COSTCO WHOLESALE CORP /NEW
Form 10-Q
June 01, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended May 8, 2016
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 ý NO o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES ý NO o
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 ý	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO ý
The number of shares outstanding of the issuer's common stock as of May 25, 2016 was 438,065,563.

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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 8, 2016	August 30, 2015
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$4,884	$ 4,801
Short-term investments	1,137	1,618
Receivables, net	1,300	1,224
Merchandise inventories	8,927	8,908
Other current assets	294	228
Total current assets	16,542	16,779
PROPERTY AND EQUIPMENT		
Land	5,266	4,961
Buildings and improvements	13,645	12,618
Equipment and fixtures	5,834	5,274
Construction in progress	707	811
	25,452	23,664
Less accumulated depreciation and amortization	(8,961)	(8,263)
Net property and equipment	16,491	15,401
OTHER ASSETS	840	837
TOTAL ASSETS	$33,873	$ 33,017
LIABILITIES AND EQUITY		
CURRENT LIABILITIES		
Accounts payable	$8,828	$ 9,011
Current portion of long-term debt	1,193	1,283
Accrued salaries and benefits	2,398	2,468
Accrued member rewards	861	813
Deferred membership fees	1,416	1,269
Other current liabilities	2,303	1,695
Total current liabilities	16,999	16,539
LONG-TERM DEBT, excluding current portion	3,921	4,852
OTHER LIABILITIES	1,205	783
Total liabilities	22,125	22,174
COMMITMENTS AND CONTINGENCIES		
EQUITY		
Preferred stock $.005 par value; 100,000,000 shares authorized; no shares issued and outstanding	0	0
Common stock $.005 par value; 900,000,000 shares authorized; 438,368,000 and 437,952,000 shares issued and outstanding	2	2
Additional paid-in capital	5,404	5,218
Accumulated other comprehensive loss	(1,126)	(1,121)
Retained earnings	7,225	6,518
Total Costco stockholders’ equity	11,505	10,617

Noncontrolling interests	243	226
Total equity	11,748	10,843
TOTAL LIABILITIES AND EQUITY	$33,873	$ 33,017

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 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
REVENUE				
Net sales	$26,151	$25,517	$80,345	$78,673
Membership fees	618	584	1,814	1,748
Total revenue	26,769	26,101	82,159	80,421
OPERATING EXPENSES				
Merchandise costs	23,162	22,687	71,252	69,969
Selling, general and administrative	2,731	2,579	8,372	7,946
Preopening expenses	18	14	54	38
Operating income	858	821	2,481	2,468
OTHER INCOME (EXPENSE)				
Interest expense	(30)	(31)	(94)	(84)
Interest income and other, net	7	9	51	64
INCOME BEFORE INCOME TAXES	835	799	2,438	2,448
Provision for income taxes	286	280	847	817
Net income including noncontrolling interests	549	519	1,591	1,631
Net income attributable to noncontrolling interests	(4)	(3)	(20)	(21)
NET INCOME ATTRIBUTABLE TO COSTCO	$545	$516	$1,571	$1,610
NET INCOME PER COMMON SHARE ATTRIBUTABLE TO COSTCO:				
Basic	$1.24	$1.17	$3.58	$3.66
Diluted	$1.24	$1.17	$3.56	$3.64
Shares used in calculation (000's):				
Basic	438,815	440,070	438,930	439,733
Diluted	441,066	443,132	441,321	442,721
CASH DIVIDENDS DECLARED PER COMMON SHARE	$0.45	$0.40	$1.25	$6.11

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 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
NET INCOME INCLUDING NONCONTROLLING INTERESTS	$549	$ 519	$1,591	$1,631
Foreign-currency translation adjustment and other, net	224	76	(5)	(656)
Comprehensive income	773	595	1,586	975
Less: Comprehensive income attributable to noncontrolling interests	10	8	20	15
COMPREHENSIVE INCOME ATTRIBUTABLE TO COSTCO	$763	$ 587	$1,566	$960

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 8, 2016	May 10, 2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income including noncontrolling interests	$1,591	$1,631
Adjustments to reconcile net income including noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization	847	776
Stock-based compensation	362	301
Excess tax benefits on stock-based awards	(74)	(84)
Other non-cash operating activities, net	25	12
Deferred income taxes	158	(42)
Changes in operating assets and liabilities:		
Decrease (increase) in merchandise inventories	8	(680)
(Decrease) increase in accounts payable	(48)	786
Other operating assets and liabilities, net	592	557
Net cash provided by operating activities	3,461	3,257
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of short-term investments	(787)	(1,033)
Maturities and sales of short-term investments	1,268	860
Additions to property and equipment	(1,800)	(1,588)
Other investing activities, net	(1)	(14)
Net cash used in investing activities	(1,320)	(1,775)
CASH FLOWS FROM FINANCING ACTIVITIES		
Change in bank checks outstanding	(127)	(128)
Repayments of short-term borrowings	(102)	0
Proceeds from short-term borrowings	102	52
Proceeds from issuance of long-term debt	94	1,037
Repayments of long-term debt	(1,200)	(8)
Minimum tax withholdings on stock-based awards	(219)	(178)
Excess tax benefits on stock-based awards	74	84
Repurchases of common stock	(350)	(225)
Cash dividend payments	(352)	(2,514)
Other financing activities, net	(8)	37
Net cash used in financing activities	(2,088)	(1,843)
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	30	(314)
Net increase (decrease) in cash and cash equivalents	83	(675)
CASH AND CASH EQUIVALENTS BEGINNING OF YEAR	4,801	5,738
CASH AND CASH EQUIVALENTS END OF PERIOD	$4,884	$5,063
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the first thirty-six weeks of year for:		
Interest (reduced by $12 and $9 interest capitalized in 2016 and 2015, respectively)	$93	$93
Income taxes, net	$545	$609

SUPPLEMENTAL DISCLOSURE OF NON-CASH FINANCING ACTIVITIES:		
Cash dividend declared, but not yet paid	$197	$176

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 based on the concept that offering members low prices on a limited selection of nationally branded and select private-label products in a wide range of merchandise categories will produce high sales volumes and rapid inventory turnover. At May 8, 2016, Costco operated 705 warehouses worldwide: 493 United States (U.S.) locations (in 44 states, Washington, D.C., and Puerto Rico), 90 Canada locations, 36 Mexico locations, 27 United Kingdom (U.K.) locations, 25 Japan locations, 12 Korea locations, 12 Taiwan locations, eight Australia locations and two Spain locations. The Company's online business operates websites in the U.S., Canada, U.K., Mexico, 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 and other consolidated entities have been eliminated in consolidation. The Company’s net income excludes income attributable to noncontrolling interests in Taiwan and Korea. 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 August 30, 2015.

