# Annual Report 2006

YEAR ENDED SEPTEMBER 3, 2006

2006

## THE COMPANY

Costco Wholesale Corporation ("Costco" or the "Company") began operations in 1983 in Seattle, Washington. In October 1993, Costco merged with The Price Company, which had pioneered the membership warehouse concept in 1976, to form Price/Costco, Inc., a Delaware corporation. In January 1997, after the spin-off of most of its non-warehouse assets to Price Enterprises, Inc., the Company changed its name to Costco Companies, Inc. On August 30, 1999, the Company reincorporated from Delaware to Washington and changed its name to Costco Wholesale Corporation, which trades on the NASDAQ under the symbol "COST."

As of December 2006, the Company operated a chain of 504 warehouses in 38 states and Puerto Rico (371 locations), nine Canadian provinces (70 locations), the United Kingdom (19 locations), Korea (five locations), Taiwan (four locations, through a 55%-owned subsidiary) and Japan (five locations), as well as 30 warehouses in Mexico through a 50%-owned joint venture.

## CONTENTS


Financial Highlights . . . . . 1

Letter to Shareholders . . . . . 2

Map of Warehouse Locations . . . . . 6

Business Overview . . . . . 8

Risk Factors . . . . . 13

Properties: Warehouse, Administration and Distribution Properties . . . . . 18

Market for Costco Common Stock, Dividend Policy and Stock Repurchase Program . . . . . 19

Five Year Operating and Financial Highlights . . . . . 20

Management's Discussion and Analysis of Financial Condition and Results of Operations . . . . . 21

Executive Officers of the Company . . . . . 35

Management's Reports . . . . . 35

Reports of Independent Registered Public Accounting Firm . . . . . 37

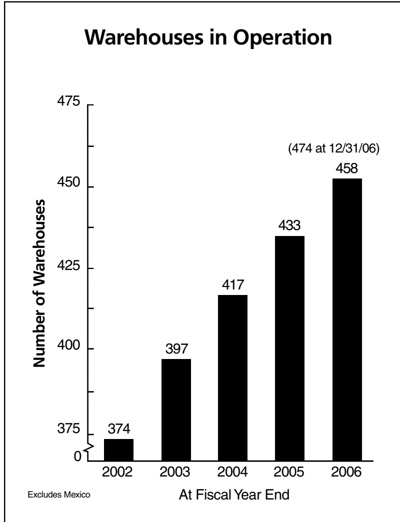
Consolidated Financial Statements . . . . . 39

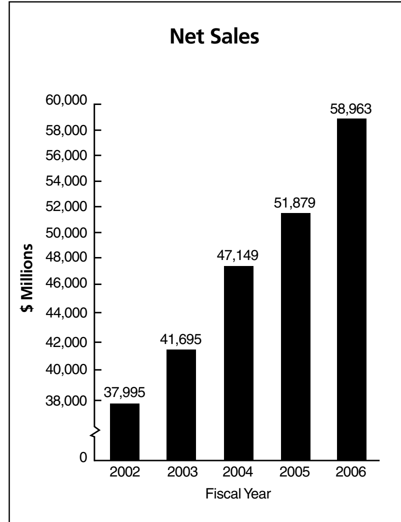
Notes to Consolidated Financial Statements . . . . . 43

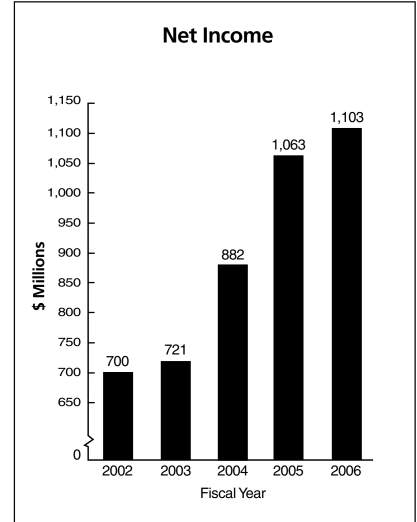
Directors and Officers of the Company . . . . . 71

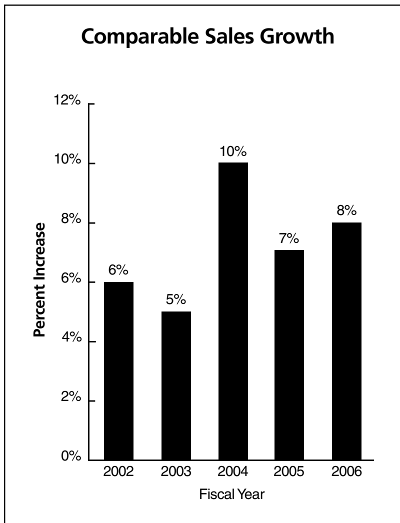
Additional Information . . . . . 73

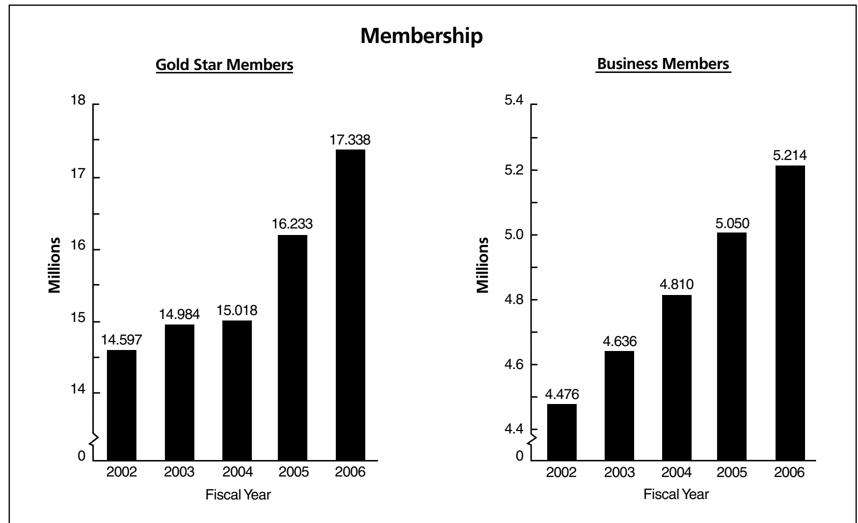
# FINANCIAL HIGHLIGHTS



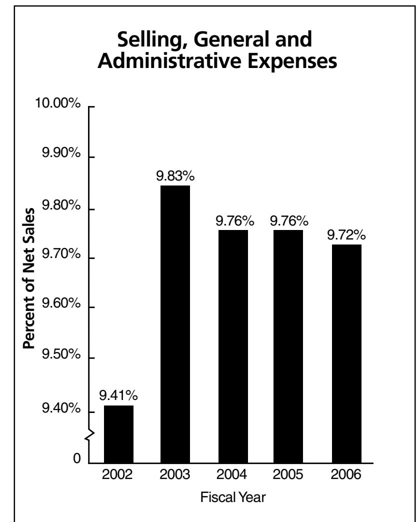




## Average Sales Per Warehouse* (Sales In Millions)

| Year Opened | # of Whses* | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2006 | 25 | | | | | | | | | | $92 |
| 2005 | 16 | | | | | | | | | $63 | 81 |
| 2004 | 20 | | | | | | | | $72 | 81 | 99 |
| 2003 | 24 | | | | | | | $67 | 79 | 91 | 101 |
| 2002 | 29 | | | | | | $58 | 62 | 77 | 88 | 98 |
| 2001 | 32 | | | | | $57 | 63 | 72 | 84 | 94 | 105 |
| 2000 | 21 | | | | $57 | 65 | 77 | 85 | 98 | 107 | 117 |
| 1999 | 15 | | | $65 | 77 | 86 | 97 | 105 | 120 | 127 | 136 |
| 1998 | 17 | | $50 | 58 | 72 | 77 | 82 | 86 | 91 | 99 | 107 |
| 1997 & Before | 259 | $83 | 89 | 97 | 108 | 111 | 116 | 121 | 132 | 137 | 145 |
| Totals | 458 | $83 | $87 | $94 | $101 | $101 | $103 | $105 | $115 | $120 | $127 |

Fiscal Year

*First year sales annualized.



December 14, 2006

Dear Costco Shareholders,

Fiscal 2006 was an outstanding year for our Company. Our sales during this 53-week fiscal year increased 13.7% over the prior fiscal year to nearly $59 billion, driven by an increase in comparable warehouse sales of 8% and the opening of 28 new warehouses (including 3 relocations). More importantly, earnings increased to a record $1.1 billion or $2.30 per share. These results came on top of a record year of sales and earnings in fiscal 2005.

Our members responded to our efforts and their satisfaction with Costco continued to improve. Key measures of this success, in addition to our strong comparable sales increase, are reflected in our high membership renewal rate of nearly 87%, our strong increase in new individual (Gold Star) and Business member sign-ups, a large increase in member upgrades to our Executive Membership, and our continuing top ranking in independent customer satisfaction surveys.

Key elements to our success continue to be high sales volumes per warehouse, leveraging our efficient operating structure and making us the low cost operator in retail today. Costco sales volumes per warehouse continue to lead the industry and are two to three times those of our nearest club competitors. For the second time, one of our warehouses topped $300 million in sales in fiscal 2006. In addition, forty-two of our locations had sales of more than $200 million, compared with only 25 warehouses in fiscal 2005, and several others are not far behind. Our average sales per warehouse increased to $127 million. This top line sales success moved us from the ninth largest retailer in the world to the seventh largest in 2006.

Our continued emphasis on cost controls and expense reduction was effective in 2006, although we know there is still much work to do here. Our selling, general and administrative (SG&A) expenses as a percent of sales declined from 9.76% in 2005 to 9.72% in 2006; and our shrink results continued to improve and were the lowest in the Company's history at less than .20% of net sales.

Our Company reached several important milestones in fiscal 2006 and the first quarter of fiscal 2007. In July we celebrated the 30th anniversary of the opening of our first warehouse in 1976 in San Diego, California, which marked the beginning of the warehouse club industry, now a retail segment exceeding $100 billion annually. With the opening of our La Quinta, California warehouse just before Thanksgiving this year, we reached 500 warehouses in operation; and with four more openings just after Thanksgiving we now have 504 warehouses in operation around the world. In addition to being named one of the most-admired companies in the U.S. by *Fortune* magazine, this year we also were honored by our peers in being twice named Retailer of the Year—by both *DSN Retailing Today* and *Mass Market Retailers*. We also received the J.D. Power Award from National Vision Retailers for having the highest overall optical department customer satisfaction in the U.S.

With our strong bottom line performance and rapid inventory turnover we generated over $1.8 billion in cash flow in fiscal 2006. With these funds, and our beginning-of-year cash balance of over $2 billion, we were able to make some prudent expenditures in fiscal 2006: we paid out over $1.2 billion in capital expenditures, primarily for new warehouse and depot construction; we retired $300 million in long-term debt; we spent $1.5 billion to buy back 28.4 million shares of our stock; and we paid out more than $230 million in dividends to our shareholders, increasing our dividend by 13% from $.115 to $.13 per quarter.

This past year we began to implement more aggressive expansion plans, targeting both new and existing markets in the United States and internationally. After opening sixteen new warehouses and relocating five in fiscal 2005, we opened twenty-eight units in 2006, three of which were relocations to larger and better-located facilities. We have found that our stronger markets can support increasing numbers of our warehouses in closer proximity to each other. This infill strategy has been successful and drives our market share and increases our sales volumes in these communities.

In the U.S., our 2006 openings included infills in the following existing markets: San Luis Obispo, La Habra, SW Bakersfield and Lake Elsinore, California; Cave Creek, Chandler and SE Gilbert, Arizona; West Bountiful and Lehi, Utah; Centennial and Sparks, Nevada; Lacey, Washington; Hillsboro, Oregon; Nampa, Idaho; S. Austin and Duncanville, Texas; Buford, Georgia; and Pembroke Pines, Florida. We entered a new market in North Carolina, opening in the city of Wilmington; and we placed our fourth unit in Puerto Rico, in East Bayamon. We also relocated warehouses in Kalispell, Montana and Sequim, Washington to new, improved and larger facilities.

Our international expansion continues at a steady pace. We opened three new infill warehouses in Canada last year: Kanata, Ontario in the Ottawa suburbs; and Sherwood Park (Edmonton) and Northwest Calgary, Alberta. Our Gatineau, Quebec warehouse, just across the river from Ottawa, was relocated to a larger facility. We also entered two new markets in England: Sheffield in the north of the country and Milton Keynes in the southeast. In Mexico, we opened in Juarez, just across the border from El Paso, Texas, and in Veracruz on the Gulf coast.

Our ramped-up expansion plans for fiscal 2007 call for the opening of 36 to 40 new warehouses, including two relocations. Most of these will be in existing markets, and we are off to a running start. Prior to the end of calendar 2006 we opened units in Kauai, Hawaii; Gypsum, Colorado; Raleigh, North Carolina; Louisville, Kentucky; Maple Grove, Minnesota; W. Nashville, Tennessee; Helena, Montana; and Columbus, Ohio. Additional infill warehouses were opened in Marysville, Washington; Cumberland Mall, Georgia; Fontana, California; La Quinta, California; and Orland Park, Illinois.

Internationally, we have opened four new warehouses so far in fiscal 2007, all in existing markets. In Canada, we opened a unit in downtown Vancouver, British Columbia, and in Boisbriand, Quebec, on the outskirts of Montreal. In Mexico, we opened a new building in Toluca, near Mexico City; and our early-December opening in Chester, England concluded our calendar 2006 openings.

Our merchandise distribution infrastructure was enhanced in fiscal 2006, with the opening of large depot facility in Salt Lake City, Utah, that services Costco warehouses in the mountain states. Additionally, expansions were completed at our depots in Langley, British Columbia, St. Bruno, Quebec, and Mira Loma, California to achieve greater distribution efficiencies.

The number of Costco members continued to grow in fiscal 2006. With more than 47 million loyal cardholders, we continued our strong member renewal rate at nearly 87%. Our members know that they can always find the highest-quality products at the best value at Costco. But that is only part of what they love about our company. It is the thrill of the hunt (we call this our “treasure hunt”) that they come for – always aware that we will have something new, exciting and novel they might find in the next aisle – things like Prada handbags, Callaway golf clubs, or a $12,000 tree house.

Our members know that Costco membership is worth more, and they are quite willing to pay for it. More and more members are taking advantage of the great benefits and services offered by our Executive Membership, at $100 a year, and enjoy the 2% reward (up to $500) they receive each year on their qualified purchases. We raised our membership fees for our Gold Star and Business Memberships by $5 in April (for member renewals in July). The incremental annualized income from this increase is $75 million, which we will realize over the next two years. Overall in fiscal 2006 we took in $1.1 billion in membership fees. These membership funds are always used to make Costco more competitive in the marketplace.

