluate the 2017 Tax Act and available data, it anticipates that adjustments may be made in future periods up to and including the first quarter of fiscal 2019.
The determination of the Company's provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws, all of which are subject to continuing review.
Note 8-Net Income per Common and Common Equivalent Share
The following table shows the amounts used in computing net income per share and the weighted average number of shares of potentially dilutive common shares outstanding (shares in 000's):

Net income attributable to Costco

| 12 Weeks | 36 Weeks |
| :--- | :--- |
| Ended | Ended |

May 1May 7, May 13,May 7, 2018201720182017
\$750 \$ $700 \quad \$ 2,091$ \$1,760
Weighted average number of common shares used in basic net income per common share
RSUs and other
438,741B8,817 438,576438,650

Weighted average number of common shares and dilutive potential of common stock used in diluted net income per share

2,975 2,239 2,807 2,095

Note 9-Commitments and Contingencies
Legal Proceedings
The Company is involved in a number of claims, proceedings and litigation arising from its business and property ownership. In accordance with applicable accounting guidance, the Company establishes an accrual for legal proceedings if and when those matters reach a stage where they present loss contingencies that are both probable and reasonably estimable. There may be exposure to loss in excess of any amounts accrued. The Company monitors those matters for developments that would affect the likelihood of a loss (taking into account where applicable indemnification arrangements concerning suppliers and insurers) and the accrued amount, if any, thereof, and adjusts the amount as appropriate. As of the date of this Report, the Company has recorded an immaterial accrual with respect to one matter described below, in addition to

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Note 9-Commitments and Contingencies (Continued)
other immaterial accruals for matters not described below. If the loss contingency at issue is not both probable and reasonably estimable, the Company does not establish an accrual, but will continue to monitor the matter for developments that will make the loss contingency both probable and reasonably estimable. In each case, there is a reasonable possibility that a loss may be incurred, including a loss in excess of the applicable accrual. For matters where no accrual has been recorded, the possible loss or range of loss (including any loss in excess of the accrual) cannot, in the Company's view, be reasonably estimated because, among other things: (i) the remedies or penalties sought are indeterminate or unspecified; (ii) the legal and/or factual theories are not well developed; and/or (iii) the matters involve complex or novel legal theories or a large number of parties.
The Company is a defendant in a class action alleging violation of California Wage Order 7-2001 for failing to provide seating to member service assistants who act as greeters and exit attendants in the Company's California warehouses. Canela v. Costco Wholesale Corp., et al. (Case No. 5:13-cv-03598, N.D. Cal. filed July 1, 2013). The complaint seeks relief under the California Labor Code, including civil penalties and attorneys' fees. The Company filed an answer denying the material allegations of the complaint. The plaintiff has since indicated that exit attendants are no longer a subject of the litigation.
On November 23, 2016, the Company's Canadian subsidiary received from the Ontario Ministry of Health and Long Term Care a request for an inspection and information concerning compliance with the anti-rebate provisions in the Ontario Drug Benefit Act and the Drug Interchangeability and Dispensing Fee Act. The Company is seeking to cooperate with the request. The Ministry has indicated it has reason to believe the Company received payments in violation of these laws.

In December 2017, the United States Judicial Panel on Multidistrict Litigation ordered consolidated numerous cases filed against various defendants by counties, cities, hospitals, Native American tribes and third-party payors concerning the impacts of opioid abuse. In re National Prescription Opiate Litigation (MDL No. 2804) (N.D. Ohio). Included are federal court cases that name the Company, including actions filed by several counties and cities in Michigan, a city in New Jersey, and a third-party payor in Ohio. Similar cases that name the Company have been filed in state courts in New Jersey and Oklahoma. The Company is defending all of these matters.
In November 2016 and September 2017, the Company received notices of violation from the Connecticut Department of Energy and Environmental Protection regarding hazardous waste practices at its Connecticut warehouses, primarily concerning unsalable pharmaceuticals. The Company is seeking to cooperate concerning the resolution of these notices.
The Company does not believe that any pending claim, proceeding or litigation, either alone or in the aggregate, will have a material adverse effect on the Company's financial position, results of operations or cash flows; however, it is possible that an unfavorable outcome of some or all of the matters, however unlikely, could result in a charge that might be material to the results of an individual fiscal quarter.

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Note 10—Segment Reporting
The Company and its subsidiaries are principally engaged in the operation of membership warehouses in the U.S., Canada, Mexico, U.K., Japan, Korea, Australia, Spain, Iceland and France and through a majority-owned subsidiary in Taiwan. Reportable segments are largely based on management's organization of the operating segments for operational decisions and assessments of financial performance, which consider geographic locations. The material accounting policies of the segments are as described in the notes to the consolidated financial statements included in the Company's Annual Report filed on Form 10-K for the fiscal year ended September 3, 2017, and Note 1 above. Inter-segment net sales and expenses have been eliminated in computing total revenue and operating income. Certain operating expenses, predominantly stock-based compensation, are incurred on behalf of the Company's Canadian and Other International Operations, but are included in the U.S. Operations because those costs are not allocated internally and generally come under the responsibility of the Company's U.S. management team.