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. References to the third quarters of 2016 and 2015 relate to the 12-week fiscal quarters ended May 8, 2016, and May 10, 2015, respectively. References to the first thirty-six weeks of 2016 and 2015 relate to the thirty-six weeks ended May 8, 2016, and May 10, 2015, 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 and 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 could differ from those estimates and assumptions.

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.

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Note 1—Summary of Significant Accounting Policies (Continued)

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.

The Company's current financial liabilities have fair values that approximate their carrying values. The Company's long-term financial liabilities consist of long-term debt, which is recorded on the balance sheet at issuance price and adjusted for any applicable unamortized discounts or premiums and debt issuance costs. 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 2015 Form 10-K.

Merchandise Inventories

Merchandise inventories are valued at the lower of cost or market, as determined primarily by the retail inventory method, and are stated using the last-in, first-out (LIFO) method for substantially all U.S. merchandise inventories. Merchandise inventories for all foreign operations are primarily valued by the retail inventory method and are stated using the first-in, first-out (FIFO) method. 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 an adjustment each quarter, if necessary, for the projected annual effect of inflation or deflation, and these estimates are adjusted to actual results determined at year-end, after actual inflation rates and inventory levels for the year have been determined. Due to overall net deflationary trends in the third quarter and first thirty-six weeks of 2016, a benefit of $13 and $33 was recorded to merchandise costs, respectively, to reduce the cumulative LIFO valuation on merchandise inventories. A benefit of $7 and $13 was recorded to merchandise costs in the third quarter and first thirty-six weeks of 2015, respectively. At May 8, 2016, and August 30, 2015, the cumulative impact of the LIFO valuation on merchandise inventories was $49 and $82, respectively.

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, with functional currencies other than the U.S. dollar. Currently, 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. These contracts do not contain any credit-risk-related contingent features. The aggregate notional amounts of open, unsettled forward foreign-exchange contracts were $775 and $889 at May 8, 2016, and August 30, 2015, respectively.

While 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 8, 2016, and August 30, 2015.

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 were a net loss of $11 and $17 in the third quarter and first thirty-six weeks of 2016,

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Note 1—Summary of Significant Accounting Policies (Continued)

respectively, as compared to a net loss of $15 and an immaterial net loss for the third quarter and first thirty-six weeks of 2015, respectively.
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 for some purchases of natural gas, in addition to fuel for its gas stations, on an index basis. These contracts meet the characteristics of derivative instruments, but generally qualify for the “normal purchases or normal sales” exception under authoritative guidance and thus 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. These items resulted in an immaterial net gain and a $34 net gain in the third quarter and first thirty-six weeks of 2016, respectively, as compared to a net gain of $12 and $24 in the third quarter and first thirty-six weeks of 2015, respectively.

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.

Recently Adopted Accounting Pronouncements

In November 2015, the Financial Accounting Standards Board (FASB) issued guidance on the presentation of deferred tax assets and liabilities by jurisdiction, along with any related valuation allowance. The guidance requires companies to classify all deferred tax assets and liabilities as non-current on the balance sheet on either a prospective or retrospective basis. The guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2016, with early adoption permitted. The Company elected to early adopt the guidance at the beginning of the second quarter of fiscal year 2016 on a retrospective basis and reclassified deferred tax assets and liabilities from current to non-current. The reclassifications reduced other current assets and other liabilities by $520 and $410, respectively, increased other assets by $109, and had a nominal impact on other current liabilities in the accompanying condensed consolidated balance sheet for the fiscal year ended August 30, 2015. Adoption of this guidance also had a nominal impact on the total assets by segment as disclosed in Note 9.
In April 2015, the FASB issued guidance to simplify the presentation of debt issuance costs by recording deferred debt issuance costs as a direct deduction from the carrying amount of the related debt liability. The guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years, with early adoption permitted. The Company elected to early adopt the guidance at the beginning of its first quarter of fiscal year 2016 on a retrospective basis. The Company reclassified deferred issuance costs from other assets to the respective debt liability. Adoption of this guidance and prior fiscal year reclassifications had an immaterial impact on previously reported consolidated financial statements.

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Note 1—Summary of Significant Accounting Policies (Continued)

Recent Accounting Pronouncements Not Yet Adopted

In May 2014, the FASB issued new 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 arising from these contracts. Companies can transition to the standard either retrospectively or as a cumulative effect adjustment as of the date of adoption. 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 year 2019.

In February 2016, the FASB issued new guidance on leases, which will require lessees to recognize assets and liabilities on the balance sheet for the rights and obligations created by all 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 year 2020.

In March 2016, the FASB issued new guidance on stock compensation, which is intended to simplify accounting for share-based payment transactions. The guidance will change several aspects of the accounting for share-based payment award transactions, including accounting for income taxes, forfeitures, and minimum statutory tax withholding requirements. The new standard is effective for fiscal years and interim periods within those years beginning after December 15, 2016, with early adoption permitted.

The Company is evaluating the impact of these standards on its consolidated financial statements and disclosures.