The partnerships we have built with our suppliers are key to our ability to provide our members with the quality and value that they have come to expect from Costco. Our reputation for being tough negotiators is well earned; but at the same time our suppliers know that we will always treat them fairly and honestly. Together, we work hard to continually improve the quality of our merchandise while

enhancing its value. In product sourcing, development and packaging we continue to be mindful of fair trade issues and the environment, and we are proud of the contributions that Costco makes in these important areas, such as our fair-trade coffee offerings and new emphasis on organic products. We continue to develop mutually-successful relationships with many of the world's leading corporations, such as Colgate-Palmolive, ConAgra, Hewlett Packard, Jones of New York, Michelin, Nestle, Panasonic, Pepsi, Procter & Gamble, Sara Lee, Apple, Starbucks and Sony TV to name just a few.

In fiscal 2006 we sold more than 1.5 million TVs and $300 million of digital cameras. We filled 26.3 million prescriptions, sold two million pairs of eyeglasses, printed more than a billion photos, and served 63 million hot dog and soda combos (still only $1.50). We sold 500 million dollars-worth of seafood globally and 28 million rotisserie chickens in the U.S. and Canada alone. Eleven percent of the organic milk and forty percent of the Tuscan olive oil sold in the United States last year was bought at Costco. We also sold $805 million of wine, including $390 million in fine wines; and our members bought more than 96,000 karats of diamonds. No wonder we are now the second-largest general merchandise retailer in the U.S.

Costco's Kirkland Signature private label products are recognized in all of our markets for their incomparable value and quality, and Kirkland Signature is becoming a respected name-brand in its own right. We currently carry 330 private label items, which account for 15% of our sales. Our plans are to increase the number of Kirkland Signature items, and we hope to drive Kirkland Signature sales to 25% of our total over the next several years.

Augmenting the Company's warehouse operations is our expanding E-commerce business, costco.com. As expected, our sales for 2006 increased 59% over 2005, and profits were up again. We project sales will be well over $1 billion in 2007 and hope to reach $5 billion in five years. Costco.com allows us to offer our customers high-end products that are not available in our warehouses, and warehouse shoppers can also order online from costco.com at kiosks in many of our buildings, as well as from their own computers. This year we expanded the online sporting goods and housewares categories and added a new business products program, as well as the ability to purchase "build-to-order" diamond rings. In its second year of operation in our important Canadian market, costco.ca had significant sales growth and was profitable. Like its U.S. counterpart, costco.ca's top sellers include electronics and jewelry.

Costco's ancillary businesses not only continue to bring our members in for more frequent shops, but they drive sales in every market where we do business and provide significant value and service to our members. Altogether, ancillary sales increased by more than 25% in 2006, to more than $8.3 billion. Our pharmacies continue to receive media acclaim as the lowest-priced providers by as much as 80% to 90% in every market, particularly for generic drugs; and the Company's Kirkland Signature over-the-counter medications also provide unparalleled value. We are pleased to note that Costco pharmacies effectively transitioned our members to the challenging Medicare Part D program. With 429 pharmacies in operation, Costco's pharmacy sales were up 16% last year. Our first Central Fill facility debuted in fiscal 2006, bringing new efficiencies to our prescription-fill process in our Northwest Region. This service is seamless to our members, with prescriptions filled and delivered in 24-hours or less to their local warehouse.

It was another tumultuous year for the gasoline market, and we all felt the price crunch at the pumps; but Costco members knew they could find the lowest prices in town at one of our 249 gas stations. The first Costco Car Wash was added to our Seattle warehouse this past year in a test program that has proved popular with our Puget Sound members. Ecologically-friendly, the car wash system recovers 75% of the water used, and the service includes rim cleaning, waxing and undercoating, all for $7.99 plus tax.

As Costco's founders, we have always said that the Company's employees are its most valuable assets. We believe our management team is one of the most cohesive and talented in the retail

industry. We are proud that they possess the skills, experience, and abilities to fully operate Costco successfully for many years to come, and that an aggressive training program is in effect to mentor the Company's future leaders. Many of our executives have been with us for more than twenty years, and some of them have worked together for nearly forty years in the retail industry. This year we added two new members to our Executive Committee: Ginnie Roeglin, Senior Vice President of E-Commerce and Publishing, and Louise Wendling, Senior Vice President and Country Manager of Canada.

We have assembled an outstanding team of warehouse managers, each of whom is directed to make their highest priority the training and developing of new managers and leaders for the Company as we prepare for expanded growth. It is very important to us that all of Costco's employees have equal opportunities for advancement and that our management teams reflect the diversity of the communities in which we do business. Our turnover rate is the lowest in the retail industry, and we are grateful to each of Costco's 132,000 employees for their excellent work ethic, exceptional member service, and loyalty to the Company.

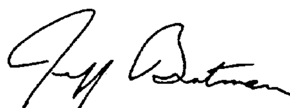
During the third fiscal quarter Costco initiated an internal review of its historical stock option grant practices to determine whether the stated grant dates of options were supported by the Company's books and records. The review determined that, in several instances, it was impossible to determine with precision the appropriate measurement date for specific grants, but only a range of such dates. Our practices did not meet the high standards to which we as a company are dedicated and which we follow in every aspect of our business. For that, as well as the expense and distraction caused by the inquiry, the Company apologizes to its shareholders. As previously disclosed, the Company has recorded an adjustment to transfer $116.2 million from retained earnings to paid-in capital, representing previously unrecorded after-tax compensation expense, and to increase the deferred tax asset account by $31.5 million; and we have improved the controls concerning equity grants. We believe that our actions have put this issue behind the Company, both from a financial statement and a controls standpoint.

The successes of fiscal 2006 highlighted above only strengthen our resolve to continue our relentless focus on our mission statement and code of ethics, which not only specify that we bring high quality goods and services to market at the lowest possible prices every day, but that we do so with integrity at every level of our company while valuing the interests of all of our stakeholders. It is this commitment that has always set Costco apart and that will spur us onward successfully in the future. We recognize that we have plenty of opportunities to improve every part of our business, and we assure you that we will stay focused on that task.

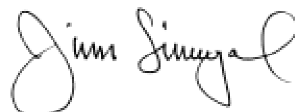
On behalf of the entire Costco management team and all of our employees, we pledge to continue our constant quest to turn challenges into opportunities and seek constructive ways to improve our existing business while initiating new avenues for growth and success in the future. We are very positive and excited about Costco's ever-expanding potential, and we look forward to discussing our plans for the future, as well as the Company's fiscal 2006 results, with many of you at our upcoming Annual Meeting of Shareholders on January 31, 2007 in Bellevue, Washington.

We appreciate the confidence you have placed in Costco and our management team, and we thank you for your support as we prepare to enter the new year. We hope that 2007 will be a peaceful and successful year for you and your loved ones. Best wishes for a joyous Holiday Season.

Warm Regards,

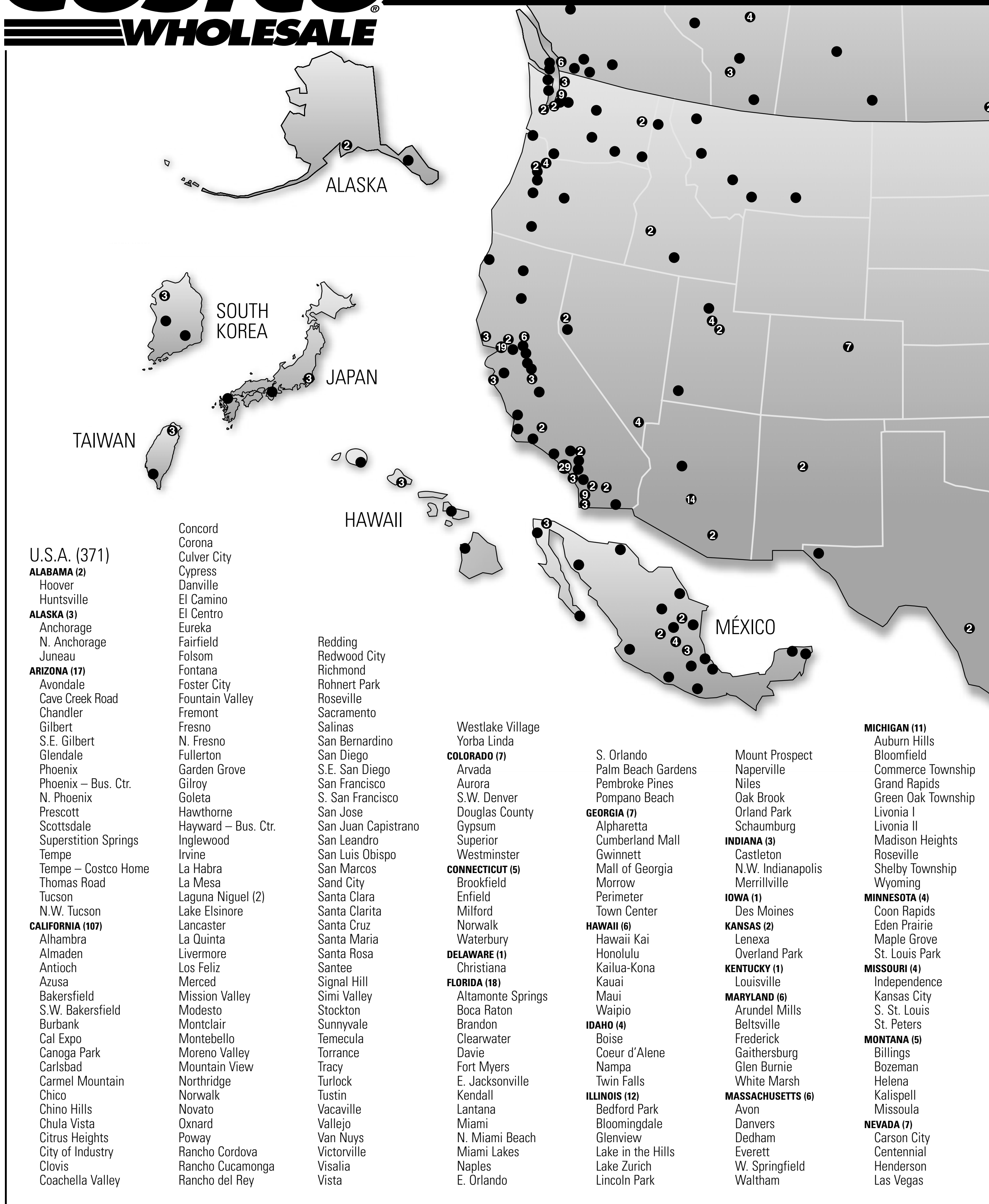


Jeff Brotman
Chairman of the Board



Jim Sinegal
President & CEO

# COSTCO WHOLESALE — 504 LOCATIONS AS O




U.S.A. (371)

**ALABAMA (2)**
Hoover
Huntsville

**ALASKA (3)**
Anchorage
N. Anchorage
Juneau

**ARIZONA (17)**
Avondale
Cave Creek Road
Chandler
Gilbert
S.E. Gilbert
Glendale
Phoenix
Phoenix – Bus. Ctr.
N. Phoenix
Prescott
Scottsdale
Superstition Springs
Tempe
Tempe – Costco Home
Thomas Road
Tucson
N.W. Tucson

**CALIFORNIA (107)**
Alhambra
Almaden
Antioch
Azusa
Bakersfield
S.W. Bakersfield
Burbank
Cal Expo
Canoga Park
Carlsbad
Carmel Mountain
Chico
Chino Hills
Chula Vista
Citrus Heights
City of Industry
Clovis
Coachella Valley
Concord
Corona
Culver City
Cypress
Danville
El Camino
El Centro
Eureka
Fairfield
Folsom
Fontana
Foster City
Fountain Valley
Fremont
Fresno
N. Fresno
Fullerton
Garden Grove
Gilroy
Goleta
Hawthorne
Hayward – Bus. Ctr.
Inglewood
Irvine
La Habra
La Mesa
Laguna Niguel (2)
Lake Elsinore
Lancaster
La Quinta
Livermore
Los Feliz
Merced
Mission Valley
Modesto
Montclair
Montebello
Moreno Valley
Mountain View
Northridge
Norwalk
Novato
Oxnard
Poway
Rancho Cordova
Rancho Cucamonga
Rancho del Rey
Redding
Redwood City
Richmond
Rohnert Park
Roseville
Sacramento
Salinas
San Bernardino
San Diego
S.E. San Diego
San Francisco
S. San Francisco
San Jose
San Juan Capistrano
San Leandro
San Luis Obispo
San Marcos
Sand City
Santa Clara
Santa Clarita
Santa Cruz
Santa Maria
Santa Rosa
Santee
Signal Hill
Simi Valley
Stockton
Sunnyvale
Temecula
Torrance
Tracy
Turlock
Tustin
Vacaville
Vallejo
Van Nuys
Victorville
Visalia
Vista
Westlake Village
Yorba Linda

**COLORADO (7)**
Arvada
Aurora
S.W. Denver
Douglas County
Gypsum
Superior
Westminster

**CONNECTICUT (5)**
Brookfield
Enfield
Milford
Norwalk
Waterbury

**DELAWARE (1)**
Christiana

**FLORIDA (18)**
Altamonte Springs
Boca Raton
Brandon
Clearwater
Davie
Fort Myers
E. Jacksonville
Kendall
Lantana
Miami
N. Miami Beach
Miami Lakes
Naples
E. Orlando
S. Orlando
Palm Beach Gardens
Pembroke Pines
Pompano Beach

**GEORGIA (7)**
Alpharetta
Cumberland Mall
Gwinnett
Mall of Georgia
Morrow
Perimeter
Town Center

**HAWAII (6)**
Hawaii Kai
Honolulu
Kailua-Kona
Kauai
Maui
Waipio

**IDAHO (4)**
Boise
Coeur d'Alene
Nampa
Twin Falls

**ILLINOIS (12)**
Bedford Park
Bloomingdale
Glenview
Lake in the Hills
Lake Zurich
Lincoln Park
Mount Prospect
Naperville
Niles
Oak Brook
Orland Park
Schaumburg

**INDIANA (3)**
Castleton
N.W. Indianapolis
Merrillville

**IOWA (1)**
Des Moines

**KANSAS (2)**
Lenexa
Overland Park

**KENTUCKY (1)**
Louisville

**MARYLAND (6)**
Arundel Mills
Beltsville
Frederick
Gaithersburg
Glen Burnie
White Marsh

**MASSACHUSETTS (6)**
Avon
Danvers
Dedham
Everett
W. Springfield
Waltham

**MICHIGAN (11)**
Auburn Hills
Bloomfield
Commerce Township
Grand Rapids
Green Oak Township
Livonia I
Livonia II
Madison Heights
Roseville
Shelby Township
Wyoming