| United States <br> Operations | Canadian <br> Operations | Other <br> International <br> Operations |  |
| :--- | :--- | :--- | :--- |
|  |  |  |  |
| $\$ 23,475$ | $\$ 4,647$ | $\$ 4,239$ | $\$ 32,361$ |
| 682 | 210 | 175 | 1,067 |
| 242 | 31 | 54 | 327 |
| 468 | 42 | 75 | 585 |
|  |  |  |  |
| $\$ 21,172$ | $\$ 4,069$ | $\$ 3,619$ | $\$ 28,860$ |
| 654 | 172 | 142 | 968 |
| 245 | 28 | 47 | 320 |
| 363 | 40 | 137 | 540 |
|  |  |  |  |
| $\$ 69,975$ | $\$ 14,163$ | $\$ 13,027$ | $\$ 97,165$ |
| 1,818 | 652 | 564 | 3,034 |
| 756 | 94 | 156 | 1,006 |
| 1,323 | 156 | 434 | 1,913 |
| 12,924 | 1,829 | 4,425 | 19,178 |
| 27,062 | 4,248 | 8,295 | 39,605 |
|  |  |  |  |
| $\$ 63,313$ | $\$ 12,397$ | $\$ 11,015$ | $\$ 86,725$ |
| 1,680 | 543 | 438 | 2,661 |
| 712 | 81 | 136 | 929 |
| 1,147 | 206 | 370 | 1,723 |
| 12,139 | 1,612 | 3,784 | 17,535 |
| 24,356 | 4,014 | 7,261 | 35,631 |
|  |  |  |  |
| $\$ 93,889$ | $\$ 18,775$ | $\$ 16,361$ | $\$ 129,025$ |
| 2,644 | 841 | 626 | 4,111 |
| 1,044 | 124 | 202 | 1,370 |
| 1,714 | 277 | 511 | 2,502 |
| 12,339 | 1,820 | 4,002 | 18,161 |
| 24,068 | 4,471 | 7,808 | 36,347 |

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Item 2-Management's Discussion and Analysis of Financial Condition and Results of Operations (amounts in millions, except per share, share, and warehouse count data)

## FORWARD-LOOKING STATEMENTS

Certain statements contained in this Report constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. They include statements that address activities, events, conditions or developments that we expect or anticipate may occur in the future and may relate to such matters as net sales growth, increases in comparable warehouse sales, cannibalization of existing locations by new openings, price or fee changes, earnings performance, earnings per share, stock-based compensation expense, warehouse openings and closures, capital spending, the effect of accounting standards, future financial reporting, financing, margins, return on invested capital, strategic direction, expense controls, membership renewal rates, shopping frequency, litigation, and the demand for our products and services. Forward-looking statements may also be identified by the words "believe," "project," "expect," "anticipate," "estimate," "intend," "strategy," "future," "opportunity," "plan," "may," "should," "will," "would," "will be," "wi likely result," and similar expressions. Forward-looking statements involve risks and uncertainties that may cause actual events, results, or performance to differ materially from those indicated by such statements. These risks and uncertainties include, but are not limited to, domestic and international economic conditions, including exchange rates, the effects of competition and regulation, uncertainties in the financial markets, consumer and small business spending patterns and debt levels, breaches of security or privacy of member or business information, conditions affecting the acquisition, development, ownership or use of real estate, capital spending, actions of vendors, rising costs associated with employees (generally including health care costs), energy and certain commodities, geopolitical conditions (including tariffs), and other risks identified from time to time in our public statements and reports filed with the SEC. Forward-looking statements speak only as of the date they are made, and we do not undertake to update these statements, except as required by law.
This management discussion should be read in conjunction with the management discussion included in our fiscal 2017 Annual Report on Form 10-K, previously filed with the SEC.

## OVERVIEW

We operate membership warehouses and e-commerce websites based on the concept that offering our members low prices on a limited selection of nationally branded and private-label products in a wide range of merchandise categories will produce high sales volumes and rapid inventory turnover. When combined with the operating efficiencies achieved by volume purchasing, efficient distribution and reduced handling of merchandise in no-frills, self-service warehouse facilities, these volumes and turnover enable us to operate profitably at significantly lower gross margins (net sales less merchandise costs) than most other retailers.
We believe that the most important driver of our profitability is sales growth, particularly comparable warehouse sales (comparable sales) growth. We define comparable sales as sales from warehouses open for more than one year, including remodels, relocations and expansions, as well as online sales related to e-commerce websites operating for more than one year. Comparable sales growth is achieved through increasing shopping frequency from new and existing members and the amount they spend on each visit (average ticket). Sales comparisons can also be particularly influenced by certain factors that are beyond our control: fluctuations in currency exchange rates (with respect to the consolidation of the results of our international operations); and changes in the cost of gasoline and associated competitive conditions (primarily impacting our U.S. and Canadian operations). The higher our comparable sales exclusive of these items, the more we can leverage certain of our selling, general and administrative expenses, reducing them as a percentage of sales and enhancing profitability. Generating comparable sales growth is foremost a question of making available to our members the right merchandise at the right prices, a skill that we believe we have repeatedly demonstrated over the long term. Another substantial factor in sales growth is the health of the economies in which we do business, including the effects of inflation or deflation, especially the United States. Sales growth and gross margins are also impacted by our competition, which is vigorous and widespread, across a wide range of global,
national and regional wholesalers and retailers. While we cannot control or