Note 2—Investments

Major categories of investments have not materially changed from the annual reporting period ended August 30, 2015. The Company's investments were as follows:

May 8, 2016:	Cost Basis	Unrealized Gains, Net	Recorded Basis
Available-for-sale:			
Government and agency securities	$909	$ 8	$ 917
Asset and mortgage-backed securities	2	0	2
Total available-for-sale	911	8	919
Held-to-maturity:			
Certificates of deposit	218		218
Total short-term investments	$1,129	$ 8	$ 1,137

August 30, 2015:	Cost Basis	Unrealized Gains, Net	Recorded Basis
Available-for-sale:			
Government and agency securities	$1,394	$ 4	$ 1,398
Asset and mortgage-backed securities	5	0	5
Total available-for-sale	1,399	4	1,403
Held-to-maturity:			
Certificates of deposit	215		215
Total short-term investments	$1,614	$ 4	$ 1,618

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Note 2—Investments (Continued)

At May 8, 2016, there were no available-for-sale securities with continuous unrealized-loss positions. At August 30, 2015, available-for-sale securities that were in continuous unrealized-loss positions were not material. During the third quarter and first thirty-six weeks of 2016 and 2015, there were no unrealized gains and losses on cash and cash equivalents.

The proceeds from sales of available-for-sale securities were $49 and $104 during the third quarter of 2016 and 2015, respectively, and $238 and $171 during the first thirty-six weeks of 2016 and 2015, respectively. Gross realized gains or losses from sales of available-for-sale securities during the third quarter and first thirty-six weeks of 2016 and 2015 were not material.

The maturities of available-for-sale and held-to-maturity securities at May 8, 2016, were as follows:

	Available-For-Sale		Held-To-Maturity
	Cost Basis	Fair Value	
Due in one year or less	$ 253	$ 253	$ 218
Due after one year through five years	612	618	0
Due after five years	46	48	0
	$ 911	$ 919	$ 218

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 fair value hierarchy reflecting the valuation techniques utilized to determine fair value.

May 8, 2016:	Level 1	Level 2
Money market mutual funds(1)	$ 215	$ 0
Investment in government and agency securities	0	917
Investment in asset and mortgage-backed securities	0	2
Forward foreign-exchange contracts, in asset position(2)	0	5
Forward foreign-exchange contracts, in (liability) position(2)	0	(10)
Total	$ 215	$ 914

August 30, 2015:	Level 1	Level 2
Money market mutual funds(1)	$ 306	$ 0
Investment in government and agency securities	0	1,398
Investment in asset and mortgage-backed securities	0	5
Forward foreign-exchange contracts, in asset position(2)	0	16
Forward foreign-exchange contracts, in (liability) position(2)	0	(4)
Total	$ 306	$ 1,415

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

(2) 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.

At May 8, 2016, and August 30, 2015, the Company did not hold any Level 3 financial assets and liabilities that were measured at fair value on a recurring basis. There were no financial assets or liabilities measured

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Note 3—Fair Value Measurement (Continued)

on a recurring basis using significant unobservable inputs (Level 3) and there were no transfers in or out of Level 1, 2, or 3 during the third quarter or first thirty-six weeks of 2016 or 2015.

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Financial assets measured at fair value on a nonrecurring basis include held-to-maturity investments that are carried at amortized cost and are not remeasured to fair value on a recurring basis. There were no fair value adjustments to these financial assets during the third quarter or first thirty-six weeks of 2016 or 2015.

Nonfinancial assets measured at fair value on a nonrecurring basis include items such as long-lived assets that are measured at fair value resulting from an impairment, if deemed necessary. There were no fair value adjustments to nonfinancial assets during the third quarter or first thirty-six weeks of 2016. There were no fair value adjustments to nonfinancial assets during the third quarter of 2015 and these adjustments were immaterial during the first thirty-six weeks of 2015.

Note 4—Debt

The estimated fair value of the Company's debt is based primarily on reported market values, recently completed market transactions, and estimates based upon interest rates, maturities, and credit risk. Substantially all of the Company's long-term debt is valued using Level 2 inputs.

The carrying and estimated fair values of the Company's long-term debt consisted of the following:

	May 8, 2016		August 30, 2015	
	Carrying Value	Fair Value	Carrying Value	Fair Value
0.65% Senior Notes due December 2015	$0	$0	$1,200	$1,201
5.5% Senior Notes due March 2017	1,099	1,144	1,099	1,171
1.125% Senior Notes due December 2017	1,099	1,105	1,098	1,097
1.7% Senior Notes due December 2019	1,196	1,219	1,195	1,186
1.75% Senior Notes due February 2020	498	508	497	494
2.25% Senior Notes due February 2022	496	512	496	484
Other long-term debt	726	756	550	555
Total long-term debt	5,114	5,244	6,135	6,188
Less current portion	1,193	1,238	1,283	1,284
Long-term debt, excluding current portion	$3,921	$4,006	$4,852	$4,904

On December 7, 2015, the Company paid the outstanding principal balance and interest on the 0.65% Senior Notes with existing sources of cash and cash equivalents and short-term investments.

On March 31, 2016, the Company's Japanese subsidiary issued approximately $103 of 0.63% Guaranteed Senior Notes through a private placement. Interest is payable semi-annually, and principal is due in March 2026. These notes are valued using Level 3 inputs.

Note 5—Equity and Comprehensive Income

Dividends

The Company's current quarterly dividend rate is $0.45 per share, compared to $0.40 per share in the third quarter of 2015. On April 14, 2016, the Board of Directors declared a quarterly cash dividend in the amount of $0.45 per share, which was paid subsequent to the end of the third quarter, on May 13, 2016.

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Note 5—Equity and Comprehensive Income (Continued)

Stock Repurchase Programs

Stock repurchase activity during the third quarter and first thirty-six weeks of 2016 and 2015 is summarized below:

	Shares Repurchased (000's)	Average Price per Share	Total Cost
Third quarter of 2016	899	$151.57	$136
First thirty-six weeks of 2016	2,328	$148.64	$346
Third quarter of 2015	839	$147.89	$124
First thirty-six weeks of 2015	1,620	$144.20	$234

The remaining amount available for stock repurchases under our approved plan, which expires in April 2019, was $3,353 at May 8, 2016. 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. 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.