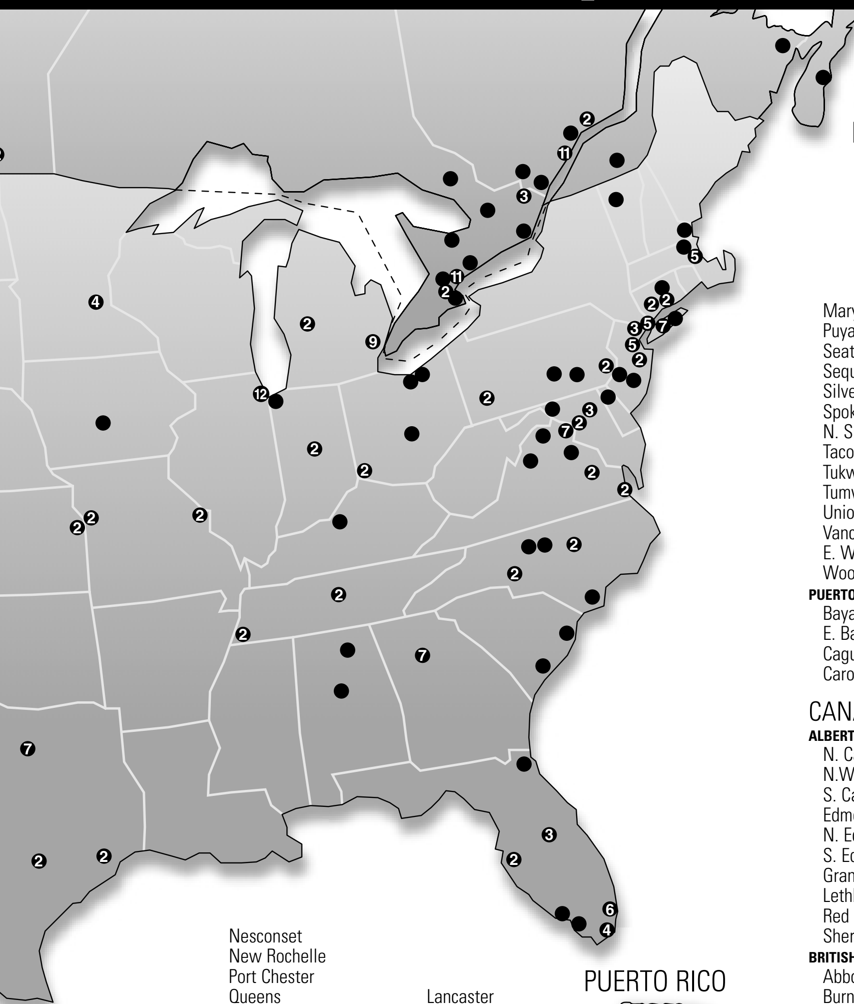
**MINNESOTA (4)**
Coon Rapids
Eden Prairie
Maple Grove
St. Louis Park

**MISSOURI (4)**
Independence
Kansas City
S. St. Louis
St. Peters

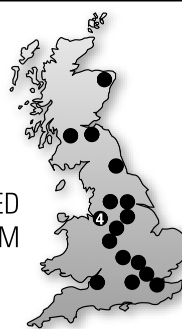
**MONTANA (5)**
Billings
Bozeman
Helena
Kalispell
Missoula

**NEVADA (7)**
Carson City
Centennial
Henderson
Las Vegas

# OF DECEMBER 31, 2006



NEWFOUNDLAND





PUERTO RICO

Reno
Sparks
Summerlin

**NEW HAMPSHIRE (1)**
Nashua

**NEW JERSEY (12)**
Brick Township
Bridgewater
Clifton
Edison
Hackensack
E. Hanover
Hazlet
Mount Laurel
Ocean Township
Union
Wayne
Wharton

**NEW MEXICO (2)**
Albuquerque
Albuquerque II

**NEW YORK (13)**
Brooklyn
Commack
Holbrook
Lawrence
Melville
Nanuet
Nesconset
New Rochelle
Port Chester
Queens
Staten Island
Westbury
Yonkers

**NORTH CAROLINA (7)**
Charlotte
Durham
Greensboro
Matthews
Raleigh
Wilmington
Winston-Salem

**OHIO (5)**
Avon
Columbus
Deerfield Township
Mayfield Heights
Springdale

**OREGON (12)**
Albany
Aloha
Bend
Clackamas
Eugene
Hillsboro
Medford
Portland
Salem
Tigard
Warrenton
Wilsonville

**PENNSYLVANIA (6)**
Cranberry
Harrisburg
King of Prussia
Lancaster
Montgomeryville
Robinson

**SOUTH CAROLINA (2)**
Charleston
Myrtle Beach

**TENNESSEE (4)**
Brentwood
N.E. Memphis
S.E. Memphis
W. Nashville

**TEXAS (14)**
Arlington
Austin
S. Austin
Duncanville
El Paso
Fort Worth
Katy Freeway
Lewisville
East Plano
West Plano
N.W. San Antonio
Sonterra Park
Southlake
Willowbrook

**UTAH (8)**
W. Bountiful
Lehi
Murray
S. Ogden
Orem
St. George
Salt Lake City
Sandy

**VERMONT (1)**
Colchester

**VIRGINIA (14)**
Chantilly
Chesterfield
Fairfax
Fredericksburg
Harrisonburg
W. Henrico
Leesburg
Manassas
Newington
Newport News
Norfolk
Pentagon City
Sterling
Winchester

**WASHINGTON (27)**
Aurora Village
Bellingham
Burlington
Clarkston
Everett
Federal Way
Fife – Bus. Ctr.
Issaquah
Kennewick
Kirkland
Kirkland – Costco Home
Lacey
Lynnwood – Bus. Ctr.
Marysville
Puyallup
Seattle
Sequim
Silverdale
Spokane
N. Spokane
Tacoma
Tukwila
Tumwater
Union Gap
Vancouver
E. Wenatchee
Woodinville

**PUERTO RICO (4)**
Bayamón
E. Bayamón
Caguas
Carolina

## CANADA (70)

**ALBERTA (10)**
N. Calgary
N.W. Calgary
S. Calgary
Edmonton
N. Edmonton
S. Edmonton
Grande Prairie
Lethbridge
Red Deer
Sherwood Park

**BRITISH COLUMBIA (13)**
Abbotsford
Burnaby
Grandview
Kamloops
Kelowna
Langford
Langley
Nanaimo
Port Coquitlam
Prince George
Richmond
Surrey
Vancouver

**MANITOBA (2)**
Winnipeg
E. Winnipeg

**NEW BRUNSWICK (1)**
Moncton

**NEWFOUNDLAND (1)**
St. John's

**NOVA SCOTIA (1)**
Halifax

**ONTARIO (23)**
Ajax
Ancaster
Barrie
Brampton
Burlington
Downsview
Etobicoke
Gloucester
Kanata
Kingston
Kitchener
London
North London
Markham
Mississauga North
Mississauga South
Nepean
Newmarket
St. Catharines
Scarborough
Sudbury
Vaughan
Windsor

**QUÉBEC (17)**
Anjou
Boisbriand
Boucherville
Brossard
Chicoutimi
Gatineau
Laval
Marché Central
Montréal
Pointe Claire
Québec
Sainte-Foy
Saint-Hubert
Saint-Jérôme
Sherbrooke
Terrebonne
Trois-Rivières-Ouest

**SASKATCHEWAN (2)**
Regina
Saskatoon

## JAPAN (5)

Amagasaki
Hisayama
Kanazawa Seaside
Makuhari
Tamasakai

## SOUTH KOREA (5)

Daegu
Daejeon
Sang Bong
Yang Jae
Yang Pyung

## TAIWAN (4)

Chung Ho
Kaohsiung
Neihu
Shih Chih

## UNITED KINGDOM (19)

**ENGLAND (16)**
Birmingham
Bristol
Chester
Chingford
Derby
Gateshead
Haydock
Leeds
Liverpool
Manchester
Milton Keynes
Oldham
Reading
Sheffield
Thurrock
Watford

**SCOTLAND (3)**
Aberdeen
Edinburgh
Glasgow

## MÉXICO (30)

(50% Joint Venture)

**AGUASCALIENTES (1)**
Aguascalientes

**BAJA CALIFORNIA (4)**
Ensenada
Mexicali
Tijuana
Tijuana II

**BAJA CALIFORNIA SUR (1)**
Cabo San Lucas

**CHIHUAHUA (1)**
Juarez

**GUANAJUATO (2)**
Celaya
León

**GUERRERO (1)**
Acapulco

**JALISCO (1)**
Guadalajara

**MÉXICO (4)**
Arboledas
Interlomas
Satélite
Toluca

**MÉXICO, D.F. (3)**
Coapa
Mixcoac
Polanco

**MICHOACÁN (1)**
Morelia

**MORELOS (1)**
Cuernavaca

**NUEVO LEÓN (2)**
Monterrey
Monterrey II

**PUEBLA (1)**
Puebla

**QUERÉTARO (1)**
Querétaro

**QUINTANA ROO (1)**
Cancún

**SAN LUIS POTOSÍ (1)**
San Luis Potosí

**SONORA (1)**
Hermosillo

**VERACRUZ (2)**
Veracruz
Xalapa

**YUCATÁN (1)**
Mérida

## BUSINESS OVERVIEW

We operate membership warehouses based on the concept that offering our members very low prices on a limited selection of nationally branded and selected private label products in a wide range of merchandise categories will produce high sales volumes and rapid inventory turnover. This 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, enables us to operate profitably at significantly lower gross margins than traditional wholesalers, mass merchandisers, supermarkets and supercenters.

We buy the majority of our merchandise directly from manufacturers and route it to a cross-docking consolidation point ("depot") or directly to our warehouses. Our depots receive container-based shipments from manufacturers and reallocate these goods for combined shipment to our individual warehouses, generally in less than twenty-four hours. This maximizes freight volume and handling efficiencies, thereby lowering our receiving costs by eliminating many of the costs associated with multiple step distribution channels, which include purchasing from distributors as opposed to manufacturers, use of central receiving, storing and distributing warehouses, and storage of merchandise in locations off the sales floor.

Because of our high sales volume and rapid inventory turnover, we generally have the opportunity to sell and be paid for inventory before we are required to pay many of our merchandise vendors, even though we take advantage of early payment discounts. As sales increase and inventory turnover becomes more rapid, a greater percentage of inventory is financed through payment terms provided by vendors rather than by our working capital.

Our typical warehouse format averages approximately 140,000 square feet. Floor plans are designed for economy and efficiency in the use of selling space, the handling of merchandise and the control of inventory. Because shoppers are attracted principally by the availability of low prices, our warehouses need not be located on prime commercial real estate sites or have elaborate facilities. By strictly controlling the entrances and exits of our warehouses and using a membership format, we have limited inventory losses to less than two-tenths of one percent of net sales in each of the last three fiscal years—well below those of typical discount retail operations.

We generally limit marketing and promotional activities to new warehouse openings, occasional direct mail marketing to prospective new members and direct marketing programs (such as the Costco Connection) to existing members promoting selected merchandise. These practices result in lower marketing expenses as compared to typical retailers, discount retailers and supermarkets. In connection with new warehouse openings, our marketing teams personally contact businesses in the area that are potential wholesale members. These contacts are supported by direct mailings during the period immediately prior to opening. Potential Gold Star (individual) members are contacted by direct mail or by providing membership offerings to be distributed through employee associations and other entities. After a membership base is established in an area, most new memberships result from word-of-mouth advertising, follow-up messages distributed through regular payroll or other organizational communications to employee groups and ongoing direct solicitations to prospective Business and Gold Star members.

Our warehouses generally operate on a seven-day, 69-hour week. Generally, warehouses are open weekdays between 10:00 a.m. and 8:30 p.m., with earlier closing hours on the weekend. Gasoline operations generally have extended hours. Because the hours of operation are shorter than those of traditional retailers, discount retailers and supermarkets and due to other operational efficiencies inherent in a warehouse-type operation, labor costs are lower relative to the volume of sales. Merchandise is generally stored on racks above the sales floor and displayed on pallets containing large quantities of each item, thereby reducing labor required for handling and stocking.

Our merchandising strategy is to provide our members with a broad range of high quality merchandise at prices consistently lower than could be obtained through traditional wholesalers, mass merchandisers, supermarkets and supercenters. An important element of this strategy is to carry only those products on which we can provide our members significant cost savings. Items that members may request but that cannot be purchased at prices low enough to pass along meaningful cost savings are often not carried. We seek to limit specific items in each product line to fast-selling models, sizes and colors. Therefore, we carry an average of approximately 4,000 active stockkeeping units (SKUs) per warehouse in our core warehouse business, as opposed to discount retailers and supermarkets that normally stock 40,000 to 60,000 SKUs or more. These practices are consistent with our membership policies of satisfying both the business and personal shopping needs of our wholesale members, thereby encouraging high volume shopping. Many consumable products are offered for sale in case, carton or multiple-pack quantities only. Appliances, equipment and tools often feature commercial and professional models. In keeping with our policy of member satisfaction, our policy is to accept returns of merchandise.

The following table indicates the approximate percentage of net sales accounted for by major category of items:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| **Sundries** (including candy, snack foods, tobacco, alcoholic and nonalcoholic beverages and cleaning and institutional supplies) | 24% | 25% | 25% |
| **Hardlines** (including major appliances, electronics, health and beauty aids, hardware, office supplies, garden and patio, sporting goods, furniture, cameras and automotive supplies) | 20% | 20% | 20% |
| **Food** (including dry and institutionally packaged foods) | 19% | 19% | 20% |
| **Softlines** (including apparel, domestics, jewelry, housewares, media, home furnishings and small appliances) | 12% | 12% | 13% |
| **Fresh Food** (including meat, bakery, deli and produce) | 11% | 11% | 11% |
| **Ancillary and Other** (including gas stations, pharmacy, food court, optical, one-hour photo, hearing aid and travel) | 14% | 13% | 11% |

Ancillary businesses within or next to our warehouses provide expanded products and services and encourage members to shop more frequently. The following table indicates the number of ancillary businesses:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Food Court and Hot Dog Stands | 452 | 427 | 412 |
| One-Hour Photo Centers | 450 | 423 | 408 |
| Optical Dispensing Centers | 442 | 414 | 397 |
| Pharmacies | 401 | 374 | 359 |
| Gas Stations | 250 | 225 | 211 |
| Hearing Aid Centers | 196 | 168 | 143 |
| Print Shops and Copy Centers | 9 | 10 | 10 |
| Number of warehouses | 458 | 433 | 417 |

Our Ecommerce businesses, costco.com in the US and costco.ca in Canada, provide our members additional products generally not found in our warehouses, in addition to services such as digital photo processing, pharmacy, travel and membership services.