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Item 2-Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued) (amounts in millions, except per share, share, and warehouse count data)
reliably predict general economic health or changes in competition, we believe that we have been successful historically in adapting our business to these changes, such as through adjustments to our pricing and to our merchandise mix, including increasing the penetration of our private label items, and through our online offerings. Our philosophy is to provide our members with quality goods and services at the most competitive prices. We do not focus in the short term on maximizing prices charged, but instead seek to maintain what we believe is a perception among our members of our "pricing authority" - consistently providing the most competitive values. Our investments in merchandise pricing can, from time to time, include reducing prices on merchandise to drive sales or meet competition and holding prices steady despite cost increases instead of passing the increases on to our members, all negatively impacting near-term gross margin as a percentage of net sales (gross margin percentage). We believe that our gasoline business draws members, but it generally has a significantly lower gross margin percentage relative to our non-gasoline business. A higher penetration of gasoline sales will generally lower our gross margin percentage. Rapidly changing gasoline prices may significantly impact our near-term net sales growth. Generally, rising gasoline prices benefit net sales growth which, given the higher sales base, negatively impacts our gross margin percentage but decreases our selling, general and administrative (SG\&A) expenses as a percentage of net sales. A decline in gasoline prices has the inverse effect. We do not operate our lower-margin gasoline business in Korea and France.
We also achieve sales growth by opening new warehouses. As our warehouse base grows, available and desirable potential sites become more difficult to secure, and square footage growth becomes a comparatively less substantial component of growth. The negative aspects of such growth, however, including lower initial operating profitability relative to existing warehouses and cannibalization of sales at existing warehouses when openings occur in existing markets, are increasingly less significant relative to the results of our total operations. Our rate of square footage growth is generally higher in foreign markets, due to the smaller base in those markets, and we expect that to continue. Our e-commerce business growth both domestically and internationally has also increased our sales.
Our membership format is an integral part of our business model and has a significant effect on our profitability. This format is designed to reinforce member loyalty and provide continuing fee revenue. The extent to which we achieve growth in our membership base, increase the penetration of our Executive members, and sustain high renewal rates materially influences our profitability. Paid membership growth is adversely impacted when warehouse openings occur in existing markets.
Our financial performance depends heavily on our ability to control costs. While we believe that we have achieved successes in this area historically, some significant costs are partially outside our control, most particularly health care and utility expenses. With respect to expenses relating to the compensation of our employees, our philosophy is not to seek to minimize their wages and benefits. Rather, we believe that achieving our longer-term objectives of reducing employee turnover and enhancing employee satisfaction requires maintaining compensation levels that are better than the industry average for much of our workforce. This may cause us, for example, to absorb costs that other employers might seek to pass through to their workforces. Because our business is operated on very low margins, modest changes in various items in the income statement, particularly merchandise costs and selling, general and administrative expenses, can have substantial impacts on net income.
Our operating model is generally the same across our U.S., Canada, and Other International operating segments (see Part I, Item 1, Note 10 of this Report). Certain countries in the Other International segment have relatively higher rates of square footage growth, lower wages and benefits costs as a percentage of country sales, and/or less or no direct membership warehouse competition.
In discussions of our consolidated operating results, we refer to the impact of changes in foreign currencies relative to the U.S. dollar, which are references to the differences between the foreign-exchange rates we use to convert the financial results of our international operations from local currencies into U.S. dollars for financial reporting purposes. This impact of foreign-exchange rate changes is calculated based on the

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difference between the current period's currency exchange rates and that of the comparable prior period. The impact of changes in gasoline prices on net sales is calculated based on the difference between the current period's average price per gallon sold and that of the comparable prior period.
Our fiscal year ends on the Sunday closest to August 31. References to the third quarters of 2018 and 2017 relate to the 12 -week fiscal quarters ended May 13, 2018, and May 7, 2017, respectively. References to the first thirty-six weeks of 2018 and 2017 relate to the first thirty-six weeks ended May 13, 2018, and May 7, 2017, respectively. Certain percentages presented are calculated using actual results prior to rounding. Unless otherwise noted, references to net income relate to net income attributable to Costco.
Key items for the third quarter of 2018 as compared to the third quarter of 2017 include:
Net sales increased $12 \%$ to $\$ 31,624$, driven by an increase in comparable sales of $10 \%$ and sales at 20 net new warehouses opened since the end of the third quarter of fiscal 2017;
Membership fee revenue increased $14 \%$ to $\$ 737$, primarily due to the fee increase and sign-ups at existing and new warehouses;

Gross margin percentage decreased 46 basis points, due to the impact of gasoline price inflation on net sales, a