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 August 30, 2015	$ 10,617	$ 226	$10,843
Comprehensive income:			
Net income	1,571	20	1,591
Foreign-currency translation adjustment and other, net	(5)	0	(5)
Comprehensive income	1,566	20	1,586
Stock-based compensation	362	0	362
Release of vested restricted stock units (RSUs), including tax effects	(145)	0	(145)
Repurchases of common stock	(346)	0	(346)
Cash dividends declared	(549)	0	(549)
Distribution to noncontrolling interest	0	(3)	(3)
Equity at May 8, 2016	$ 11,505	$ 243	$11,748

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Note 5—Equity and Comprehensive Income (Continued)

	Attributable to Costco	Noncontrolling Interests	Total Equity
Equity at August 31, 2014	$ 12,303	$ 212	$ 12,515
Comprehensive income:			
Net income	1,610	21	1,631
Foreign-currency translation adjustment and other, net	(650)	(6)	(656)
Comprehensive income	960	15	975
Stock-based compensation	301	0	301
Stock options exercised, including tax effects	68	0	68
Release of vested RSUs, including tax effects	(121)	0	(121)
Repurchases of common stock	(234)	0	(234)
Cash dividends declared	(2,690)	0	(2,690)
Equity at May 10, 2015	$ 10,587	$ 227	$ 10,814

Note 6—Stock-Based Compensation

The Seventh Restated 2002 Stock Incentive Plan (Seventh 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 equal to the minimum statutory withholding taxes.

Summary of Restricted Stock Unit Activity

At May 8, 2016, 15,032,000 shares were available to be granted as RSUs and the following awards were outstanding:

- 7,927,000 time-based RSUs, which vest upon continued employment over specified periods of time;
- 212,000 performance-based RSUs, granted to certain 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
- 236,000 performance-based RSUs, granted to executive officers of the Company, subject to achievement of performance targets for fiscal 2016, 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 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 2016:

	Number of Units (in 000's)	Weighted-Average Grant Date Fair Value
Outstanding at August 30, 2015	9,233	$ 99.72
Granted	3,521	153.46
Vested and delivered	(4,134)	102.41
Forfeited	(245)	114.74
Outstanding at May 8, 2016	8,375	$ 120.55

The remaining unrecognized compensation cost related to non-vested RSUs at May 8, 2016 was $797, and the weighted-average period over which this cost will be recognized is 1.7 years.

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Note 6—Stock-Based Compensation (Continued)

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 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Stock-based compensation expense before income taxes	$75	$ 65	$362	$ 301
Less recognized income tax benefit	(23)	(21)	(120)	(101)
Stock-based compensation expense, net of income taxes	$52	$ 44	$242	$ 200

Note 7—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 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Net income available to common stockholders used in basic and diluted net income per common share	$545	$ 516	$1,571	$ 1,610
Weighted average number of common shares used in basic net income per common share	438,815	440,070	438,930	439,733
RSUs	2,241	3,050	2,380	2,976
Conversion of convertible notes	10	12	11	12
Weighted average number of common shares and dilutive potential of common stock used in diluted net income per share	441,066	443,132	441,321	442,721

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Note 8—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. 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 our 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 the following matters, among others:
Numerous putative class actions have been brought around the United States against motor fuel retailers, including the Company, alleging that they have been overcharging consumers by selling gasoline or diesel that is warmer than 60 degrees without adjusting the volume sold to compensate for heat-related expansion or disclosing the effect of such expansion on the energy equivalent received by the consumer. The Company is named in the following actions: Raphael Sagalyn, et al., v. Chevron USA, Inc., et al., Case No. 07-430 (D. Md.); Phyllis Lerner, et al., v. Costco Wholesale Corporation, et al., Case No. 07-1216 (C.D. Cal.); Linda A. Williams, et al., v. BP Corporation North America, Inc., et al., Case No. 07-179 (M.D. Ala.); James Graham, et al. v. Chevron USA, Inc., et al., Civil Action No. 07-193 (E.D. Va.); Betty A. Delgado, et al., v. Allsups, Convenience Stores, Inc., et al., Case No. 07-202 (D.N.M.); Gary Kohut, et al. v. Chevron USA, Inc., et al., Case No. 07-285 (D. Nev.); Mark Rushing, et al., v. Alon USA, Inc., et al., Case No. 06-7621 (N.D. Cal.); James Vanderbilt, et al., v. BP Corporation North America, Inc., et al., Case No. 06-1052 (W.D. Mo.); Zachary Wilson, et al., v. Ampride, Inc., et al., Case No. 06-2582 (D.Kan.); Diane Foster, et al., v. BP North America Petroleum, Inc., et al., Case No. 07-02059 (W.D. Tenn.); Mara Redstone, et al., v. Chevron USA, Inc., et al., Case No. 07-20751 (S.D. Fla.); Fred Aguirre, et al. v. BP West Coast Products LLC, et al., Case No. 07-1534 (N.D. Cal.); J.C. Wash, et al., v. Chevron USA, Inc., et al.; Case No. 4:07cv37 (E.D. Mo.); Jonathan Charles Conlin, et al., v. Chevron USA, Inc., et al.; Case No. 07 0317 (M.D. Tenn.); William Barker, et al. v. Chevron USA, Inc., et al.; Case No. 07-cv-00293 (D.N.M.); Melissa J. Couch, et al. v. BP Products North America, Inc., et al., Case No. 07cv291 (E.D. Tex.); S. Garrett Cook, Jr., et al., v. Hess Corporation, et al., Case No. 07cv750 (M.D. Ala.); Jeff Jenkins, et al. v. Amoco Oil Company, et al., Case No. 07-cv-00661 (D. Utah); and Mark Wyatt, et al., v. B. P. America Corp., et al., Case No. 07-1754 (S.D. Cal.). On June 18, 2007, the Judicial Panel on Multidistrict Litigation assigned the action, entitled In re Motor Fuel Temperature Sales Practices Litigation, MDL Docket No 1840, to Judge Kathryn Vratil in the United States District Court for the District of Kansas. On April 12, 2009, the Company agreed to settle the actions in which it is named as a defendant. Under the settlement, which was subject to final approval by the court, the Company agreed, to the extent allowed by law and subject to other terms and conditions in the agreement, to install over five years from the effective date of the settlement temperature-correcting dispensers in the States of Alabama, Arizona, California, Florida, Georgia, Kentucky, Nevada, New Mexico, North Carolina, South Carolina, Tennessee, Texas, Utah, and Virginia. Other than payments to class representatives, the settlement does not provide for cash payments to class members. On September 22, 2011, the court preliminarily approved a revised settlement, which did not materially alter the terms. On April 24, 2012, the court granted final approval of the revised settlement. A class member who objected has filed a notice of appeal from the order