Our warehouses accept cash, checks, certain debit cards, American Express and a private label Costco credit card. Losses associated with dishonored checks have been minimal as members who have issued dishonored checks are identified and prevented from cashing checks at the point of sale until restitution is made.

We have direct buying relationships with many producers of national brand name merchandise. No significant portion of merchandise is obtained from any one of these or any other single supplier. We have not experienced any difficulty in obtaining sufficient quantities of merchandise, and believe that if one or more of our current sources of supply became unavailable, we would be able to obtain alternative sources without experiencing a substantial disruption of our business. We also purchase selected private label merchandise, as long as quality and customer demand are comparable and the value to our members is greater.

Financial information of our segments and geographic areas is included in Note 12, Segment Reporting, to the accompanying consolidated financial statements.

We report on a 52/53-week fiscal year, consisting of thirteen four-week periods and ending on the Sunday nearest the end of August. The first, second and third quarters consist of three periods each, and the fourth quarter consists of four periods (five weeks in the thirteenth period in a 53-week year). There is no material seasonal impact on our operations, except an increased level of net sales and earnings during the winter holiday season. Fiscal year 2006 was a 53-week year, and fiscal years 2005 and 2004 each consisted of 52 weeks.

**Membership Policy**

Our membership format is designed to reinforce customer loyalty and provide a continuing source of membership fee revenue, which allows us to offer low prices.

Members can utilize their memberships at any Costco warehouse location. We have two primary types of members: Business, and Gold Star (individual). In addition, members can upgrade to an Executive Membership. We continue to experience strong member renewal rates, currently at 86.5%. As of September 3, 2006, our membership base was made up of the following (in thousands):

| | |
|---|---|
| Gold Star | 17,338 |
| Business | 5,214 |
| Total primary cardholders | 22,552 |
| Add-on cardholders | 25,127 |
| Total cardholders | 47,679 |

Businesses, including individuals with a business license, retail sales license or other evidence of business existence, may become Business members. Business members generally pay an annual membership fee of $50 for the primary and spouse membership card, with add-on membership cards available for an annual fee of $40 (including a free spouse card). A significant number of our business members also shop at Costco for their personal needs.

Individual memberships (Gold Star memberships) are available to individuals who do not qualify for a Business membership. Individual members generally pay an annual membership fee of $50, which includes a spouse card.

Executive Membership is available to all members in the U.S. and Canada for an annual fee of $100. The Executive Membership program offers members additional savings and benefits on various

business and consumer services offered by Costco, such as merchant credit card processing, small business loans, auto and home insurance, long-distance telephone service, check printing, and real estate and mortgage services. The services offered are generally provided by third-party providers and vary by state. In addition, Executive members may qualify for a 2% reward (which can be redeemed at Costco warehouses), up to a maximum of $500 per year, on all qualified purchases made at Costco. At the end of fiscal 2006, Executive members represented 23% of our primary membership base and generated approximately 45% of our consolidated net sales.

**Labor**

As of September 3, 2006, our employee count approximated:

| | |
|---|---|
| Full-time employees | 71,000 |
| Part-time employees | 56,000 |
| Total employees | 127,000 |

The number of employees above includes approximately 8,000 individuals who were employed by Costco Mexico (a 50%-owned joint venture), which is not consolidated in our financial statements. Approximately 13,800 hourly employees in certain of our locations in California, Maryland, New Jersey, New York and one warehouse in Virginia are represented by the International Brotherhood of Teamsters. All remaining employees are non-union. We consider our employee relations to be very good.

**Competition**

Our industry is highly competitive, based on factors such as price, merchandise quality and selection, location and member service. In addition to other membership warehouse operators, we compete with a wide range of national and regional retailers and wholesalers, including supermarkets, supercenters, general merchandise chains, specialty chains, gasoline stations, as well as E-commerce businesses. Over 1,178 warehouse club locations exist across the U.S. and Canada, including our 426 North American warehouses, and every major metropolitan area has one, if not several, club operations. Wal-Mart has become the largest retailer in the world and has expanded further into various food merchandising formats. Target and Kohl’s have also emerged as significant retail competitors. Low-cost operators selling a single category or narrow range of merchandise, such as Lowe’s, Home Depot, Office Depot, PetSmart, Staples, Best Buy and Barnes & Noble, have significant market share in their respective categories.

**Regulation**

Certain state laws require that we apply minimum markups to our selling prices for specific goods, such as tobacco products, alcoholic beverages and gasoline. While compliance with such laws may cause us to charge somewhat higher prices than we otherwise would charge, other retailers are also typically governed by the same restrictions, and we believe that compliance with such laws does not have a material adverse effect on our operations.

It is our policy to sell at lower than manufacturers’ suggested retail prices. Some manufacturers attempt to maintain the resale price of their products by refusing to sell to us or to other purchasers that do not adhere to suggested retail prices or that otherwise sell at discounted prices. To date, we believe that we have not been materially affected by our inability to purchase directly from such manufacturers. Both federal and state legislation is proposed from time to time which, if enacted, would restrict our ability to purchase goods or extend the application of laws enabling the establishment of minimum prices. We cannot predict the effect on our business of the enactment of such federal or state legislation.

Certain states, counties and municipalities have enacted or proposed laws and regulations that would prevent or restrict the operations or expansion plans of certain large retailers and warehouse clubs, including us, within their jurisdictions. We believe that, if enacted, such laws and regulations could have a material adverse effect on our operations.

**Energy Management and Conservation**

The subject of energy usage continues to receive much attention. Because of our commitment to our members to keep our prices low and because energy is a significant operating cost for us, we have always been focused on reducing our energy consumption. As technology improves and energy costs increase, we continue to search for new ways to improve our performance in this area. This improved performance not only benefits our members and shareholders but the communities in which we operate and the environment as a whole.

Our warehouses have always utilized significant numbers of skylights, which reduce electrical demand. We turn lights on and off depending upon the time of day. This is simply one part of the energy management system that operates in every warehouse, allowing us to better measure and control our energy usage. We also constantly review new lighting technologies for fixtures that give us greater illumination at lower cost. The exteriors of our warehouses use minimal lighting as compared to other retailers.

We design and construct all of our warehouses in the United States to, in large part, meet or exceed the demanding energy efficiency standards of California law (or higher if local law requires). This allows us not only to operate at lower cost but to receive energy-efficiency incentive payments from local utilities. Also, where permissible under local restrictions, we utilize metal exteriors for our warehouses, which have superior insulation value and allow us to heat and cool the buildings with less energy. Among other things, we use high efficiency air conditioning equipment (which we typically operate at temperatures higher than many retailers). In addition, we have found that more rigorous maintenance of our air conditioning systems pays off in more efficient performance. Other recent improvements have included: switching from mechanical to electronic valves in new warehouse refrigeration systems; changing to a refrigerant that reduces horsepower requirements for our refrigeration systems; installing reclamation systems that use hot gas emitted from refrigeration systems to heat water; and providing energy management systems on new pizza ovens to reduce gas usage.

This year, we took our energy saving efforts to a new level with the installation of our first large-scale solar (photovoltaic) panel system in one of our California warehouses. In addition to generating as much as 500 kilowatts at peak output, the location of this system on the roof helps cool the building through reflection of the warming rays of the sun. Our initial assessments of this system are positive, and we are in the process of a second installation at another California warehouse. If performance continues as we expect, this program could yield substantial benefits when rolled out to a number of our other locations.

We also continue to focus on methods for reducing fuel consumption by trucks that keep our warehouses in stock. These include training drivers in fuel-efficient techniques and enhanced vehicle maintenance. In addition, this Spring we will be testing “hybrid” trucks in our business delivery operations.

The performance of our management is measured by, among other things, what we term “controllable expenses,” which include energy expense. This is also one of the factors in management’s compensation. Accordingly, people throughout our Company have the incentive to continue to focus on reducing energy usage and the attendant expense.

In addition, we encourage our employees to carpool or vanpool whenever practical—to reduce energy consumption, as well as reduce emissions going into the atmosphere. We began a Commute Trip Reduction (CTR) program twelve years ago at our corporate office with eighteen vans. Today, we have fifty-two vans (vans, fuel, maintenance and insurance provided by four transit agencies), and offer employees subsidies to vanpool. We also subsidize employees who purchase monthly bus passes.

**Available Information**

We maintain an internet website at www.costco.com. We make available on our website, free of charge, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements and Forms 3, 4 and 5, and any amendments to those reports, as soon as reasonably practicable after filing such material with, or furnishing such documents to, the Securities and Exchange Commission (SEC). Our SEC reports can be accessed through the investor relations section of our website. The information found on our website is not part of this or any other report filed with or furnished to the SEC.

## RISK FACTORS

Certain statements contained in this document constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. For these purposes, forward-looking statements are statements that address activities, events, conditions or developments that we expect or anticipate may occur in the future. Such forward-looking statements involve risks and uncertainties that may cause actual events, results or performance to differ materially from those indicated by such statements.

The risks described below could materially and adversely affect our business, financial condition or results of operations. They could cause our actual results to differ materially from our historical experience and from results predicted by our forward-looking statements. Those statements may relate to such matters as sales growth, increases in comparable store sales, impact of cannibalization, commodity price changes, earnings performance, earnings per share, stock-based compensation expense, warehouse openings and closures, the effect of adopting certain accounting standards, future financial reporting, financing, margins, return on invested capital, strategic direction and the demand for our products and services. All of our forward-looking statements are qualified by the risks described below. These risks are not the only risks we face. Our operations could also be affected by additional factors that are not presently known to us or that we currently consider immaterial.

**We face strong competition from other retailers and wholesale club operators, which could adversely affect our financial performance.**

The retail business is highly competitive. We compete for members, employees, warehouse sites, products and services and in other important respects with many other local, regional and national retailers, both in the United States and in foreign countries. We compete with other wholesale club operators, discount retailers, retail and wholesale grocers and general merchandise wholesalers and distributors, as well as e-commerce retailers, wholesalers and catalog businesses. Internationally, we compete with retailers who operate department, drug, variety and specialty stores, supermarkets, supercenter stores, wholesale clubs, internet-based retailers and catalog businesses. Such retailers and wholesale club operators compete in a variety of ways, including merchandise selection and availability, services offered to members, location, store hours and price. Our ability to respond effectively to competitive pressures and changes in the retail markets could adversely affect our financial performance. Some competitors may have greater financial resources, better access to merchandise, and greater market penetration than we do.

**General economic factors, domestically and internationally, may adversely affect our financial performance.**

Higher interest rates, energy costs, inflation, levels of unemployment, consumer debt levels, and other economic factors could adversely affect demand for our products and services or require a change in the mix of products we sell that adversely affects profitability. These factors can also increase our cost of sales and operating, selling, general and administrative expenses, and otherwise adversely affect our operations and results. General economic conditions can also be affected by the outbreak of war, acts of terrorism or other significant national or international events.

**Our growth strategy includes expanding our business, both in existing markets and by opening warehouses in new markets.**

Our future growth is dependent, in part, on our ability to build or lease new warehouses. We compete with other retailers and businesses for suitable locations for our warehouses. Local land use, local zoning issues, environmental regulations and other regulations applicable to the types of warehouses we desire to construct may impact our ability to find suitable locations, and also influence the cost of constructing and leasing our warehouses. We also may have difficulty negotiating leases or real estate purchase agreements on acceptable terms. Failure to manage these and other similar factors effectively will affect our ability to build or lease new warehouses, which may have a material adverse affect on our future profitability.

We seek to expand our business in existing markets in order to attain a greater overall market share. Because our warehouses typically draw members from their local areas, a new warehouse may draw members away from our nearby existing warehouses and may cause comparable warehouse sales performance and member traffic at those existing warehouses to decline.

We also intend to open warehouses in new markets. The risks associated with entering a new market include difficulties in attracting members due to a lack of familiarity with us, our lack of familiarity with local member preferences and seasonal differences in the market. In addition, entry into new markets may bring us into competition with new competitors or with existing competitors with a large, established market presence. While we have a track record of profitable growth, in new markets we cannot ensure that our new warehouses will be profitably deployed; as a result, our future profitability may be materially adversely affected.

**Any inability to open new warehouses on schedule could hurt our financial performance.**

We expect to increase our presence in existing markets and enter new markets. Our opening of new warehouses, domestically and internationally, will depend on our ability to: identify and secure suitable locations; negotiate leases or real estate purchase agreements on acceptable terms; attract and train qualified employees; and manage preopening expenses, including construction costs. We compete with other retailers and businesses for suitable locations for our warehouses. Our ability to open new warehouses also is affected by environmental regulations, local zoning issues and other laws related to land use. Failure to effectively manage these and other similar factors will affect our ability to open warehouses on schedule, which could adversely affect our financial performance.

**We are highly dependent on the financial performance of our United States and Canada operations.**

Our financial performance is highly dependent on our United States and Canada operations, which comprised 94% of consolidated net sales in both fiscal 2006 and 2005. Within the United States, we are highly dependent on our California operations, which comprised 31% and 30% of consolidated net sales in fiscal 2006 and 2005, respectively. Any substantial or sustained decline in these operations

could materially adversely affect our business and financial results. Declines in financial performance of our United States and Canada operations could arise from, among other things: failing to meet annual targets for warehouse openings; declines in actual or estimated comparable warehouse sales growth rates and expectations; negative trends in operating expenses, including increased labor costs; cannibalizing existing locations with new warehouses; shifts in sales mix toward lower gross margin products; changes or uncertainties in economic conditions in our markets; and failing consistently to provide high quality products and innovative new products to retain our existing member base and attract new members.

**Risks associated with the suppliers from whom our products are sourced could adversely affect our financial performance.**

The products we sell are sourced from a wide variety of domestic and international suppliers. Effective global sourcing of many of the products we sell is an important factor in our financial performance. Our ability to find qualified suppliers who meet our standards, and to access products in a timely and efficient manner is a significant challenge, especially with respect to suppliers located and goods sourced outside the United States. Political and economic instability in the countries in which foreign suppliers are located, the financial instability of suppliers, suppliers' failure to meet our standards, labor problems experienced by our suppliers, the availability of raw materials to suppliers, merchandise quality issues, currency exchange rates, transport availability and cost, inflation, and other factors relating to the suppliers and the countries in which they are located are beyond our control. In addition, the United States' foreign trade policies, tariffs and other impositions on imported goods, trade sanctions imposed on certain countries, the limitation on the importation of certain types of goods or of goods containing certain materials from other countries and other factors relating to foreign trade are beyond our control. We may also face changes in the cost to us of accepting various payment methods and changes in the rate of utilization of these payment methods by our members.