- shift in sales penetration to certain lower margin warehouse ancillary businesses from our core merchandise categories, and lower gross margin in our core merchandise categories;
SG\&A expenses as a percentage of net sales decreased 32 basis points, due to the impact of gasoline price inflation and leveraging increased net sales;
Net income increased $7 \%$ to $\$ 750$, or $\$ 1.70$ per diluted share, compared to $\$ 700$, or $\$ 1.59$ per diluted share in 2017. The prior year results were positively impacted by an $\$ 82$ tax benefit, or $\$ 0.19$ per diluted share;
On April 24, 2018, our Board of Directors declared a quarterly cash dividend of $\$ 0.57$ per share, an increase from $\$ 0.50$ per share, which was paid on May 25, 2018; and
Subsequent to the end of the quarter, we announced that effective in June 2018, a portion of the savings generated from the Tax Cuts and Jobs Act (the "2017 Tax Act") will be used to benefit the majority of our U.S. hourly employees by increasing their wages. The estimated annualized pre-tax cost of these increases is approximately $\$ 110-\$ 120$.


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## RESULTS OF OPERATIONS

Net Sales

## Net Sales

| 12 Weeks Ended | 36 Weeks Ended |  |  |
| :--- | :--- | :--- | :--- |
| May 13, | May 7, | May 13, | May 7, |
| 2018 | 2017 | 2018 | 2017 |
| $\$ 31,624$ | $\$ 28,216$ | $\$ 95,020$ | $\$ 84,815$ |

Changes in net sales:

| U.S. | 11 | $\%$ | 8 | $\%$ | 11 | $\%$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| 5 | $\%$ | $\%$ |  |  |  |  |
| Canada | 14 | $\%$ | 5 | $\%$ | 14 | $\%$ |
| 7 | $\%$ |  |  |  |  |  |
| Other International | 17 | $\%$ | 8 | $\%$ | 18 | $\%$ |
| 4 | $\%$ |  |  |  |  |  |
| Total Company | 12 | $\%$ | 8 | $\%$ | 12 | $\%$ |

Changes in comparable sales excluding the impact of changes in foreign exchange rates and gasoline prices:

| U.S. | 8 | $\%$ | 5 | $\%$ | 7 | $\%$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Canada | 5 | $\%$ | 3 | $\%$ | $\%$ | $\%$ |
| 3 | $\%$ |  |  |  |  |  |
| Other International | 6 | $\%$ | 6 | $\%$ | 7 | $\%$ |
| 4 | $\%$ |  |  |  |  |  |
| Total Company | 7 | $\%$ | 5 | $\%$ | 7 | $\%$ |
|  |  | 3 | $\%$ |  |  |  |

Net Sales
Net sales increased $\$ 3,408$ or $12 \%$, and $\$ 10,205$ or $12 \%$ during the third quarter and first thirty-six weeks of 2018, respectively, compared to the third quarter and first thirty-six weeks of 2017. These increases were attributable to an increase in comparable sales of $10 \%$ in the third quarter and thirty-six weeks of 2018 and sales at the 20 net new warehouses opened since the end of the third quarter of 2017.

During the third quarter of 2018, changes in gasoline prices positively impacted net sales by approximately $\$ 504$, or 179 basis points, due to a $17 \%$ increase in the average sales price per gallon. Changes in foreign currencies relative to the U.S. dollar positively impacted net sales by approximately $\$ 412$, or 146 basis points, compared to the third quarter of 2017, attributable to our Canadian and Other International operations.

During the first thirty-six weeks of 2018, changes in gasoline prices positively impacted net sales by approximately $\$ 1,283$, or 151 basis points, due to a $16 \%$ increase in the average sales price per gallon.
Changes in foreign currencies relative to the U.S. dollar positively impacted net sales by approximately $\$ 1,254$, or 148 basis points, compared to the first thirty-six weeks of 2017, attributable to our Canadian and Other International operations.
Comparable Sales
Comparable sales increased $10 \%$ in the third quarter and first thirty-six weeks of 2018 and were positively impacted by increases in shopping frequency and average ticket. Comparable sales for the third quarter and

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first thirty-six weeks of 2018 were negatively impacted by cannibalization (established warehouses losing sales to our newly opened locations).
Membership Fees

Membership fees

| 12 Weeks Ended | 36 Weeks Ended |  |
| :---: | :---: | :---: |
| May 13, May 7, | May 13, | May 7, |
| 20182017 | 2018 | 2017 |
| \$737 \$644 | \$2,145 | \$1,910 |
| 2.33 \% 2.28 \% | 2.26 \% | 2.25 \% |
| 50,900 48,600 | - | - |
| 93,000 88,900 | - | - |