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Note 8—Commitments and Contingencies (Continued)

approving the settlement. Plaintiffs have moved for an award of $10 in attorneys' fees, as well as an award of costs and payments to class representatives. A report and recommendation has been issued in favor of a fee award of $3.8, to which the Company is objecting. On March 20, 2014, the Company filed a notice invoking a "most favored nation" provision under the settlement, under which it seeks to adopt provisions in later settlements with certain other defendants. The motion was denied on January 23, 2015. Final judgment was entered on September 22, 2015, and the Company has filed a notice of appeal.

The Company received notices from most states stating that they have appointed an agent to conduct an examination of the books and records of the Company to determine whether it has complied with state unclaimed property laws. In addition to seeking the turnover of unclaimed property subject to escheat laws, the states may seek interest, penalties, costs of examinations, and other relief. Certain states have separately also made requests for payment by the Company concerning a specific type of property, some of which have been paid in immaterial amounts.

The Company has received from the Drug Enforcement Administration subpoenas and administrative inspection warrants concerning the Company's fulfillment of prescriptions related to controlled substances and related practices. Offices of the United States Attorney in various districts have communicated to the Company their belief that the Company has committed civil regulatory violations concerning these subjects. The Company is seeking to cooperate with these processes and is holding discussions concerning a potential resolution.

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; 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 9—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, Australia, and Spain and through majority-owned subsidiaries in Taiwan and Korea. 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 the same 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 August 30, 2015, 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 8, 2016				
Total revenue	$ 19,528	$ 3,869	$ 3,372	$26,769
Operating income	539	185	134	858
Depreciation and amortization	220	26	45	291
Additions to property and equipment	335	41	85	461
Twelve Weeks Ended May 10, 2015				
Total revenue	$ 19,141	$ 3,778	$ 3,182	$26,101
Operating income	551	164	106	821
Depreciation and amortization	199	27	36	262
Additions to property and equipment	302	25	94	421
Thirty-six Weeks Ended May 8, 2016				
Total revenue	$ 60,016	$ 11,542	$ 10,601	$82,159
Operating income	1,542	524	415	2,481
Depreciation and amortization	636	75	136	847
Additions to property and equipment	1,252	112	436	1,800
Net property and equipment	11,466	1,449	3,576	16,491
Total assets	23,652	3,373	6,848	33,873
Thirty-six Weeks Ended May 10, 2015				
Total revenue	$ 58,201	$ 12,010	$ 10,210	$80,421
Operating income	1,540	538	390	2,468
Depreciation and amortization	580	85	111	776
Additions to property and equipment	1,065	103	420	1,588
Net property and equipment	10,494	1,503	3,086	15,083
Total assets	22,973	3,859	6,277	33,109
Year Ended August 30, 2015				
Total revenue	$ 84,351	$ 17,341	$ 14,507	$116,199
Operating income	2,308	771	545	3,624
Depreciation and amortization	848	119	160	1,127
Additions to property and equipment	1,574	148	671	2,393
Net property and equipment	10,815	1,381	3,205	15,401
Total assets	22,988	3,608	6,421	33,017

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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, actions of vendors, rising costs associated with employees (generally including health care costs), energy and certain commodities, geopolitical conditions, and other risks identified from time to time in the Company's 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 2015 Annual Report on Form 10-K, previously filed with the SEC.

OVERVIEW

We operate membership warehouses 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 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, 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

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)

retailers. While we cannot control or 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.

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 expenses as a percentage of net sales. A decline in gasoline prices has the inverse effect.

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 higher in foreign markets, due to the smaller base in those markets, and we expect that to continue. Our online business growth 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 penetration of our Executive members, and sustain high renewal rates materially influences our profitability.

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 the wages and benefits that they earn. 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 gross margin 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 9 of this Report). Certain countries in the Other International segment have relatively higher rates of square footage growth, lower wages and benefit costs as a percentage of country sales, and/or less or no direct membership warehouse competition. Additionally, we operate our lower-margin gasoline business in the U.S., Canada, Australia, U.K., Japan, and Spain.

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 2016 and 2015 relate to the twelve-week fiscal quarters ended May 8, 2016, and May 10, 2015, 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 2016 as compared to the third quarter of 2015 include:

- We opened seven net new warehouses, five in the U.S. and two in our Other International operating segment, compared to two net new warehouses in 2015;
- Net sales increased 2% to $26,151, driven by sales at new warehouses opened since the end of the third quarter of fiscal 2015, while comparable sales were flat. Net and comparable sales results were negatively impacted by decreases in the price of gasoline and changes in certain foreign currencies relative to the U.S. dollar;
- Membership fee revenue increased 6% to $618, primarily due to sign-ups at existing and new warehouses and executive membership upgrades;
- Gross margin percentage increased 34 basis points, primarily from the impact of gasoline price deflation on net sales;
- Selling, general and administrative (SG&A) expenses as a percentage of net sales increased 33 basis points, primarily from the impact of gasoline price deflation on net sales;
- Net income increased 5% to $545, or $1.24 per diluted share, compared to $516, or $1.17 per diluted share in 2015;
- Changes in foreign currencies relative to the U.S. dollar adversely impacted diluted earnings per share by $0.03, primarily due to changes in the Canadian dollar and Mexican peso; and
- On April 14, 2016, our Board of Directors declared a quarterly cash dividend in the amount of $0.45 per share, which was paid subsequent to the end of the third quarter of 2016.