**We may not timely identify or effectively respond to consumer trends, which could adversely affect our relationship with our members, the demand for our products and services, and our market share.**

It is difficult to consistently and successfully predict the products and services our members will demand. The success of our business depends in part on our ability to identify and respond to evolving trends in demographics and consumer preferences. Failure to timely identify or effectively respond to changing consumer tastes, preferences and spending patterns could adversely affect our relationship with our members, the demand for our products and services and our market share.

**Changes in accounting standards and subjective assumptions, estimates and judgments by management related to complex accounting matters could significantly affect our financial results.**

Generally accepted accounting principles and related accounting pronouncements, implementation guidelines and interpretations with regard to a wide range of matters that are relevant to our business, such as revenue recognition, impairment of long-lived assets and warehouse closing costs, inventories, self insurance, stock-based compensation, income taxes, unclaimed property laws and litigation, are highly complex and involve many subjective assumptions, estimates and judgments by our management. Changes in these rules or their interpretation or changes in underlying assumptions, estimates or judgments by our management could significantly change our reported or expected financial performance.

**Our international operations subject us to risks associated with the legislative, judicial, accounting, regulatory, political and economic factors specific to the countries or regions in which we operate, which could adversely affect our financial performance.**

Our international operations could form a larger portion of our net sales in future years. Future operating results internationally could be negatively affected by a variety of factors, many beyond our control. These factors include political conditions, economic conditions, regulatory constraints, currency regulations and exchange rates, and other matters in any of the countries or regions in which we operate, now or in the future. Other factors that may impact international operations include foreign trade, monetary and fiscal policies both of the United States and of other countries, laws and regulations of foreign governments, agencies and similar organizations, and risks associated with having major facilities located in countries which have been historically less stable than the United States.

**Implementation of technology initiatives could disrupt our operations in the near term and fail to provide the anticipated benefits.**

We have made and will continue to make significant technology investments both in our warehouses and in our administrative functions. The cost and potential problems and interruptions associated with the implementation of technology initiatives could disrupt or reduce the efficiency of our operations in the near term. In addition, new or upgraded technology might not provide the anticipated benefits; it might take longer than expected to realize the anticipated benefits or the technology might fail.

**Market expectations for our financial performance is high.**

We believe that the price of our stock reflects high market expectations for our future operating results. Any failure to meet these expectations for our comparable warehouse sales growth rates, earnings per share and new warehouse openings could cause the market price of our stock to drop.

**Cost related to natural disasters could adversely affect our financial performance.**

The occurrence of one or more natural disasters, such as hurricanes or earthquakes (particularly in California where over 30% of our net sales are generated) could adversely affect our operations and financial performance. Such events could result in physical damage to one or more of our properties, the temporary closure of one or more warehouses or depots, the temporary lack of an adequate work force in a market, the temporary or long-term disruption in the supply of products from some local and overseas suppliers, the temporary disruption in the transport of goods from overseas, delay in the delivery of goods to our depots or warehouses within a country in which we are operating and the temporary reduction in the availability of products in our warehouses.

**We are subject to a wide variety of federal, state, regional, local and international laws and regulations relating to the use, storage, discharge, and disposal of hazardous materials and hazardous and non-hazardous wastes, and other environmental matters.**

While we believe that our operations are currently in material compliance with all environmental laws, any failure to comply with these laws could result in costs to satisfy environmental compliance, remediation requirements, or the imposition of severe penalties or restrictions on operations by government agencies or courts that could adversely affect our operations.

**We are involved in a number of legal proceedings, and while we cannot predict the outcomes of such proceedings and other contingencies with certainty, some of these outcomes may adversely affect our operations or increase our costs.**

We are involved in a number of legal proceedings, including consumer, employment, tort and other litigation. We cannot predict with certainty the outcomes of these legal proceedings and other contingencies, including environmental remediation and other proceedings commenced by government authorities. The outcome of some of these legal proceedings and other contingencies could require us to take, or refrain from taking, actions which could adversely affect our operations or could require us to pay substantial amounts of money. Additionally, defending against these lawsuits and proceedings may involve significant expense and diversion of management's attention and resources. Our business requires compliance with a great variety of laws and regulations. Failure to achieve compliance could subject us to lawsuits and other proceedings, and lead to damage awards, fines and penalties.

**Failure of our internal control over financial reporting could harm our business and financial results.**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting for external purposes in accordance with U.S. generally accepted accounting principles. Internal control over financial reporting includes: maintaining records that in reasonable detail accurately and fairly reflect our transactions; providing reasonable assurance that transactions are recorded as necessary for preparation of the financial statements; providing reasonable assurance that our receipts and expenditures of our assets are made in accordance with management authorization; and providing reasonable assurance that unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements would be prevented or detected on a timely basis. Because of its inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of our financial statements would be prevented or detected. Any failure to maintain an effective system of internal control over financial reporting could limit our ability to report our financial results accurately and timely or to detect and prevent fraud.

The foregoing list of important factors is not exclusive and we do not undertake to revise any forward-looking statement to reflect events or circumstances that occur after the date the statement is made.

## PROPERTIES

### Warehouse Properties

At September 3, 2006, Costco operated 458 warehouse clubs: 358 in the United States (in 37 states and Puerto Rico); 68 in Canada (in 9 Canadian provinces); 18 in the United Kingdom (15 in England; 3 in Scotland); 5 in Korea; 4 in Taiwan; and 5 in Japan. The following is a summary of owned and leased warehouses by region:

| | Own Land and Building | Lease Land and/or Building(1) | Total |
|---|---|---|---|
| United States | 281 | 77 | 358 |
| Canada | 59 | 9 | 68 |
| United Kingdom | 16 | 2 | 18 |
| Korea | 2 | 3 | 5 |
| Taiwan | 0 | 4 | 4 |
| Japan | 1 | 4 | 5 |
| Total | 359 | 99 | 458 |

(1) 57 of the 99 leases are land leases only where Costco owns the building.

The following schedule shows warehouse openings (net of closings) by region for the past five fiscal years and expected warehouse openings (net of closings) through December 31, 2006:

| Openings by Fiscal Year | United States | Canada | Other International | Total | Total Warehouses in Operation |
|---|---|---|---|---|---|
| 2002 and prior | 290 | 60 | 24 | 374 | 374 |
| 2003 | 19 | 1 | 3 | 23 | 397 |
| 2004 | 18 | 2 | 0 | 20 | 417 |
| 2005 | 11 | 2 | 3 | 16 | 433 |
| 2006 | 20 | 3 | 2 | 25 | 458 |
| 2007 (expected through 12/31/06) | 16 | 3 | 1 | 20 | 478 |
| Total | 374 | 71 | 33 | 478 | |

At September 3, 2006, we operated 29 warehouses in Mexico (through a 50%-owned joint venture). These warehouses are not included in the number of warehouses open in any period because the joint venture is accounted for using the equity method, and its operations are not consolidated in our financial statements.

At the end of fiscal 2006 our warehouses contained approximately 64.2 million square feet of operating floor space: 50.7 million in the United States, 9.1 million in Canada and 4.4 million in other international locations, excluding Mexico.

### Administration and Distribution Properties

Our executive offices are located in Issaquah, Washington and occupy approximately 395,000 square feet. We operated eight regional offices in the United States, two regional offices in Canada and four regional offices internationally at the end of fiscal 2006, containing approximately 309,000 square feet. Additionally, we operate regional cross-docking facilities (depots) for the consolidation and distribution of most shipments to the warehouses, and various processing, packaging, and other facilities to support ancillary and other businesses. At the end of fiscal 2006, we operated eleven depots in the United States, three in Canada and two internationally, excluding Mexico, consisting of approximately 6.5 million square feet.

## MARKET FOR COSTCO COMMON STOCK

### Market Information and Dividend Policy

Our common stock is traded on the National Market tier of the NASDAQ Stock Market LLC ("NASDAQ") under the symbol "COST." On October 31, 2006 we had 8,172 stockholders of record.

The following table shows the quarterly high and low closing sale prices as reported by NASDAQ for each quarter during the last two fiscal years and the quarterly cash dividend declared per share of our common stock during the periods indicated.

| | Price Range | | Cash Dividends Declared |
|---|---|---|---|
| | High | Low | |
| Fiscal 2006: | | | |
| Fourth Quarter | $57.58 | $46.79 | $0.130 |
| Third Quarter | 56.70 | 50.11 | 0.130 |
| Second Quarter | 51.00 | 48.29 | 0.115 |
| First Quarter | 50.14 | 41.36 | 0.115 |
| Fiscal 2005: | | | |
| Fourth Quarter | 46.62 | 42.04 | 0.115 |
| Third Quarter | 47.00 | 40.17 | 0.115 |
| Second Quarter | 49.69 | 45.51 | 0.100 |
| First Quarter | 49.74 | 39.99 | 0.100 |

Payment of future dividends is subject to declaration by the Board of Directors. Factors considered in determining the size of the dividends are our profitability and expected capital needs. Subject to qualifications stated above, we presently expect to pay dividends on a quarterly basis.

### Stock Repurchase Program

The following table sets forth information on our common stock repurchase program activity for the fourth quarter of fiscal 2006 (amounts in thousands, except per share data):

| Period(1) | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program(2) | Maximum Dollar Value of Shares that May Yet be Purchased Under the Program(2) |
|---|---|---|---|---|
| May 8–June 4, 2006 | 2,044 | $54.55 | 2,044 | $1,045,207 |
| June 5–July 2, 2006 | 3,334 | 53.67 | 3,334 | 866,281 |
| July 3–July 30, 2006 | 2,924 | 53.60 | 2,924 | 2,709,531 |
| July 31–September 3, 2006 | 1,650 | 50.91 | 1,650 | 2,625,534 |
| Total Fourth Quarter | 9,952 | $53.37 | 9,952 | |

(1) Monthly information is presented by reference to our fiscal periods during the fourth quarter of fiscal 2006.

(2) Our share repurchase program is conducted under authorizations made by our Board of Directors. The amounts reported in the table are covered by Board authorizations to repurchase shares of common stock as follows: $1 billion authorized in January 2006 (expires after three years) and $2 billion authorized in July 2006 (expires after 3 years). Amounts remaining for repurchase relate to both authorizations.

### Equity Compensation Plans

Information related to our equity compensation plans is incorporated herein by reference to the Proxy Statement filed with the Securities and Exchange Commission.

## FIVE YEAR OPERATING AND FINANCIAL HIGHLIGHTS

The following selected financial and operating data are derived from our consolidated financial statements and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," and our consolidated financial statements.

### SELECTED FINANCIAL DATA
### (dollars in thousands, except per share data)

| As of and for the fiscal year ended(1) | Sept. 3, 2006 (53 weeks) | Aug. 28, 2005 (52 weeks) | Aug. 29, 2004 (52 weeks) | Aug. 31, 2003 (52 weeks) | Sept. 1, 2002 (52 weeks) |
|---|---|---|---|---|---|
| RESULTS OF OPERATION | | | | | |
| Net sales | $58,963,180 | $51,879,070 | $47,148,627 | $41,694,561 | $37,994,608 |
| Merchandise costs | 52,745,497 | 46,346,961 | 42,092,016 | 37,235,383 | 33,983,121 |
| Gross Margin | 6,217,683 | 5,532,109 | 5,056,611 | 4,459,178 | 4,011,487 |
| Membership fees | 1,188,047 | 1,073,156 | 961,280 | 852,853 | 769,406 |
| Operating income | 1,625,632 | 1,474,303 | 1,385,648 | 1,156,628 | 1,131,535 |
| Net income | 1,103,215 | 1,063,092 | 882,393 | 721,000 | 699,983 |
| Net income per diluted share | 2.30 | 2.18 | 1.85 | 1.53 | 1.48 |
| Dividends per share | $ 0.49 | $ 0.43 | $ 0.20 | $ — | $ — |
| Increase in comparable warehouse sales: | | | | | |
| United States | 7% | 6% | 9% | 4% | 7% |
| International | 11% | 11% | 14% | 10% | 2% |
| Total | 8% | 7% | 10% | 5% | 6% |
| BALANCE SHEET DATA | | | | | |
| Working capital | $ 412,891 | $ 1,477,464 | $ 1,098,549 | $ 700,431 | $ 180,806 |
| Net property and equipment | 8,564,295 | 7,790,192 | 7,219,829 | 6,960,008 | 6,523,619 |
| Total assets | 17,495,070 | 16,665,205 | 15,092,548 | 13,191,688 | 11,620,263 |
| Short-term borrowings | 41,385 | 54,356 | 21,595 | 47,421 | 103,774 |
| Long-term debt | 215,369 | 710,675 | 993,746 | 1,289,649 | 1,210,638 |
| Stockholders' equity | $ 9,143,439 | $ 8,881,109 | $ 7,624,810 | $ 6,554,980 | $ 5,694,237 |
| WAREHOUSE INFORMATION | | | | | |
| Warehouses in Operation(2) | | | | | |
| Beginning of year | 433 | 417 | 397 | 374 | 345 |
| Opened(3) | 28 | 21 | 20 | 29 | 35 |
| Closed(3) | (3) | (5) | — | (6) | (6) |
| End of Year | 458 | 433 | 417 | 397 | 374 |

(1) Certain reclassifications have been made to prior fiscal years to conform to the presentation adopted in the current fiscal year.

(2) Excludes warehouses operated in Mexico through a 50% owned joint venture.

(3) Includes relocations.

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

### Overview

Our fiscal year ends on the Sunday closest to the end of August. Fiscal year 2006, ended September 3, 2006, included 53 weeks, with the 53rd week falling in the fiscal fourth quarter. The fiscal years ended August 28, 2005 and August 29, 2004, each included 52 weeks.

Key items for fiscal year 2006 included:

- Net sales in fiscal 2006 (53 weeks) increased 13.7% over fiscal 2005 (52 weeks), driven by an increase in comparable sales (sales in warehouses open for at least one year) of 8% and the opening of 25 (net of relocations) new warehouses;
- Membership fees for fiscal 2006 increased 10.7% to $1.2 billion, representing new member sign-ups at new warehouses opened during the fiscal year, increased penetration of the Executive Membership program, and continued strong member renewal rates;
- We increased annual membership fees by $5 for our U.S. and Canada Gold Star (individual), Business, and Business Add-on Members, effective May 1, 2006, for new members and July 1, 2006, for existing members;
- Gross margin (net sales less merchandise costs) as a percentage of net sales declined eleven basis points over the prior year, primarily due to increased penetration of the Executive Membership two-percent reward program;
- Selling, general and administrative expenses as a percentage of net sales improved four basis points over the prior year, largely due to increased expense leverage of warehouse payroll and a lower rate of increase in workers' compensation costs, somewhat offset by higher stock-based compensation expense;
- Net income for fiscal 2006 was $1.1 billion, or $2.30 per diluted share, compared to $1.06 billion, or $2.18 per diluted share, in fiscal 2005. The fiscal 2005 results included several non-recurring items that in the aggregate positively impacted that years reported earnings by approximately $0.14 per diluted share;
- The Board of Directors approved an increase in the quarterly cash dividend from $0.115 to $0.13 per share in April 2006; and
- We repurchased 28.4 million shares of our common stock, expending approximately $1.5 billion at an average cost of $51.44 per share.