Total cardholders as of quarter end ( 000 's) $93,00088,900-\quad$ -
Membership fees increased $14 \%$ and $12 \%$ in the third quarter and first thirty-six weeks of 2018, respectively. This was primarily due to the fee increase (discussed below) and sign-ups at existing and new warehouses. Renewal rates are $90 \%$ in the U.S. and Canada and $87 \%$ worldwide.
As previously reported, in fiscal 2017 we increased our annual membership fees in certain of our Other International operations and in the U.S. and Canada. We account for membership fee revenue on a deferred basis, recognized ratably over the one-year membership period. These fee increases had a positive impact on revenues during the third quarter and first thirty-six weeks of 2018 of approximately $\$ 48$ and $\$ 109$ respectively, and will positively impact the next several quarters totaling approximately $\$ 175$ in fiscal 2018 and $\$ 70$ in fiscal 2019.
Gross Margin
Net sales $\quad \$ 31,624 \quad \$ 28,216 \quad \$ 95,020 \quad \$ 84,815$

Less merchandise costs $28,131 \quad 24,970 \quad 84,481 \quad 75,185$
$\begin{array}{lllll}\text { Gross margin } & \$ 3,493 & \$ 3,246 & \$ 10,539 & \$ 9,630\end{array}$
Gross margin percentage 11.05 \% 11.51 \% $11.09 \quad \% \quad 11.35 \quad \%$
Quarterly Results
The gross margin of core merchandise categories (food and sundries, hardlines, softlines, and fresh foods), when expressed as a percentage of core merchandise sales (rather than total net sales), decreased four basis points across all core merchandise categories, except food and sundries. This measure eliminates the impact of changes in sales penetration and gross margins from our warehouse ancillary and other businesses.
Total gross margin percentage decreased 46 basis points compared to the third quarter of 2017. Excluding the impact of gasoline price inflation on net sales, gross margin as a percentage of adjusted net sales was $11.23 \%$, a decrease of 28 basis points. This was primarily due to a shift in sales penetration to certain lower margin warehouse ancillary businesses, which contributed to a 17 basis point decrease in our core merchandise categories, primarily food and sundries, fresh foods, and softlines. Our warehouse ancillary and other businesses margin decreased six basis points, primarily due to our pharmacy business. Gross margin percentage was also negatively impacted by costs related to our new centralized return centers.

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Gross margin on a segment basis, when expressed as a percentage of the segment's own sales and excluding the impact of changes in gasoline prices on net sales (segment gross margin percentage), decreased in our U.S. operations, primarily due to a shift in sales penetration to certain lower margin warehouse ancillary businesses. The segment gross margin percentage in our Canadian operations increased, predominantly due to an increase in core merchandise categories, primarily fresh foods and hardlines. Other International operations increased, primarily in our core merchandise categories.
Year-to-date Results
The gross margin of core merchandise categories, when expressed as a percentage of core merchandise sales (rather than total net sales), increased two basis points. This was primarily attributable to increases in food and sundries and softlines.

Total gross margin percentage decreased 26 basis points compared to the first thirty-six weeks of 2017. Excluding the impact of changes in gasoline prices on net sales, gross margin as a percentage of adjusted net sales was $11.24 \%$, a decrease of 11 basis points from the first thirty-six weeks of 2017. This was primarily due to a shift in sales penetration to certain lower margin warehouse ancillary businesses, which contributed to an eight basis point decrease in our core merchandise categories, primarily food and sundries, fresh foods and softlines. Gross margin percentage was also negatively impacted by 12 basis points due to a non-recurring legal settlement benefiting the first quarter of 2017 and costs related to our new centralized return centers. These decreases were partially offset by an increase in our warehouse ancillary and other businesses of 10 basis points, primarily due to our gasoline business.

The segment gross margin percentage decreased in our U.S. operations, predominantly in all our core merchandise categories, the non-recurring legal settlement in 2017, and the costs of our centralized return centers mentioned above. These were partially offset by an increase in our warehouse ancillary and other businesses, predominantly our gasoline business. The segment gross margin percentage in our Canadian and Other International operations increased, due to our warehouse ancillary and other businesses, primarily our gasoline business.
Selling, General and Administrative Expenses

SG\&A expenses
12 Weeks Ended 36 Weeks Ended
May 13, May 7, May 13, May 7,
$\begin{array}{llll}2018 & 2017 & 2018 & 2017\end{array}$
$\begin{array}{llll}\$ 3,155 & \$ 2,907 & \$ 9,613 & \$ 8,827\end{array}$
SG\&A expenses as a percentage of net sales $9.98 \quad \% \quad 10.30 \quad \% \quad 10.12 \quad \% \quad 10.41 \quad \%$
Quarterly Results
SG\&A expenses as a percentage of net sales decreased 32 basis points compared to the third quarter of 2017.
Excluding the impact of gasoline price inflation on net sales, SG\&A expenses as a percentage of adjusted net sales were $10.14 \%$, a decrease of 16 basis points. Warehouse operating costs decreased 13 basis points, predominantly in our U.S. operations, due to leveraging increased sales. SG\&A expense improved five basis points due to a non-recurring legal matter in the third quarter of 2017 and no such item in the third quarter of 2018. These decreases were partially offset by a three basis point increase in central operating costs.
Year-to-date Results
SG\&A expenses as a percentage of net sales decreased 29 basis points compared to the first thirty-six weeks of 2017. Excluding the impact of gasoline price inflation on net sales, SG\&A expenses as a percentage of adjusted net sales were $10.26 \%$, a decrease of 15 basis points. Warehouse operating costs decreased