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RESULTS OF OPERATIONS

Net Sales

	12 Weeks Ended		36 Weeks Ended	
	May 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Net Sales	$26,151	$25,517	$80,345	$78,673
Changes in net sales:				
U.S.	2 %	3 %	3 %	5 %
Canada	2 %	(4)%	(4)%	(1)%
Other International	6 %	(1)%	4 %	5 %
Total Company	2 %	1 %	2 %	4 %
Changes in comparable sales:				
U.S.	0 %	1 %	2 %	4 %
Canada	1 %	(6)%	(5)%	(3)%
Other International	(2)%	(6)%	(4)%	(2)%
Total Company	0 %	(1)%	0 %	2 %
Increases in comparable sales excluding the impact of changes in foreign exchange rates and gasoline prices:				
U.S.	3 %	5 %	4 %	7 %
Canada	8 %	9 %	9 %	9 %
Other International	3 %	4 %	5 %	5 %
Total Company	3 %	6 %	5 %	7 %

Net Sales

Net sales increased $634 or 2%, and $1,672 or 2% during the third quarter and first thirty-six weeks of 2016, respectively, compared to the third quarter and first thirty-six weeks of 2015. This increase was attributable to sales at the 32 net new warehouses opened since the end of the third quarter of 2015. Comparable sales in the third quarter and first thirty-six weeks of 2016 were flat.

During the third quarter of 2016, changes in gasoline prices negatively impacted net sales by approximately $483, or 189 basis points, due to a 20% decrease in average sales price per gallon. Net sales were also negatively impacted by changes in foreign currencies relative to the U.S. dollar by $372, or 146 basis points, compared to the third quarter of 2015. The negative impact was primarily Canada of $208 and Mexico of $101.

During the first thirty-six weeks of 2016, changes in foreign currencies relative to the U.S. dollar negatively impacted net sales by approximately $2,426, or 308 basis points, compared to the first thirty-six weeks of 2015. The negative impact was attributable to all foreign countries in which we operate, predominantly Canada of $1,525, Mexico of $420 and Korea of $169. Changes in gasoline prices negatively impacted net sales by approximately $1,431, or 182 basis points, due to a 19% decrease in the average sales price per gallon.

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Comparable Sales

Comparable sales were flat in the third quarter and first thirty-six weeks of 2016. Comparable sales were positively impacted by an increase in shopping frequency, offset by the negative impacts of changes in foreign currencies relative to the U.S. dollar and a decrease in gasoline prices in both the third quarter and first thirty-six weeks of 2016. The average ticket was also negatively impacted by these items. Comparable sales also includes the negative impact of cannibalization (established warehouses losing sales to our newly opened locations).

Membership Fees

	12 Weeks Ended		36 Weeks Ended	
	May 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Membership fees	$618	$584	$1,814	$1,748
Membership fees as a percentage of net sales	2.36 %	2.29 %	2.26 %	2.22 %
Total paid members as of quarter end (000's)	46,900	43,700	—	—
Total cardholders as of quarter end (000's)	85,500	79,600	—	—

Membership fees increased 6% and 4% in the third quarter and first thirty-six weeks of 2016, respectively. They were adversely impacted by changes in foreign currencies relative to the U.S. dollar by approximately $7 and $49 for the third quarter and first thirty-six weeks of 2016, respectively. Excluding this negative impact, membership fees increased 7% in the third quarter and first thirty-six weeks of 2016, due to sign-ups at existing and new warehouses and increased penetration of our higher-fee Executive Membership program. Our member renewal rates are currently 90% in the U.S. and Canada and 88% worldwide.

Gross Margin

	12 Weeks Ended		36 Weeks Ended	
	May 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Net sales	$26,151	$25,517	$80,345	$78,673
Less merchandise costs	23,162	22,687	71,252	69,969
Gross margin	$2,989	$2,830	$9,093	$8,704
Gross margin percentage	11.43 %	11.09 %	11.32 %	11.06 %

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), increased 16 basis points. This was attributable to increases in food and sundries, softlines, and hardlines, partially offset by a decrease in fresh foods. This measure eliminates the impact of changes in sales penetration and gross margins from our warehouse ancillary and other businesses.

Total gross margin percentage increased 34 basis points compared to the third quarter of 2015. Excluding the impact of gasoline price deflation on net sales, gross margin as a percentage of adjusted net sales was 11.22%, an increase of 13 basis points from the third quarter of 2015. This increase was predominantly due to non-recurring legal settlements of seven basis points, a positive contribution from our warehouse ancillary and other businesses of four basis points, primarily our gasoline business, and a larger LIFO benefit in the current quarter compared to the third quarter of 2015, which contributed two basis points. These increases

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were partially offset by a decrease in our core merchandise categories of two basis points as a result of lower bounty revenue earned for new co-branded credit card sign-ups in the U.S. Changes in foreign currencies relative to the U.S. dollar negatively impacted gross margin by approximately $40 in the third quarter of 2016.

Gross margin on a segment basis, when expressed as a percentage of the segment's own sales and excluding the impact of gasoline price deflation on net sales (segment gross margin percentage), increased in our U.S. operations, primarily due to: the non-recurring legal settlements discussed above; increases in our core merchandise categories, predominantly hardlines and food and sundries; increases in our warehouse ancillary and other businesses, primarily our gasoline business; and the LIFO benefit discussed above. These increases were partially offset by the reduced bounty revenue discussed above. The segment gross margin percentage in our Canadian operations improved due to increases across all core merchandise categories and in our warehouse ancillary and other businesses, primarily our pharmacy and e-commerce businesses. The segment gross margin percentage in our Other International operations improved due to increases in our warehouse ancillary and other businesses, partially offset by decreases across all core merchandise categories except fresh foods, which was higher.