### Results of Operations (dollars in thousands, except per share data)

***Net Sales***

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Net sales | $58,963,180 | $51,879,070 | $47,148,627 |
| Net sales increase | 13.7% | 10.0% | 13.1% |
| Increase in comparable warehouse sales | 8% | 7% | 10% |
| Warehouse openings (net of relocations) | 25 | 16 | 20 |

*2006 vs. 2005*

Net sales increased 13.7% to $58.96 billion in fiscal 2006, from $51.88 billion in fiscal 2005. The increase was due to comparable warehouse sales growth of 8%, the opening of 25 new warehouses (28 opened, 3 closed due to relocations) during fiscal 2006 and one additional week of sales in fiscal 2006.

Changes in prices of merchandise, with the exception of gasoline, did not materially affect the sales increase. Gasoline sales contributed to the 13.7% increase in net sales by approximately 235 basis points for fiscal 2006, with approximately 70% of this increase related to the change in price. In addition, translation of foreign sales into U.S. dollars contributed to the increase in sales due to stronger foreign currencies, accounting for approximately 87 basis points of the comparable year-over-year sales increase.

*2005 vs. 2004*

Net sales increased 10.0% to $51.88 billion in fiscal 2005 from $47.15 billion in fiscal 2004. The increase was due to comparable warehouse sales growth of 7% and to the opening of 16 new warehouses (21 opened, 5 closed due to relocations) during fiscal 2005. Net sales were reduced by the implementation of Emerging Issues Task Force (EITF) Issue No. 03-10, "Application of Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor," by Resellers to Sales Incentives Offered to Consumers by Manufacturers," (EITF 03-10) which was effective at the beginning of our fiscal 2004 third quarter. EITF 03-10, which primarily impacts our vendor coupon programs, reduces net sales and merchandise costs by an equal amount and does not affect our consolidated gross margin or net income. Had EITF 03-10 been in effect for the comparable periods in fiscal 2004, the net sales increase in fiscal 2005 would have been 10.5% and the comparable sales increase for fiscal 2005 would have been 8%.

Changes in prices of merchandise, with the exception of gasoline, did not materially affect the sales increase. Gasoline sales contributed to the 10.0% increase in net sales by approximately 155 basis points for fiscal 2005, with approximately 62% of this increase related to the change in price. In addition, translation of foreign sales into U.S. dollars contributed to the increase in sales due to stronger foreign currencies, accounting for approximately 134 basis points of the comparable year-over-year sales increase.

***Membership Fees***

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Membership fees | $1,188,047 | $1,073,156 | $961,280 |
| Membership fees increase | 10.7% | 11.6% | 12.7% |
| Membership fees as a percent of net sales | 2.02% | 2.07% | 2.04% |
| Total cardholders | 47,679 | 45,258 | 42,416 |

*2006 vs. 2005*

Membership fees increased 10.7% to $1.19 billion, or 2.02% of net sales, in fiscal 2006 from $1.07 billion, or 2.07% of net sales, in fiscal 2005. This increase was primarily due to additional membership sign-ups at the 25 new warehouses opened in fiscal 2006, increased penetration of the Executive Membership program, and high overall member renewal rates consistent with recent years, currently 86.5%.

In April 2006, we announced plans to increase annual membership fees by $5 for our U.S. and Canada Gold Star (individual), Business, and Business Add-on Members, effective May 1, 2006 for new members and July 1, 2006 for renewals. Approximately 15 million members will be affected by this increase. Membership fees are accounted for on a deferred basis, whereby membership fee revenue is recognized ratably over the one-year term of the membership, which will have the effect of spreading the full realization of the increase over the next two fiscal years.

*2005 vs. 2004*

Membership fees increased 11.6% to $1.07 billion, or 2.07% of net sales, in fiscal 2005 from $961 million, or 2.04% of net sales, in fiscal 2004. This increase was primarily due to additional membership

sign-ups at the 16 new warehouses opened in fiscal 2005, increased penetration of our Executive Membership program and a high overall member renewal rate of 86%.

### *Gross Margin*

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Gross margin | $6,217,683 | $5,532,109 | $5,056,611 |
| Gross margin increase | 12.4% | 9.4% | 13.4% |
| Gross margin as a percent of net sales | 10.55% | 10.66% | 10.73% |

*2006 vs. 2005*

Gross margin was $6.22 billion in fiscal 2006 or 10.55% of net sales, compared to $5.53 billion or 10.66% of net sales in fiscal 2006. This eleven basis point decrease reflected increased penetration of the Executive Membership two-percent reward program and increased spending by executive members, which decreased gross margin by ten basis points. Additionally, a decrease of four basis points in gross margin in our merchandise departments and warehouse ancillary businesses was primarily due to changes in the sales mix, with higher sales penetration of lower margin departments and slightly lower overall gross margins in our hardlines and softlines categories. These decreases were partially offset by a three basis point improvement due to the absence of a charge to inventories following the last-in, first-out (LIFO) method.

*2005 vs. 2004*

Gross margin increased 9.4% to $5.53 billion, or 10.66% of net sales, in fiscal 2005 from $5.06 billion, or 10.73% of net sales in fiscal 2004. This seven basis point decrease in gross margin as a percentage of net sales reflected a decrease of three basis points in gross margin in our merchandise departments. The three basis point decrease in merchandising is largely due to changes in the sales mix, with higher penetration of lower margin departments. This effect was offset by gross margin gains in most of our merchandise departments, as well as our international operations. Gross margin as a percentage of net sales was positively impacted by five basis points due to the implementation of EITF 03-10, whereby net sales and merchandise costs were reduced equally. The gross margin percentage was reduced by ten basis points due to the increased penetration of the Executive Member two-percent reward program, increased spending by Executive members and the resulting increases in the related costs.

The gross margin figures reflect accounting for most U.S. merchandise inventories on the LIFO method. Fiscal 2005 included a $13.0 million LIFO charge (increase in merchandise costs), while fiscal 2004 included a $6.0 million LIFO charge. The impact of the LIFO adjustment on a year-over-year basis negatively impacted gross margin, as a percentage of sales, by one additional basis point.

### *Selling, General and Administrative Expenses*

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Selling, general and administrative expense | $5,732,141 | $5,061,339 | $4,600,792 |
| Selling, general and administrative expense as a percent of net sales | 9.72% | 9.76% | 9.76% |

*2006 vs. 2005*

Selling, general and administrative (SG&A) expenses were $5.73 billion, or 9.72% of net sales in fiscal 2006, compared to $5.06 billion, or 9.76% of net sales in fiscal 2005. Improved warehouse and central operating costs positively impacted SG&A by approximately nine basis points, primarily due to

increased expense leverage of warehouse payroll, which was positively impacted by strong comparable warehouse sales and a lower rate of increase in workers' compensation costs. This improvement was partially offset by an increase in stock-based compensation cost of approximately five basis points in fiscal 2006.

*2005 vs. 2004*

SG&A expenses were $5.06 billion, or 9.76% of net sales, in fiscal 2005 compared to $4.60 billion, or 9.76% of net sales, in fiscal 2004. Had EITF 03-10 been in effect for all of fiscal 2004, SG&A expenses as a percent of net sales would have shown improvement of four basis points as a percent of net sales in fiscal 2005.

For fiscal 2005, warehouse and central operating costs positively impacted SG&A comparisons year-over-year by approximately ten basis points, primarily due to improved payroll utilization at the warehouse level, including increased leverage from increased comparable sales and cost control measures employed in employee benefits, primarily health care. This improvement was offset by the implementation of EITF 03-10, which negatively impacted SG&A as a percentage of net sales by five basis points, and an increase in stock-based compensation costs approximating six basis points year-over-year.

### *Preopening Expenses*

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Preopening expenses | $42,504 | $53,230 | $30,451 |
| Preopening expenses as a percent of net sales | 0.07% | 0.10% | 0.07% |
| Warehouse openings | 28 | 21 | 20 |
| Relocations | (3) | (5) | — |
| Warehouse openings, net of relocations | 25 | 16 | 20 |

*2006 vs. 2005*

Preopening expenses totaled $42.5 million, or 0.07% of net sales, during fiscal 2006 compared to $53.2 million, or 0.10% of net sales, during fiscal 2005. During fiscal 2005, in response to the February 7, 2005 letter of the Securities and Exchange Commission (SEC) concerning accounting standards related to leases, we adjusted our method of accounting for leases (entered into over the previous twenty years), primarily related to ground leases at certain owned warehouse locations that did not require rental payments during the period of construction. We recorded a cumulative pre-tax, non-cash charge of $16.0 million to preopening expense in the second quarter of fiscal 2005. Twenty-eight warehouses (including three relocations) were opened in fiscal 2006 compared to the opening of twenty-one warehouses (including five relocations) in fiscal 2005. Preopening expenses also include costs related to remodels and expanded ancillary operations at existing warehouses.

*2005 vs. 2004*

Preopening expenses totaled $53.2 million, or 0.10% of net sales, during fiscal 2005 compared to $30.5 million, or 0.07% of net sales, during fiscal 2004. As discussed above, fiscal 2005 included a cumulative pre-tax, non-cash charge of $16.0 million to preopening expense related to an adjustment to the method of accounting for leases. Twenty-one warehouses (including five relocations) were opened in fiscal 2005 compared to the opening of 20 warehouses in fiscal 2004. Preopening expenses also include costs related to remodels and expanded ancillary operations at existing warehouses.

### ***Provision for Impaired Assets and Closing Costs, net***

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Provision for Impaired Assets and Closing Costs, net: | | | |
| Warehouse closing expenses | $3,762 | $11,619 | $ 16,548 |
| Impairment of long-lived assets | — | 3,893 | — |
| Net losses (gains) on the sale of real property | 1,691 | 881 | (15,548) |
| Total | $5,453 | $16,393 | $ 1,000 |
| Provision for Impaired Assets and Closing Costs, net as a percent of net sales | 0.01% | 0.03% | 0.00% |

*2006 vs. 2005*

The net provision for impaired assets and closing costs was $5.5 million in fiscal 2006, compared to $16.4 million in fiscal 2005. The provision includes costs related to impairment of long-lived assets, future lease obligations of warehouses that have been relocated to new facilities, and losses or gains resulting from the sale of real property. The provision for fiscal 2006 included charges of $3.8 million for warehouse closing expenses and $1.7 million for net losses on the sale of real property. The provision for fiscal 2005 included charges of $3.9 million for impairment of long-lived assets, $11.6 million for warehouse closing expenses and $0.9 million for net losses on the sale of real property.

*2005 vs. 2004*

The net provision for impaired assets and closing costs was $16.4 million in fiscal 2005, compared to $1.0 million in fiscal 2004. The provision for fiscal 2005 included charges of $3.9 million for impairment of long-lived assets, $11.6 million for warehouse closing expenses and $0.9 million for net losses on the sale of real property. The provision for fiscal 2004 included charges of $16.5 million for warehouse closing expenses that were offset by gains of $15.5 million on the sale of real property.

The reserve for warehouse closing costs at the end of fiscal 2006 and 2005 included:

| | September 3, 2006 | August 28, 2005 |
|---|---|---|
| Reserve for warehouse closing costs: | | |
| Future lease obligations | $5,950 | $9,118 |
| Other | 1,091 | 438 |
| Total | $7,041 | $9,556 |

### ***Interest Expense***

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Interest expense | $12,570 | $34,437 | $36,651 |

*2006 vs. 2005*

Interest expense totaled $12.6 million in fiscal 2006, compared to $34.4 million in fiscal 2005. Interest expense in fiscal 2006 primarily included interest on the 5½% Senior Notes, the 3½% Zero Coupon Notes, and balances outstanding under our bank credit facilities and promissory notes. In fiscal 2005, interest expense also included interest on the 7⅛% Senior Notes. The decrease in interest expense in

fiscal 2006 resulted primarily from the repayment of the 7 1⁄8% Senior Notes in June 2005. In addition, interest expense decreased on the 3 1⁄2% Zero Coupon Notes as note holders converted approximately $190.9 million in principal amount of the Notes into common stock. The amount of interest capitalized increased in fiscal 2006, contributing to the decrease in interest expense, as both interest rates and the dollar amount of projects under construction increased. The overall decrease in interest expense in fiscal 2006 was partially offset by the increase in interest rates on the 5 1⁄2% Senior Notes, which were swapped into variable rate debt in March 2002.

*2005 vs. 2004*

Interest expense totaled $34.4 million in fiscal 2005, compared to $36.7 million in fiscal 2004. Interest expense in both fiscal 2005 and 2004 included interest on the 3 1⁄2% Zero Coupon Notes, the 7 1⁄8% and 5 1⁄2% Senior Notes, and on balances outstanding under our bank credit facilities and promissory notes. The decrease was primarily a result of a decrease in interest on our 3 1⁄2% Zero Coupon Notes as note holders converted approximately $280.8 million in principle amount of the Notes into common stock during fiscal 2005. Additionally, capitalized interest increased year-over-year as interest rates and construction costs increased in fiscal 2005 over fiscal 2004. These decreases were partially offset by increases in interest on the Senior Notes as these fixed rate instruments were swapped into variable rate debt in November 2001 and March 2002, which was mitigated by the fact that the 7 1⁄8% Senior Notes matured and were repaid on June 15, 2005.

***Interest Income and Other***

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Interest income and other . . . . . . . . . . . . . . | $138,355 | $109,096 | $51,627 |

*2006 vs. 2005*

Interest income and other totaled $138.4 million in fiscal 2006, compared to $109.1 million in fiscal 2005. This increase primarily reflects increased interest income resulting from higher interest rates earned, as well as an extra week in fiscal 2006 as compared to fiscal 2005.

*2005 vs. 2004*

Interest income and other totaled $109.1 million in fiscal 2005, compared to $51.6 million in fiscal 2004. The increase primarily reflects increased interest income resulting from higher cash and cash equivalents balances and short-term investments on hand throughout fiscal 2005, as well as higher interest rates earned on the balances as compared to fiscal 2004.