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11 basis points, predominantly in our U.S. and Other International operations, due to leveraging increased sales. Stock compensation expense decreased by two basis points, and SG\&A also benefited from a two basis point decrease due to a non-recurring legal matter in the third quarter of 2017.
Preopening Expense

Preopening expenses
Warehouse openings, including relocations
United States
Canada
Other International
Total warehouse openings, including relocations $2 \quad 3 \quad 10 \quad 16$

Preopening expenses include costs for startup operations related to new warehouses and relocations, developments in new international markets, development of new manufacturing and distribution facilities, and expansions at existing warehouses. Preopening expenses vary due to the number of warehouse openings, the timing of the openings relative to our quarter-end, whether the warehouse is owned or leased, and whether the opening is in an existing, new or international market. For the remainder of fiscal 2018, we expect to open 15 additional warehouses, including two relocations, compared to 12 warehouses opened in the remainder of fiscal 2017.
Interest Expense

| 12 Weeks | 36 Weeks |
| :--- | :--- |
| Ended | Ended |
| May May 7, | May 1May 7, |
| 20182017 | 20182017 |

Interest expense \$37 \$ $21 \quad \$ 111$ \$ 81
Interest expense is primarily related to Senior Notes issued by the Company. In May 2017, we issued $\$ 3,800$ in aggregate principal amount of Senior Notes. Also, in March and June of 2017, we repaid \$2,200 in total outstanding principal of the $5.5 \%$ and $1.125 \%$ Senior Notes, respectively.
Interest Income and Other, Net

Interest income

| 12 Weeks | 36 Weeks |
| :---: | :---: |
| Ended | Ended |
| May May 7, | May May 7 |
| 20182017 | 20182017 |
| \$16 \$ 12 | \$45 \$ 31 |
| 203 | $10 \quad$ (4 |
| 53 | $15 \quad 13$ |
| \$41 \$ 18 | \$70 \$ 40 |

Interest income increased for the third quarter and thirty-six weeks ended May 13, 2018, due to higher interest rates earned on cash and cash equivalents as well as higher average cash and cash equivalent

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Item 2-Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued) (amounts in millions, except per share, share, and warehouse count data)
balances. Foreign-currency transaction gains (losses), net, include mark-to-market adjustments for forward foreign-exchange contracts and the revaluation or settlement of monetary assets and liabilities by our Canadian and Other International operations. See Derivatives and Foreign Currency sections in Part I, Item 1, Note 1 of this Report. Provision for Income Taxes

|  | 12 Weeks <br> Ended | 36 Weeks |  |
| :---: | :---: | :---: | :---: |
|  |  | Ended |  |
|  | May 13, May 7, | May 1 | , May 7, |
|  | 20182017 | 2018 | 2017 |
| Provision for income taxes | \$309 \$259 | \$867 | \$838 |
| Effective tax rate | 28.8 \% 26.8 \% | 29.0 | 32.0 |

The effective tax rates for the third quarter and first thirty-six weeks of 2018 of $28.8 \%$ and $29.0 \%$, respectively, were favorably impacted by the 2017 Tax Act, which included a reduction in the U.S. federal corporate rate from $35 \%$ to $21 \%$. Due to the timing of our fiscal year relative to the effective date of the rate change, our U.S. federal corporate rate for fiscal 2018 is expected to be approximately $25.6 \%$. The first thirty-six weeks of 2018 was favorably impacted by discrete net tax benefits of $\$ 20$. This includes a benefit related to the 2017 Tax Act of $\$ 160$ for the provisional remeasurement of certain deferred tax liabilities offset by discrete tax expense of $\$ 142$ for the estimated tax on deemed repatriation of unremitted earnings and $\$ 43$ for the reduction in foreign tax credits and other immaterial items. The provision was also favorably impacted by the adoption of an accounting standard related to stock-based compensation of $\$ 33$ in the first quarter of 2018.
The effective tax rates for the third quarter and first thirty-six weeks of 2017 were favorably impacted by net discrete tax benefits of $\$ 82$ and $\$ 88$, respectively, primarily due to a net tax benefit of $\$ 82$ related to the May 2017 special cash dividend paid to employees through our 401(k) Retirement Plan.
The determination of our provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws, all of which are subject to continuing review. See Part I, Item 1, Note 7 of this Report for additional information.

## LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes our significant sources and uses of cash and cash equivalents:

> 36 Weeks Ended
> May 13, May 7,
> $2018 \quad 2017$

Net cash provided by operating activities $\$ 4,220 \quad \$ 4,892$
Net cash used in investing activities $(1,852)(1,550)$
Net cash used in financing activities $\quad(1,014)(2,141)$
Our primary sources of liquidity are cash flows from warehouse operations, cash and cash equivalents, and short-term investment balances. Cash and cash equivalents and short-term investments were $\$ 7,044$ and $\$ 5,779$ at May 13, 2018, and September 3, 2017, respectively. Of these balances, approximately $\$ 1,311$ and $\$ 1,255$ represented unsettled credit and debit card receivables, respectively. These receivables generally settle within four days.