Year-to-date Results

The gross margin of our core merchandise categories, when expressed as a percentage of core merchandise sales, increased 13 basis points, predominantly due to increases in hardlines, softlines, and food and sundries.

Total gross margin percentage increased 26 basis points compared to the first thirty-six weeks of 2015. Excluding the impact of gasoline price deflation on net sales, gross margin as a percentage of adjusted net sales was 11.12%, an increase of six basis points from the prior year. This increase was due to a positive contribution from our warehouse ancillary and other businesses of six basis points, primarily our hearing aid and e-commerce businesses, and a larger LIFO benefit compared to the prior year which contributed two basis points. These increases were partially offset by a decrease in our core merchandise categories of two basis points as a result of lower bounty revenue earned for new co-branded credit card sign-ups in the U.S. Changes in foreign currencies relative to the U.S. dollar negatively impacted gross margin by $261 in the first thirty-six weeks of 2016.

The segment gross margin percentage in our U.S. operations improved due to: increases in our core merchandise categories, predominantly hardlines and softlines; increases in our warehouse ancillary and other businesses, primarily our hearing aid and e-commerce businesses; and the LIFO benefit discussed above. These increases were partially offset by the reduced bounty revenue discussed above. The segment gross margin percentage in our Canadian operations decreased due to decreases across all core merchandise categories except hardlines, which was flat, partially offset by increases in our warehouse ancillary and other businesses, primarily our pharmacy and e-commerce businesses. The segment gross margin percentage in our Other International operations decreased due to decreases from all core merchandise categories except for fresh foods, which was higher.

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Selling, General and Administrative Expenses

	12 Weeks Ended		36 Weeks Ended	
	May 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
SG&A expenses	$2,731	$2,579	$8,372	$7,946
SG&A expenses as a percentage of net sales	10.44 %	10.11 %	10.42 %	10.10 %

Quarterly Results

SG&A expenses as a percentage of net sales increased 33 basis points compared to the third quarter of 2015. Excluding the negative impact of gasoline price deflation on net sales, SG&A expenses as a percentage of adjusted net sales were 10.25%, an increase of 14 basis points. This increase was largely due to an increase in warehouse operating costs of eight basis points, due to higher employee benefit costs, primarily healthcare, and payroll expenses in our U.S. operations. This increase was partially offset by lower payroll expense as a percentage of net sales in our Canadian operations. Central operating costs were higher by four basis points, due to costs associated with our information systems modernization, including increased depreciation for projects placed in service, incurred by our U.S. operations. Stock compensation expense was higher by two basis points. Changes in foreign currencies relative to the U.S. dollar decreased our SG&A expenses by approximately $29 in the third quarter of 2016.

Year-to-date Results

SG&A expenses as a percentage of net sales increased 32 basis points compared to the first thirty-six weeks of 2015. Excluding the negative impact of gasoline price deflation on net sales, SG&A expenses as a percentage of adjusted net sales were 10.24%, an increase of 14 basis points. This increase was largely due to higher stock compensation expense of six basis points, due to appreciation in the trading price of our stock at the time of grant. Central operating costs were higher by six basis points, predominantly due to costs associated with our information systems modernization, including increased depreciation for projects placed in service, incurred by our U.S. operations. Charges for non-recurring legal and regulatory matters during the first quarter of 2016 also negatively impacted SG&A expenses by three basis points. These increases were offset by a net one basis point improvement in our warehouse operating costs, largely due to lower employee payroll and benefit expenses in our Canadian operations. Changes in foreign currencies relative to the U.S. dollar decreased our SG&A expenses by approximately $193 in the first thirty-six weeks of 2016.

Preopening Expense

	12 Weeks Ended		36 Weeks Ended	
	May 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Preopening expenses	$18	$ 14	$54	$ 38
Warehouse openings, including relocations				
United States	6	1	16	8
Canada	0	1	1	1
Other International	2	2	5	4
Total warehouse openings, including relocations	8	4	22	13

Preopening expenses include costs for startup operations related to new warehouses, including relocations, development in new international markets, and expansions at existing warehouses. Preopening expenses vary due to the number of warehouse openings, the timing of the opening relative to our quarter-end, whether

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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 warehouse is owned or leased, and whether the opening is in an existing, new or international market. For the remainder of fiscal 2016, we expect to open up to 11 additional warehouses, including one relocation, compared to 13 warehouses opened in the the last quarter of fiscal 2015.

Interest Expense

	12 Weeks Ended		36 Weeks Ended	
	May 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Interest expense	$30	$ 31	$94	$ 84

Interest expense is primarily related to Senior Notes issued by the Company. The increase in interest expense in the first thirty-six weeks of 2016 is primarily due to the Senior Notes issued in February 2015.

Interest Income and Other, Net

	12 Weeks Ended		36 Weeks Ended	
	May 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Interest income	$10	$ 10	$26	$ 38
Foreign-currency transaction gains, net	(7)	(3)	17	20
Other, net	4	2	8	6
Interest income and other, net	$7	$ 9	$51	$ 64

The decrease in interest income in the first thirty-six weeks of 2016 is attributable to lower average cash and investment balances. This is due to the payment of the outstanding principal balance and interest on the 0.65% Senior Notes in the second quarter of 2016 (see discussion in Part I, Item 1, Note 4 of this Report). Foreign-currency transaction gains, 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 8, 2016	May 10, 2015	May 8, 2016	May 10, 2015
Provision for income taxes	$286	$280	$847	$817
Effective tax rate	34.2 %	35.0 %	34.7 %	33.4 %

The effective tax rate for the third quarter of 2016 was positively impacted by immaterial discrete net tax benefits. Our provision for income taxes in the first thirty-six weeks of 2015 was favorably impacted by discrete net tax benefits of $45, primarily due to a $57 tax benefit recorded in the second quarter of 2015 in connection with the special cash dividend paid to employees through our 401(k) Retirement Plan. Dividends paid on these shares were deductible for U.S. income tax purposes.

