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)

	May 13, 2018	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)

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
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(amounts in millions, except per share data)
(unaudited)

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
REVENUE				
Net sales	$31,624	$28,216	$95,020	$84,815
Membership fees	737	644	2,145	1,910
Total revenue	32,361	28,860	97,165	86,725
OPERATING EXPENSES				
Merchandise costs	28,131	24,970	84,481	75,185
Selling, general and administrative	3,155	2,907	9,613	8,827
Preopening expenses	8	15	37	52
Operating income	1,067	968	3,034	2,661
OTHER INCOME (EXPENSE)				
Interest expense	(37)	(21)	(111)	(81)
Interest income and other, net	41	18	70	40
INCOME BEFORE INCOME TAXES	1,071	965	2,993	2,620
Provision for income taxes	309	259	867	838
Net income including noncontrolling interests	762	706	2,126	1,782
Net income attributable to noncontrolling interests	(12)	(6)	(35)	(22)
NET INCOME ATTRIBUTABLE TO COSTCO	$750	$700	$2,091	$1,760
NET INCOME PER COMMON SHARE ATTRIBUTABLE TO COSTCO:				
Basic	$1.71	$1.59	$4.77	$4.01
Diluted	$1.70	$1.59	$4.74	$3.99
Shares used in calculation (000's):				
Basic	438,740	438,817	438,576	438,650
Diluted	441,715	441,056	441,383	440,745
CASH DIVIDENDS DECLARED PER COMMON SHARE	$0.57	$7.50	$1.57	$8.40

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

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COSTCO WHOLESALE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(amounts in millions)
(unaudited)

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
NET INCOME INCLUDING NONCONTROLLING INTERESTS	$762	$ 706	$2,126	$1,782
Foreign-currency translation adjustment and other, net	(149)	21	(22)	(210)
Comprehensive income	613	727	2,104	1,572
Less: Comprehensive income attributable to noncontrolling interests	4	15	37	34
COMPREHENSIVE INCOME ATTRIBUTABLE TO COSTCO	$609	$ 712	$2,067	$1,538

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

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COSTCO WHOLESALE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(amounts in millions)
(unaudited)

	36 Weeks Ended	
	May 13, 2018	May 7, 2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income including noncontrolling interests	$2,126	$1,782
Adjustments to reconcile net income including noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization	1,006	929
Stock-based compensation	431	404
Other non-cash operating activities, net	(3)	(66)
Deferred income taxes	(21)	47
Changes in operating assets and liabilities:		
Merchandise inventories	(828)	(952)
Accounts payable	1,160	2,234
Other operating assets and liabilities, net	349	514
Net cash provided by operating activities	4,220	4,892
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of short-term investments	(679)	(901)
Maturities and sales of short-term investments	743	1,046
Additions to property and equipment	(1,913)	(1,723)
Other investing activities, net	(3)	28
Net cash used in investing activities	(1,852)	(1,550)
CASH FLOWS FROM FINANCING ACTIVITIES		
Change in bank checks outstanding	(23)	(243)
Repayments of long-term debt	(58)	(1,100)
Tax withholdings on stock-based awards	(217)	(202)
Repurchases of common stock	(238)	(236)
Cash dividend payments	(439)	(396)
Other financing activities, net	(39)	36
Net cash used in financing activities	(1,014)	(2,141)
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(23)	(42)
Net change in cash and cash equivalents	1,331	1,159
CASH AND CASH EQUIVALENTS BEGINNING OF YEAR	4,546	3,379
CASH AND CASH EQUIVALENTS END OF PERIOD	$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	$250	$3,290

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:

May 13, 2018:	Cost Basis	Unrealized Loss, Net	Recorded Basis
Available-for-sale:			
Government and agency securities	$914	$ (17)	$ 897
Held-to-maturity:			
Certificates of deposit	270		270
Total short-term investments	$1,184	$ (17)	$ 1,167