Management believes that our cash position and operating cash flows will be sufficient to meet our liquidity and capital requirements for the foreseeable future. While we believe that our U.S. current and projected asset position is sufficient to meet our U.S. liquidity requirements, beginning in the second quarter of fiscal

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Item 2—Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued) (amounts in millions, except per share, share, and warehouse count data)

2018, we no longer consider current fiscal year and future earnings of our non-U.S. consolidated subsidiaries to be permanently reinvested. We have recorded the estimated incremental foreign withholding (net of available foreign tax credits) and state income taxes payable assuming a hypothetical repatriation to the U.S. We consider undistributed earnings of non-U.S. consolidated subsidiaries prior to fiscal 2018 to be indefinitely reinvested.

In the first thirty-six weeks of 2018, we recorded a one-time charge of $\$ 142$ for the estimated tax on deemed repatriation of unremitted earnings under the 2017 Tax Act. The 2017 Tax Act provides for the payment of the tax over an eight year period. Because of the availability of foreign tax credits, the amount payable is $\$ 101$, of which $\$ 84$ is classified as long-term and included in other liabilities on our condensed consolidated balance sheet.

## Cash Flows from Operating Activities

Net cash provided by operating activities totaled $\$ 4,220$ in the first thirty-six weeks of 2018, compared to $\$ 4,892$ in the first thirty-six weeks of 2017. Cash provided by operations is primarily derived from net sales and membership fees. Cash used in operations generally consists of payments to our merchandise vendors, warehouse operating costs (including payroll, employee benefits, and utilities), as well as payments for income taxes. The decrease in net cash provided by operating activities was primarily due to accelerated vendor payments of approximately $\$ 1,700$ made in the last week of fiscal 2016, which positively impacted cash flows in the first thirty-six weeks of 2017.

## Cash Flows from Investing Activities

Net cash used in investing activities totaled $\$ 1,852$ in the first thirty-six weeks of 2018 compared to $\$ 1,550$ in the first thirty-six weeks of 2017. Cash used in investing activities is primarily to fund warehouse expansion and remodeling activities. Net cash from investing activities also includes purchases and maturities of short-term investments. Capital Expenditure Plans
We opened 10 new warehouses including two relocations in the first thirty-six weeks of 2018 and plan to open 15 additional new warehouses, including two relocations, for the remainder of fiscal 2018. Our primary requirements for capital are acquiring land, buildings, and equipment for new and remodeled warehouses. To a lesser extent, capital is required for initial warehouse operations, information systems, manufacturing and distribution facilities, and working capital. In the first thirty-six weeks of 2018, we spent approximately $\$ 1,913$, and it is our current intention to spend approximately $\$ 2,500$ to $\$ 2,700$ during fiscal 2018. There can be no assurance that current expectations will be realized, and plans are subject to change upon further review of our capital expenditure needs.
Cash Flows from Financing Activities
Net cash used in financing activities totaled $\$ 1,014$ in the first thirty-six weeks of 2018 compared to $\$ 2,141$ in the first thirty-six weeks of 2017. Cash flow used in financing activities primarily related to the payment of cash dividends, repurchases of common stock, and withholding taxes on stock-based awards. The decrease in cash used in financing activities from the first thirty-six weeks of 2017 to 2018 related primarily to a repayment of $\$ 1,100$ of long-term debt in the third quarter of 2017.
Stock Repurchase Programs
During the first thirty-six weeks of 2018 and 2017, we repurchased $1,337,000$ and $1,486,000$ shares of common stock, at an average price of $\$ 174.30$ and $\$ 156.51$, respectively, totaling approximately $\$ 233$ in both periods. These amounts may differ from the stock repurchase balances in the accompanying condensed consolidated statements of cash flows due to changes in unsettled stock repurchases at the end of a quarter.

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Item 2-Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued) (amounts in millions, except per share, share, and warehouse count data)

The amount available for stock repurchases under our approved plan was $\$ 2,516$ at May 13, 2018. Purchases are made from time-to-time, as conditions warrant, in the open market or in block purchases and pursuant to plans under SEC Rule 10b5-1. Repurchased shares are retired, in accordance with the Washington Business Corporation Act. Dividends
Our current quarterly cash dividend rate is $\$ 0.57$ per share. On April 24, 2018, our Board of Directors declared a quarterly dividend of $\$ 0.57$ per share payable to shareholders of record on May 11, 2018. The dividend was paid on May 25, 2018.
Bank Credit Facilities and Commercial Paper Programs
We maintain bank credit facilities for working capital and general corporate purposes. At May 13, 2018, we had borrowing capacity under these facilities of $\$ 866$, of which $\$ 353$ was maintained by our international operations. Of the $\$ 353, \$ 166$ is guaranteed by the Company. There were no outstanding short-term borrowings under the bank credit facilities at the end of the third quarter of 2018 or at the end of 2017.
The Company has letter of credit facilities, for commercial and standby letters of credit, totaling $\$ 223$. Outstanding commitments under these facilities at the end of the third quarter of 2018 totaled $\$ 151$, all of which were standby letters of credit with expiration dates within one year. The bank credit facilities have various expiration dates, most of which are within one year, and we generally intend to renew these facilities. The amount of borrowings available at any time under the facilities is reduced by the amount of standby and commercial letters of credit outstanding. Contractual Obligations