***Provision for Income Taxes***

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Income tax expense . . . . . . . . . . . . . . . . . . . . . . . | $648,202 | $485,870 | $518,231 |
| Effective tax rate . . . . . . . . . . . . . . . . . . . . . . . . | 37.01% | 31.37% | 37.00% |

The effective income tax rate on earnings in fiscal 2006, 2005 and 2004 was 37.01%, 31.37% and 37.00%, respectively. The low rate in fiscal 2005 was primarily attributable to a non-recurring $54.2 million income tax benefit resulting primarily from the settlement of a transfer pricing dispute between the United States and Canada (covering the years 1996-2003) and a net tax benefit on excess foreign tax credits on unremitted foreign earnings of $20.6 million. Excluding these benefits the effective income tax rate on earnings in fiscal 2005 would have been 36.2%.

***Net Income***

| | Fiscal 2006 | Fiscal 2005 | Fiscal 2004 |
|---|---|---|---|
| Net income | $1,103,215 | $1,063,092 | $882,393 |
| Net income increase | 3.8% | 20.5% | 22.4% |
| Net income as a percentage of net sales | 1.87% | 2.05% | 1.87% |
| Diluted earnings per share | $ 2.30 | $ 2.18 | $ 1.85 |
| Shares used to calculate diluted earnings per share | 480,341 | 492,035 | 482,459 |
| Diluted earnings per share increase | 6% | 18% | 21% |

*2006 vs. 2005*

Net income for fiscal 2006 increased 3.8%, to $1.10 billion or $2.30 per diluted share, from $1.06 billion or $2.18 per diluted share, during fiscal 2005. The fiscal 2005 results included several non-recurring items that in the aggregate positively impacted reported earnings for all of fiscal 2005 by approximately $0.14 per share: a $54.2 million (approximately $0.11 per diluted share) income tax benefit resulting primarily from the settlement of a transfer pricing dispute between the United States and Canada; a cumulative pre-tax, non-cash charge to preopening expenses of $16.0 million (approximately $0.02 per diluted share) related to a correction to our method of accounting for ground leases; and a net tax benefit with respect to excess foreign tax credits on unremitted foreign earnings recorded in the fourth quarter of $20.6 million (approximately $0.04 per diluted share). Exclusive of these items, fiscal 2005 earnings were $2.04 per diluted share. Fiscal 2006's earnings per diluted share represents an increase of 13% over that figure.

*2005 vs. 2004 Net Income*

Net income for fiscal 2005 increased 20.5% to $1.06 billion, or $2.18 per diluted share, from $882.4 million, or $1.85 per diluted share, during fiscal year 2004. As discussed above, the fiscal 2005 results included several non-recurring items that in the aggregate positively impacted reported earnings for all of fiscal 2005 by approximately $0.14 per share. Exclusive of these items, fiscal 2005 earnings were $2.04 per diluted share, which represents an increase of 10% over fiscal 2004 earnings per diluted share.

**Liquidity and Capital Resources (dollars in thousands, except per share amounts)**

The following table itemizes components of our most liquid assets:

| | September 3, 2006 | August 28, 2005 |
|---|---|---|
| Cash and cash equivalents | $1,510,939 | $2,062,585 |
| Short-term investments | 1,322,181 | 1,397,272 |
| Total | $2,833,120 | $3,459,857 |

Our primary sources of liquidity are cash flows generated from warehouse operations and our existing cash and cash equivalents and short-term investments balances, which were $2.83 billion and $3.46 billion at September 3, 2006 and August 28, 2005, respectively. Of these balances, approximately $594 million and $522 million at September 3, 2006 and August 28, 2005, respectively, represented debit and credit card receivables, primarily related to weekend sales immediately prior to the year-end close. The decrease in our most liquid assets of $627 million to $2.83 billion at September 3, 2006 was due primarily to the repurchase of our common stock, the acquisition of property and equipment related to warehouse expansion and the payment of cash dividends.

Net cash provided by operating activities totaled $1.83 billion in fiscal 2006 compared to $1.78 billion in fiscal 2005, an increase of $51 million. This increase is attributable to higher net income and an increase in cash flow from operating assets and liabilities of $338 million, offset by an increase in net merchandise inventories (merchandise inventory less accounts payable) of $388 million.

Net cash used in investing activities totaled $1.15 billion in fiscal 2006 compared to $2.05 billion in fiscal 2005. The decrease relates primarily to a decrease in the net investment in short-term investments of $1.16 billion, offset by an increase of $217 million in additions to property and equipment related to warehouse expansion and remodel projects. The decrease in the net investment in short-term investments was due primarily to our stock repurchase activity.

Net cash used in financing activities totaled $1.23 billion in fiscal 2006 compared to $519 million in fiscal 2005. The increase of $715 million primarily resulted from the repurchase of common stock in fiscal 2006, which used $1.44 billion of cash, compared to $413 million in fiscal 2005. In addition, $304 million was used in fiscal 2005 for the repayment of the 7⅛% Senior Notes.

### *Dividends*

In April 2006, our quarterly cash dividend was increased from $0.115 to $0.13 per share. Our cash dividends paid in fiscal 2006 totaled $0.49 per share. In fiscal 2005, we paid quarterly cash dividends totaling $0.43 per share. Our current quarterly dividend rate is $0.13 per share or $0.52 per share on an annualized basis.

### *Contractual Obligations*

Our commitments at year end to make future payments under contractual obligations were as follows, as of September 3, 2006:

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| **Contractual obligations** | **Total** | **Less than 1 year** | **1 to 3 years** | **4 to 5 years** | **After 5 years** |
| Long-term debt(1) | $ 523,391 | $ 317,959 | $ 57,358 | $ 60,046 | $ 88,028 |
| Capital lease obligations and other(1) | 20,928 | 8,152 | 4,666 | 2,034 | 6,076 |
| Operating leases(2) | 1,647,683 | 130,259 | 237,373 | 200,052 | 1,079,999 |
| Purchase obligations (merchandise)(3) | 3,538,948 | 3,538,096 | 852 | — | — |
| Purchase obligations (building, equipment, services and other)(4) | 385,650 | 350,721 | 29,563 | 5,366 | — |
| Other(5) | 11,809 | 1,703 | 2,852 | 2,692 | 4,562 |
| Total | $6,128,409 | $4,346,890 | $332,664 | $270,190 | $1,178,665 |

(1) Amounts include contractual interest payments.

(2) Operating lease obligations have been reduced by $162,120 to reflect sub-lease income.

(3) Includes open merchandise purchase orders.

(4) The amounts exclude minor outsourced services negotiated at the individual warehouse level that are not significant and generally contain clauses allowing for cancellation without significant penalty.

(5) Consists of asset retirement and deferred compensation obligations.

### *Expansion Plans*

Our primary requirement for capital is the domestic and international financing of the land, building and equipment costs for new and remodeled warehouses plus the costs of initial warehouse operations and working capital requirements.

While there can be no assurance that current expectations will be realized, and plans are subject to change upon further review, it is management's current intention to spend approximately $1.4 billion to $1.6 billion during fiscal 2007 for real estate, construction, remodeling and equipment for warehouse clubs and related operations. These expenditures are expected to be financed with a combination of cash provided from operations and the use of cash and cash equivalents and short-term investments.

Plans for the United States and Canada during fiscal 2007 are to open approximately 33 to 35 new warehouses on a net basis, inclusive of one to two relocations. We expect to continue our review of expansion plans in our international operations, including the United Kingdom and Asia, along with other international markets. At present, we are planning to open one additional warehouse in the United Kingdom during fiscal 2007. Costco Mexico plans to open one to two new warehouses during fiscal 2007.

### *Additional Equity Investments in Subsidiaries and Joint Ventures*

During fiscal 2006 and 2005, we contributed an additional $15 million each year to our investment in Costco Mexico (a 50%-owned joint venture), which did not impact our percentage ownership of this entity, as our joint venture partner contributed a like amount. In addition, in fiscal 2005, we acquired the remaining 4% interest in CWC Travel Inc. for $4 million, bringing our ownership in this entity to 100%.

### *Bank Credit Facilities and Commercial Paper Programs (all amounts stated in U.S. dollars)*

A wholly-owned Canadian subsidiary has a $181 million commercial paper program ($167 million at August 28, 2005) supported by a $54 million bank credit facility ($50 million at August 28, 2005) with a Canadian bank, which we guarantee and which expires in March 2007. We intend to renew the bank credit facility. At both September 3, 2006 and August 28, 2005, there were no amounts outstanding under the Canadian commercial paper program or the bank credit facility. Applicable interest rates on the credit facility at September 3, 2006 and August 28, 2005, were 4.65% and 4.25%, respectively. At September 3, 2006, standby letters of credit totaling $21 million issued under the bank credit facility left $33 million available for commercial paper support. At August 28, 2005, standby letters of credit totaling $23 million issued under the bank credit facility left $27 million available for commercial paper support.

Our wholly-owned Japanese subsidiary has a short-term $13 million bank line of credit ($14 million at August 28, 2005) that expires in February 2007, which we intend to renew. At September 3, 2006 and August 28, 2005, $2.5 million and $6 million, respectively, were borrowed under the line of credit, and $4 million in both years was used to support standby letters of credit. A second $13 million bank line of credit also expires in February 2007, which we intend to renew. At September 3, 2006 and August 28, 2005, $0.9 million and $9 million, respectively, were borrowed under the second facility. Applicable interest rates on the credit facilities at September 3, 2006 and August 28, 2005, were 0.95% and 0.84%, respectively.

Our Korean subsidiary has a short-term $13 million bank line of credit, which expires in February 2007, and which we intend to renew. At September 3, 2006 and August 28, 2005, no amounts were borrowed under the line of credit and $2 million in both years was used to support standby letters of credit. Applicable interest rates on the credit facility at September 3, 2006 and August 28, 2005 were 5.48% and 4.51%, respectively.

Our Taiwan subsidiary has a $5 million bank revolving credit facility that expires in January 2007, which we intend to renew. At September 3, 2006 and August 28, 2005, no amounts were borrowed under the

credit facility and $2 million and $3 million, respectively, were used to support standby letters of credit. A second $15 million bank revolving credit facility is in place, which expires in August 2007. At September 3, 2006 and August 28, 2005, no amounts were borrowed under the second credit facility and $2 million and $1 million, respectively, were used to support standby letters of credit. Applicable interest rates on the credit facility at September 3, 2006 and August 28, 2005, were 4.00% and 3.75%, respectively.

Our wholly-owned United Kingdom subsidiary has a $114 million bank revolving credit facility expiring in February 2007, and a $67 million bank overdraft facility renewable on a yearly basis in March 2007. We intend to renew both facilities. At September 3, 2006, $38 million was outstanding under the revolving credit facility with an applicable interest rate of 5.32% and no amounts were outstanding under the bank overdraft facility. At August 28, 2005, $40 million was outstanding under the revolving credit facility, with an applicable interest rate of 5.30%, and no amounts were outstanding under the bank overdraft facility.

On November 15, 2005, upon the expiration of our $150 million bank credit facility in the U.S. with a group of nine banks, we terminated our $500 million commercial paper program. At August 28, 2005, no amounts were outstanding under the commercial paper program and no amounts were outstanding under the credit facility. The applicable interest rate on the credit facility at August 28, 2005, was 3.92%.

***Letters of Credit***

We have letter of credit facilities (for commercial and standby letters of credit) totaling $400 million. The outstanding commitments under these facilities at September 3, 2006 and August 28, 2005 totaled $85 million and $131 million, respectively, including $55 million and $65 million, respectively, in standby letters of credit.

***Financing Activities***

In April 2003, our wholly-owned Japanese subsidiary issued promissory notes bearing interest at 0.92% in the aggregate amount of $34 million, through a private placement. Interest is payable semi-annually and principal is due in April 2010.

In March 2002, we issued $300 million of 5½% Senior Notes, carried at $301 million, due in March 2007. Interest is payable semi-annually on March 15 and September 15. Simultaneous with the issuance of the 5½% Senior Notes, we entered into interest rate swap agreements converting the interest to a floating rate indexed to LIBOR. We plan to repay the 5½% Senior Notes at maturity from our cash and cash equivalents and short-term investments balances.

In February 1996, we filed with the Securities and Exchange Commission a shelf registration statement for $500 million of senior debt securities. In October 2001, additional debt securities of $100 million were registered. The $300 million of 5½% Senior Notes issued in March 2002 reduced the amount of registered securities available for future issuance to $300 million. In April 2006, we cancelled the shelf registration.

During fiscal 2006, $191 million in principal amount of our 3½% Zero Coupon Convertible Subordinated Notes were converted by note holders into 6.5 million shares of common stock. The current Notes outstanding are convertible into a maximum of 2,925,057 shares of Costco common stock at an initial conversion price of $22.71.

***Derivatives***

We have limited involvement with derivative financial instruments and use them only to manage well-defined interest rate and foreign exchange risks. Forward foreign exchange contracts are used to

hedge the impact of fluctuations of foreign exchange on inventory purchases and typically have very short terms. The aggregate notional amount, which approximates the fair value of foreign exchange contracts outstanding at September 3, 2006 and August 28, 2005, was $63 million and $42 million, respectively. The majority of the forward foreign exchange contracts were entered into by our wholly-owned United Kingdom subsidiary, primarily to hedge U.S. dollar merchandise inventory purchases.

We also hold interest rate swaps to manage the interest rate risk associated with our borrowings and the mix of fixed-rate and variable-rate debt. As of September 3, 2006 and August 28, 2005, we had "fixed-to-floating" interest rate swaps with an aggregate notional amount of $300 million and an aggregate fair value of $1 million and $8 million, respectively. These amounts were recorded in deferred income taxes and other current assets as of September 3, 2006 and in other assets as of August 28, 2005, in our consolidated balance sheets. These swaps were entered into effective March 25, 2002, and are designated and qualify as fair value hedges of our $300 million 5½% Senior Notes. As the terms of the swaps match those of the underlying hedged debt, the changes in the fair value of these swaps are offset by corresponding changes in the carrying amount of the hedged debt and result in no net earnings impact.

We are exposed to market risk for changes in utility commodity pricing, which we partially mitigate through the use of firm-price contracts with counterparties for approximately 19% of our locations in the U.S. and Canada. The effects of these arrangements are not significant for any period presented.

### *Off-Balance Sheet Arrangements*

With the exception of our operating leases, we have no off-balance sheet arrangements that have had, or are reasonably likely to have, a material current or future effect on our financial condition or consolidated financial statements.