September 3, 2017:	Cost Basis	Unrealized Gains, Net	Recorded Basis
Available-for-sale:			
Government and agency securities	$947	$ 0	$ 947
Mortgage-backed securities	1	0	1
Total available-for-sale	948	0	948
Held-to-maturity:			
Certificates of deposit	285		285
Total short-term investments	$1,233	$ 0	$ 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 Basis	Fair Value	
Due in one year or less	$ 207	$ 206	$ 270
Due after one year through five years	687	672	0
Due after five years	20	19	0
Total	$ 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)	$ 8	$ 0
Investment in government and agency securities(2)	0	907
Forward foreign-exchange contracts, in asset position(3)	0	10
Forward foreign-exchange contracts, in (liability) position(3)	0	(3)
Total	$ 8	$ 914

September 3, 2017:	Level 1	Level 2
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
Forward foreign-exchange contracts, in (liability) position(3)	0	(8)
Total	$ 7	$ 942

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

(2) 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.

(3) The asset and the liability values are included in other current assets and other current liabilities, respectively, in 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, 2018	September 3, 2017
1.70% Senior Notes due December 2019	$ 1,198	$ 1,198
1.75% Senior Notes due February 2020	499	498
2.15% Senior Notes due May 2021	995	994
2.25% Senior Notes due February 2022	498	497
2.30% Senior Notes due May 2022	794	793
2.75% Senior Notes due May 2024	992	991
3.00% Senior Notes due May 2027	986	986
Other long-term debt	649	702
Total long-term debt	6,611	6,659
Less current portion	119	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 Repurchased (000's)	Average Price per Share	Total Cost
Third quarter of 2018	290	$ 189.66	$ 55
First thirty-six weeks of 2018	1,337	$ 174.30	$ 233
Third quarter of 2017	266	$ 168.09	$ 45
First thirty-six of 2017	1,486	$ 156.51	$ 233

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:

	Attributable to Costco	Noncontrolling Interests	Total Equity
Equity at September 3, 2017	$ 10,778	$ 301	$ 11,079
Comprehensive income:			
Net income	2,091	35	2,126
Foreign-currency translation adjustment and other, net	(24)	2	(22)
Comprehensive income	2,067	37	2,104
Stock-based compensation	434	0	434
Release of vested restricted stock units (RSUs), including tax effects	(217)	0	(217)
Repurchases of common stock	(233)	0	(233)
Cash dividends declared and other	(686)	(34)	(720)
Equity at May 13, 2018	$ 12,143	$ 304	$ 12,447

	Attributable to Costco	Noncontrolling Interests	Total Equity
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 Units (in 000's)	Weighted-Average Grant Date Fair Value
Outstanding at September 3, 2017	8,199	$ 128.15
Granted	3,722	156.19
Vested and delivered	(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 Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
Stock-based compensation expense before income taxes	$ 85	$ 82	$ 431	$ 404
Less recognized income tax benefit [1]	(19)	(26)	(98)	(132)
Stock-based compensation expense, net of income taxes	$ 66	$ 56	$ 333	$ 272

(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):

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
Net income attributable to Costco	$750	$ 700	$2,091	$ 1,760
Weighted average number of common shares used in basic net income per common share	438,740	438,817	438,576	438,650
RSUs and other	2,975	2,239	2,807	2,095
Weighted average number of common shares and dilutive potential of common stock used in diluted net income per share	441,715	441,056	441,383	440,745

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.