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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)

LIQUIDITY AND CAPITAL RESOURCES

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

	36 Weeks Ended	
	May 8, 2016	May 10, 2015
Net cash provided by operating activities	$3,461	$3,257
Net cash used in investing activities	(1,320)	(1,775)
Net cash used in financing activities	(2,088)	(1,843)

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 $6,021 and $6,419 at May 8, 2016, and August 30, 2015, respectively. Of these balances, approximately $1,364 and $1,243 represented debit and credit card receivables at the end of the third quarter of 2016 and of fiscal year 2015, respectively, primarily related to sales within the last week of our fiscal quarter or fiscal year. Our cash flows were positively impacted by changes in foreign exchange rates by $30 in the first thirty-six weeks of 2016 and negatively impacted by $314 in the first thirty-six weeks of 2015.

We have not provided for U.S. deferred taxes on cumulative undistributed earnings of certain non-U.S. consolidated subsidiaries, including the remaining undistributed earnings of our Canadian operations, because our subsidiaries have invested or will invest the undistributed earnings indefinitely, or the earnings, if repatriated would not result in an adverse tax consequence. Although we have historically asserted that certain non-U.S. undistributed earnings will be permanently reinvested, we may repatriate such earnings to the extent we can do so without an adverse tax consequence. If we determine that such earnings are no longer indefinitely reinvested, deferred taxes, to the extent required and applicable, are recorded at that time. Earnings in our Canadian operations that were previously determined not to be indefinitely reinvested were repatriated in the third quarter of 2016.

Management believes that our cash position and operating cash flows will be sufficient to meet our liquidity and capital requirements for the foreseeable future. We believe that our U.S. current and projected asset position is sufficient to meet our U.S. liquidity requirements and have no current plans to repatriate for use in the U.S. cash and cash equivalents and short-term investments held by non-U.S. consolidated subsidiaries whose earnings are considered indefinitely reinvested. Cash and cash equivalents and short-term investments held at these subsidiaries and considered to be indefinitely reinvested totaled $1,570 at May 8, 2016.

Cash Flows from Operating Activities

Net cash provided by operating activities totaled $3,461 in the first thirty-six weeks of 2016, compared to $3,257 in the first thirty-six weeks of 2015. 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 and employee benefits, credit card processing fees, and utilities. Cash used in operations also includes payments for income taxes.

Cash Flows from Investing Activities

Net cash used in investing activities totaled $1,320 in the first thirty-six weeks of 2016 compared to $1,775 in the first thirty-six weeks of 2015. Our 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.

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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)

Capital Expenditure Plans

We opened 19 new warehouses and relocated three in the first thirty-six weeks of 2016 and plan to open up to 10 new warehouses and relocate one for the remainder of fiscal 2016. 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, the modernization of our information systems, and working capital. In the first thirty-six weeks of 2016, we spent approximately $1,800, and it is our current intention to spend approximately $2,500 to $2,700 during fiscal 2016. These expenditures are expected to be financed with cash from operations, existing cash and cash equivalents, and short-term investments. 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 $2,088 in the first thirty-six weeks of 2016 compared to $1,843 in the first thirty-six weeks of 2015. Cash used in financing activities primarily related to the $1,200 repayment of our 0.65% Senior Notes on December 7, 2015.

On March 31, 2016, the Company's Japanese subsidiary issued approximately $103 of 0.63% Guaranteed Senior Notes through a private placement. Interest is payable semi-annually, and principal is due in March 2026.

Stock Repurchase Programs

During the first thirty-six weeks of 2016 and 2015, we repurchased 2,328,000 and 1,620,000 shares of common stock, at an average price of $148.64 and $144.20, totaling approximately $346 and $234, respectively. The amount available for stock repurchases under our approved plan was $3,353 at May 8, 2016. 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 $0.45 per share, or $1.80 per share on an annualized basis. On April 14, 2016, our Board of Directors declared a quarterly dividend of $0.45 per share payable to shareholders of record on April 29, 2016. The dividend was paid on May 13, 2016.

Bank Credit Facilities and Commercial Paper Programs

We maintain bank credit facilities for working capital and general corporate purposes. As of May 8, 2016, we had borrowing capacity within these facilities of $427, of which $357 was maintained by our international operations. Of the $357, $168 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 2016 or at the end of 2015.

The Company has letter of credit facilities, for commercial and standby letters of credit, totaling $149. The outstanding commitments under these facilities at the end of the third quarter of 2016 totaled $94, including $91 in standby letters of credit with expiration dates within one year. The bank credit facilities have various expiration dates, all within one year, and we generally intend to renew these facilities. The amount of borrowings available at any time under our bank credit facilities is reduced by the amount of standby and commercial letters of credit then outstanding.

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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)

Contractual Obligations

Other than the repayment and issuance of Senior Notes described above, 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 our estimates and judgments 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 August 30, 2015. 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 interest rates and foreign currency exchange 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 August 30, 2015.

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 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 has been no change 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 has materially affected or is 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 8 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 August 30, 2015. There have been no material changes in our risk factors from those disclosed in our Annual Report on Form 10-K.

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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 2016 (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 15, 2016 - March 13, 2016	277,000	$150.37	277,000	$ 3,447
March 14, 2016 - April 10, 2016	261,000	153.83	261,000	3,407
April 11, 2016 - May 8, 2016	361,000	150.85	361,000	3,353
Total third quarter	899,000	$151.57	899,000	

(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 the registrant		10-Q	2/15/2015	3/11/2015
3.2	Bylaws of the registrant		8-K		8/24/2010
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			

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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 1, 2016	By	/s/ W. CRAIG JELINEK
Date		W. Craig Jelinek President, Chief Executive Officer and Director
June 1, 2016	By	/s/ RICHARD A. GALANTI
Date		Richard A. Galanti Executive Vice President, Chief Financial Officer and Director