As of the date of this report, there were no material changes to our contractual obligations outside the ordinary course of business since the end of our last fiscal year.
Critical Accounting Estimates
The preparation of our consolidated financial statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP) requires that we make estimates and judgments. We base these on historical experience and on assumptions that we believe to be reasonable. Our critical accounting policies are discussed in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of our Annual Report on Form 10-K, for the fiscal year ended September 3, 2017. There have been no material changes to the critical accounting policies previously disclosed in that Report.
Recent Accounting Pronouncements
See discussion of Recent Accounting Pronouncements in Note 1 to the condensed consolidated financial statements included in Part I, Item 1 of this Report.
Item 3-Quantitative and Qualitative Disclosures About Market Risk
Our direct exposure to financial market risk results from fluctuations in foreign currency exchange rates and interest rates. There have been no material changes to our market risks as disclosed in our Annual Report on Form 10-K, for the fiscal year ended September 3, 2017.
Item 4-Controls and Procedures
As of the end of the period covered by this Quarterly Report on Form 10-Q, we performed an evaluation under the supervision and with the participation of management, including our Chief Executive Officer and

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Item 4-Controls and Procedures (Continued)

Chief Financial Officer, of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 (the Exchange Act)). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report, our disclosure controls and procedures are effective.
There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) of the Exchange Act) during our most recently completed 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
See discussion of Legal Proceedings in Note 9 to the condensed consolidated financial statements included in Part I, Item 1 of this Report.
Item 1A—Risk Factors
In addition to the other information set forth in the Quarterly Report on Form 10-Q, you should carefully consider the factors discussed in Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K, for the fiscal year ended
September 3, 2017. There have been no material changes in our risk factors from those disclosed in our Annual Report on Form 10-K.
Item 2-Unregistered Sales of Equity Securities and Use of Proceeds
The following table sets forth information on our common stock repurchase program activity for the third quarter of fiscal 2018 (amounts in millions, except share and per share data):

| Period | Total | Average | Total | Maximum <br> Dollar <br> Value of |
| :---: | :---: | :---: | :---: | :---: |
|  |  |  | Number of |  |
|  |  |  | Shares |  |
|  | Number of | Price | Purchased | Shares that |
|  | Shares | Paid Per | as Part of | May Yet be |
|  | Purchased | Share | Publicly | Purchased |
|  |  |  | Announced | Under the |
|  |  |  | Programs ${ }^{(1)}$ | Programs ${ }^{(1)}$ |
| February 19, 2018 - March 18, 2018 | 85,000 | \$188.83 | 85,000 | \$ 2,555 |
| March 19, 2018 - April 15, 2018 | 102,000 | 185.21 | 102,000 | 2,536 |
| April 16, 2018 - May 13, 2018 | 103,000 | 194.78 | 103,000 | 2,516 |
| Total third quarter | 290,000 | \$189.66 | 290,000 |  |

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Item 6-Exhibits
The following exhibits are filed as part of this Quarterly Report on Form 10-Q or are incorporated herein by reference.
Exhibit Exhibit Description
Number

3.1 $\quad$| Articles of Incorporation as amended of Costco Wholesale |
| :--- |
| Corporation | Filed

Herewith Form Period Ending Filing Date
3.2 Bylaws as amended of the registrant $\quad 8-\mathrm{K} \quad 11 / 2 / 2017$
31.1 Rule 13(a)-14(a) Certifications x
32.1 Section 1350 Certifications x
101.INS XBRL Instance Document x
101.SCH XBRL Taxonomy Extension Schema Document x
101.CAL XBRL Taxonomy Extension Calculation Linkbase Document x
101.DEF XBRL Taxonomy Extension Definition Linkbase Document $x$
101.LAB XBRL Taxonomy Extension Label Linkbase Document x
101.PRE XBRL Taxonomy Extension Presentation Linkbase Document x SIGNATURES
Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

COSTCO WHOLESALE CORPORATION
(Registrant)
June 6, 2018 By /s/ W. CRAIG JELINEK
Date W. Craig Jelinek
President, Chief Executive Officer and Director
June 6, 2018 By /s/ RICHARD A. GALANTI
$\begin{array}{ll}\text { Date } & \text { Richard A. Galanti } \\ & \text { Executive Vice President, Chief Financial Officer and Director }\end{array}$
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[^0]:    (1) Our stock repurchase program is conducted under a $\$ 4,000$ authorization approved by of our Board of Directors in April 2015, which expires in April 2019.
    Item 3-Defaults Upon Senior Securities
    None.
    Item 4-Mine Safety Disclosures
    Not applicable.
    Item 5-Other Information
    None.

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