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 Operations	Canadian Operations	Other International Operations	Total
Twelve Weeks Ended May 13, 2018				
Total revenue	$ 23,475	$ 4,647	$ 4,239	$32,361
Operating income	682	210	175	1,067
Depreciation and amortization	242	31	54	327
Additions to property and equipment	468	42	75	585
Twelve Weeks Ended May 7, 2017				
Total revenue	$ 21,172	$ 4,069	$ 3,619	$28,860
Operating income	654	172	142	968
Depreciation and amortization	245	28	47	320
Additions to property and equipment	363	40	137	540
Thirty-six Weeks Ended May 13, 2018				
Total revenue	$ 69,975	$ 14,163	$ 13,027	$97,165
Operating income	1,818	652	564	3,034
Depreciation and amortization	756	94	156	1,006
Additions to property and equipment	1,323	156	434	1,913
Net property and equipment	12,924	1,829	4,425	19,178
Total assets	27,062	4,248	8,295	39,605
Thirty-six Weeks Ended May 7, 2017				
Total revenue	$ 63,313	$ 12,397	$ 11,015	$86,725
Operating income	1,680	543	438	2,661
Depreciation and amortization	712	81	136	929
Additions to property and equipment	1,147	206	370	1,723
Net property and equipment	12,139	1,612	3,784	17,535
Total assets	24,356	4,014	7,261	35,631
Year Ended September 3, 2017				
Total revenue	$ 93,889	$ 18,775	$ 16,361	$129,025
Operating income	2,644	841	626	4,111
Depreciation and amortization	1,044	124	202	1,370
Additions to property and equipment	1,714	277	511	2,502
Net property and equipment	12,339	1,820	4,002	18,161
Total assets	24,068	4,471	7,808	36,347

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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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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

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
Net Sales	$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 %	6 %
Changes in comparable sales:				
U.S.	10 %	6 %	9 %	3 %
Canada	11 %	2 %	10 %	5 %
Other International	12 %	4 %	13 %	0 %
Total Company	10 %	5 %	10 %	3 %
Changes in comparable sales excluding the impact of changes in foreign exchange rates and gasoline prices:				
U.S.	8 %	5 %	7 %	3 %
Canada	5 %	3 %	4 %	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

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
Membership fees	$737	$644	$2,145	$1,910
Membership fees as a percentage of net sales	2.33 %	2.28 %	2.26 %	2.25 %
Total paid members as of quarter end (000's)	50,900	48,600	—	—
Total cardholders as of quarter end (000's)	93,000	88,900	—	—

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

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
Net sales	$31,624	$28,216	$95,020	$84,815
Less merchandise costs	28,131	24,970	84,481	75,185
Gross margin	$3,493	$3,246	$10,539	$9,630
Gross margin percentage	11.05 %	11.51 %	11.09 %	11.35 %

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

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
SG&A expenses	$3,155	$2,907	$9,613	$8,827
SG&A expenses as a percentage of net sales	9.98 %	10.30 %	10.12 %	10.41 %

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

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
Preopening expenses	$8	$ 15	$37	$ 52
Warehouse openings, including relocations				
United States	0	1	7	9
Canada	0	1	1	4
Other International	2	1	2	3
Total warehouse openings, including relocations	2	3	10	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 Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
Interest expense	$37	$ 21	$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

	12 Weeks Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 2017
Interest income	$16	$ 12	$45	$ 31
Foreign-currency transaction gains (losses), net	20	3	10	(4)
Other, net	5	3	15	13
Interest income and other, net	$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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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 Ended		36 Weeks Ended	
	May 13, 2018	May 7, 2017	May 13, 2018	May 7, 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, 2018	May 7, 2017
Net cash provided by operating activities	$4,220	$4,892
Net cash used in investing activities	(1,852)	(1,550)
Net cash used in financing activities	(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.

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 Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs[1]	Maximum Dollar Value of Shares that May Yet be Purchased Under the 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	

(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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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 Number	Exhibit Description	Filed Herewith	Incorporated by Reference Form	Period Ending	Filing Date
3.1	Articles of Incorporation as amended of Costco Wholesale Corporation		10-Q	2/15/2015	3/11/2015
3.2	Bylaws as amended of the registrant		8-K		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
Date Richard A. Galanti
Executive Vice President, Chief Financial Officer and Director