### *Stock Repurchase Programs*

Our Board of Directors has approved the following stock repurchase programs (000's):

| | Amount Approved | Amount Remaining |
|---|---|---|
| August 2005 | $1,000,000 | $ 0 |
| January 2006(1) | 1,000,000 | 625,534 |
| July 2006(2) | 2,000,000 | 2,000,000 |
| Total | $4,000,000 | $2,625,534 |

(1) Expires in January 2009.

(2) Expires in July 2009.

During fiscal 2005, we repurchased 9.2 million shares of common stock, at an average price of $44.89, totaling approximately $413 million. During fiscal 2006, we repurchased 28.4 million shares at an average price of $51.44, totaling approximately $1.46 billion. The amount available to be purchased under the approved plans was approximately $2.63 billion at September 3, 2006. Purchases are made from time-to-time as conditions warrant in the open market or in block purchases, or pursuant to plans under SEC Rule 10b5-1. Repurchased shares are retired.

## Critical Accounting Policies

The preparation of our financial statements requires that management make estimates and judgments that affect the financial position and results of operations. Management continues to review its accounting policies and evaluate its estimates, including those related to revenue recognition, merchandise inventory valuation, impairment of long-lived assets, warehouse closing costs, insurance/self-insurance liabilities,

stock-based compensation and income taxes. We base our estimates on historical experience and on other assumptions that management believes to be reasonable under the circumstances.

***Revenue Recognition***

We recognize sales, net of estimated returns, at the time customers take possession of merchandise or receive services. When we collect payment from customers prior to the transfer of ownership of merchandise or the performance of services, the amount received is recorded as deferred revenue on the balance sheet until the sale or service is completed. We provide for estimated sales returns based on historical returns levels.

We evaluate the criteria of the Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent," in determining whether it is appropriate to record the gross amount of merchandise sales and related costs or the net amount earned as commissions. Generally, when we are the primary obligor, subject to inventory risk, have latitude in establishing prices and selecting suppliers, influence product or service specifications, or have several but not all of these indicators, revenue is recorded on a gross basis. If we are not the primary obligor and do not possess other indicators of gross reporting as noted above, we record the net amounts as commissions earned, which is reflected in net sales.

Membership fee revenue represents annual membership fees paid by substantially all of our members. We account for membership fee revenue on a deferred basis, whereby membership fee revenue is recognized ratably over one year. Our Executive members qualify for a 2% reward (which can be redeemed only at Costco warehouses), up to a maximum of $500 per year, on all qualified purchases made at Costco. We account for this 2% reward as a reduction in sales, with the related liability being classified within other current liabilities.

***Merchandise Inventories***

Merchandise inventories are valued at the lower of cost or market, as determined primarily by the retail method of accounting, 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 method of accounting and are stated using the first-in, first-out (FIFO) method. We believe the LIFO method more fairly presents the results of operations by more closely matching current costs with current revenues. We record an adjustment each quarter, if necessary, for the expected annual effect of inflation, and these estimates are adjusted to actual results determined at year-end. At both September 3, 2006 and August 28, 2005 merchandise inventories valued at LIFO approximated FIFO after considering the lower of cost or market principle.

We provide for estimated inventory losses between physical inventory counts as a percentage of net sales. The provision is adjusted periodically to reflect the actual physical inventory count results, which generally occur in the second and fourth fiscal quarters of the fiscal year.

Inventory cost, where appropriate, is reduced by estimates of vendor rebates when earned or as we progress toward earning those rebates, provided they are probable and reasonably estimable. Other consideration received from vendors is generally recorded as a reduction of merchandise costs upon completion of contractual milestones, terms of agreement, or other systematic and rational approach.

***Impairment of Long-Lived Assets and Warehouse Closing costs***

We periodically evaluate our long-lived assets for indicators of impairment. Our judgments are based on existing market and operational conditions. Future events could cause us to conclude that impairment factors exist, requiring an adjustment of these assets to their then-current fair market value.

We provide estimates for warehouse closing costs based on applicable U.S. generally accepted accounting principles. Future circumstances may result in actual closing costs or the amount recognized upon the sale of the property to differ substantially from the original estimates.

### *Insurance/Self Insurance Liabilities*

We use a combination of insurance and self-insurance mechanisms, including a wholly-owned captive insurance entity and participation in a reinsurance pool, to provide for potential liabilities for workers' compensation, general liability, property damage, director and officers' liability, vehicle liability and employee health care benefits. Liabilities associated with the risks that we retain are not discounted and are estimated, in part, by considering historical claims experience and evaluations of outside expertise, demographic factors, severity factors and other actuarial assumptions. The estimated accruals for these liabilities could be significantly affected if future occurrences and claims differ from these assumptions and historical trends.

### *Stock–Based Compensation*

We account for stock–based compensation in accordance with the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123R. We use the Black–Scholes option–pricing model, which requires the input of subjective assumptions. These assumptions include: estimating the length of time employees will retain their vested stock options before exercising them (expected term); the estimated volatility of our common stock price over the expected term (volatility), and the number of options that will ultimately not complete their vesting requirements (forfeitures). Changes in these assumptions can materially affect the estimate of fair value of stock–based compensation. In the fourth quarter of fiscal 2006, we ceased the granting of stock options in favor of restricted stock units.

### *Income Taxes*

The determination of our provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. Significant judgment is required in assessing, among other things, the timing and amounts of deductible and taxable items. We establish reserves when, despite our belief that our tax return positions are fully supportable, we believe that certain positions may be successfully challenged. When facts and circumstances change, we adjust these reserves through our provision for income taxes.

## Recent Accounting Pronouncements

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements" (SAB 108). SAB 108 addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in current-year financial statements. SAB 108 requires an entity to quantify misstatements using a balance sheet and income-statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. We early-adopted SAB 108 as of August 29, 2005, the beginning of our fiscal year. See Note 11 to the consolidated financial statements included in Item 8 of this report for further discussion.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair-value measurements required under other accounting pronouncements but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 is effective for our fiscal year 2008. We are currently evaluating the impact of adopting SFAS 157.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective beginning in fiscal 2008. We are currently evaluating the impact of adopting FIN 48.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force (EITF) Issue No. 06-03, "How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (that is, Gross Versus Net Presentation)." The EITF reached a consensus that the presentation of taxes on either a gross or net basis is an accounting policy decision that requires disclosure. EITF 06-03 is effective for the first interim or annual reporting period beginning after December 15, 2006. Amounts collected from our members, which under common trade practices are referred to as sales taxes, are and have been recorded on a net basis. We have no intention of modifying this accounting policy. Therefore, the adoption of EITF 06-03 will not have any effect on our financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections, a Replacement of Accounting Principles Board Opinion No. 20, and FASB Statement No. 3." SFAS 154 requires retrospective application to prior periods' financial statements for changes in accounting principles, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We will adopt the provisions of SFAS 154 beginning in fiscal 2007. We do not believe the adoption will have a significant effect on our future consolidated financial statements.

**Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to financial market risk resulting from changes in interest and foreign currency rates. As a policy, we do not engage in speculative or leveraged transactions, nor hold or issue financial instruments for trading purposes.

The nature and amount of our long and short-term debt can be expected to vary as a result of future business requirements, market conditions and other factors. As of September 3, 2006, our fixed rate long-term debt included $129 million principal amount at maturity Zero Coupon Subordinated Notes carried at $88 million and additional notes and capital lease obligations totaling $135 million. Our debt also includes $300 million 5½% Senior Notes carried at $301 million. We entered into "fixed-to-floating" interest rate swaps on the Senior Notes, effectively converting these fixed interest rate securities to variable rate securities. As of September 3, 2006 and August 28, 2005, we had "fixed-to-floating" interest rate swaps with an aggregate notional amount of $300 million and an aggregate fair value of $1 million and $8 million, respectively. Fluctuations in interest rates may affect the fair value of the fixed rate debt and may affect the interest expense related to the variable rate debt.

We hold interest-bearing instruments that are classified as cash and cash equivalents and short-term investments. Our investment policy is to manage our cash and cash equivalents and short-term investments balances to preserve principal and liquidity, while seeking to maximize the return on our investment portfolio through the full investment of available funds. We diversify our investment portfolio

by investing in multiple types of investment-grade securities and through a combination of internal and third-party investment management. Short-term investments generally have a maturity of three months to five years from the purchase date. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. As the majority of these instruments are of a short-term nature, if interest rates were to increase or decrease, there is no material risk of a valuation adjustment related to these instruments. For those instruments that are classified as available for sale, the unrealized gains or losses related to fluctuations in interest rates are reflected in accumulated other comprehensive income or loss. Based on our cash and cash equivalents and short-term investments balances at September 3, 2006, a 100 basis point increase or decrease in interest rates would result in an increase or decrease of approximately $9 million to interest income (pre-tax) on an annual basis.

Most transactions of our foreign subsidiaries are conducted in local currencies, limiting our exposure to changes in currency rates. We periodically enter into short-term forward foreign exchange contracts to hedge the impact of fluctuations in foreign currency rates on inventory purchases. The notional value of foreign exchange contracts outstanding at September 3, 2006 was $62 million.

## EXECUTIVE OFFICERS OF THE COMPANY

A list of our Directors and nominees for Director is included in Costco's Proxy Statement for its Annual Meeting of Shareholders to be held on January 31, 2007. A list of the names and positions of the Directors, as well as the Executive and Senior Officers of the Company, appears on page 71 of this report.

The Company has adopted a code of ethics for senior financial officers pursuant to Section 406 of the Sarbanes-Oxley Act. Copies of the code are available free of charge by writing to Secretary, Costco Wholesale Corporation, 999 Lake Drive, Issaquah, WA 98027.

Costco's Form 10-K for its fiscal year ended September 3, 2006, as filed with the Securities and Exchange Commission, includes the certifications of Costco's Chief Executive Officer and Chief Financial Officer required by Section 302 of the Sarbanes-Oxley Act of 2002.

### Executive Compensation

The information required by this Item is incorporated herein by reference to the Proxy Statement filed with the Securities and Exchange Commission.

## MANAGEMENT'S REPORTS

### Management's Report on the Financial Statements

Our management is responsible for the preparation, integrity and objectivity of the accompanying consolidated financial statements and the related financial information. The financial statements have been prepared in conformity with U.S. generally accepted accounting principles and necessarily include certain amounts that are based on estimates and informed judgments. Our management also prepared the related financial information included in this Annual Report on Form 10-K and is responsible for its accuracy and consistency with the financial statements.

The consolidated financial statements have been audited by KPMG LLP, an independent registered public accounting firm, who conducted their audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). The independent registered public accounting firm's responsibility is to express an opinion as to the fairness with which such financial statements present our financial position, results of operations and cash flows in accordance with accounting principles generally accepted in the United States.

### Disclosure Controls and Procedures

Our management, including the Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer), evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 (Exchange Act) as of September 3, 2006. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

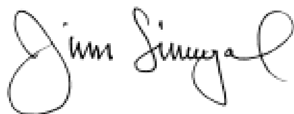
### Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Exchange Act. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect our transactions and the dispositions of our assets; (2) provide reasonable assurance that our transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with appropriate authorizations; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Under the supervision and with the participation of our management, we assessed the effectiveness of our internal control over financial reporting as of September 3, 2006, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. Based on its assessment, management has concluded that our internal control over financial reporting was effective as of September 3, 2006.

KPMG LLP, an independent registered public accounting firm, has audited management's assessment of the effectiveness of our internal control over financial reporting as of September 3, 2006, as stated in their audit report herein, which appears on page 38.



James D. Sinegal
President
Chief Executive Officer

Richard A. Galanti
Executive Vice President
Chief Financial Officer

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
Costco Wholesale Corporation:

We have audited the accompanying consolidated balance sheets of Costco Wholesale Corporation and subsidiaries as of September 3, 2006 and August 28, 2005 and the related consolidated statements of income, stockholders' equity and comprehensive income and cash flows for the 53-week period ended September 3, 2006, and the 52-week periods ended August 28, 2005, and August 29, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Costco Wholesale Corporation and subsidiaries as of September 3, 2006 and August 28, 2005, and the results of their operations and their cash flows for the 53-week period ended September 3, 2006, and the 52-week periods ended August 28, 2005, and August 29, 2004, in conformity with U.S. generally accepted accounting principles.

Effective August 29, 2005, the beginning of the Company's fiscal year ended September 3, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" and Securities and Exchange Commission Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements."

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of September 3, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated November 16, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

KPMG LLP

Seattle, Washington
November 16, 2006

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
Costco Wholesale Corporation:

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting appearing under Item 8, that Costco Wholesale Corporation and subsidiaries (the Company) maintained effective internal control over financial reporting as of September 3, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of September 3, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 3, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of September 3, 2006 and August 28, 2005, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for the 53 weeks ended September 3, 2006, and the 52 weeks ended August 28, 2005 and August 29, 2004 and our report dated November 16, 2006 expressed an unqualified opinion on those consolidated financial statements. Our report refers to the Company's adoption of Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" and Securities and Exchange Commission Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements" effective August 29, 2005, the beginning of the Company's fiscal year ended September 3, 2006.

KPMG LLP

Seattle, Washington
November 16, 2006

## COSTCO WHOLESALE CORPORATION

## CONSOLIDATED BALANCE SHEETS
**(dollars in thousands, except par value)**

| | September 3, 2006 | August 28, 2005 |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS** | | |
| Cash and cash equivalents | $ 1,510,939 | $ 2,062,585 |
| Short-term investments | 1,322,181 | 1,397,272 |
| Receivables, net | 565,373 | 529,150 |
| Merchandise inventories | 4,568,723 | 4,014,699 |
| Deferred income taxes and other current assets | 264,866 | 234,295 |
| Total current assets | 8,232,082 | 8,238,001 |
| **PROPERTY AND EQUIPMENT** | | |
| Land | 2,747,396 | 2,502,247 |
| Buildings, leasehold and land improvements | 6,241,357 | 5,622,439 |
| Equipment and fixtures | 2,405,229 | 2,181,740 |
| Construction in progress | 248,454 | 180,604 |
| | 11,642,436 | 10,487,030 |
| Less accumulated depreciation and amortization | (3,078,141) | (2,696,838) |
| Net property and equipment | 8,564,295 | 7,790,192 |
| **OTHER ASSETS** | 698,693 | 637,012 |
| | $17,495,070 | $16,665,205 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| **CURRENT LIABILITIES** | | |
| Short-term borrowings | $ 41,385 | $ 54,356 |
| Accounts payable | 4,581,395 | 4,224,676 |
| Accrued salaries and benefits | 1,080,382 | 1,025,181 |
| Accrued sales and other taxes | 324,274 | 263,899 |
| Deferred membership income | 583,946 | 500,558 |
| Current portion of long-term debt | 308,523 | 3,225 |
| Other current liabilities | 899,286 | 688,642 |
| Total current liabilities | 7,819,191 | 6,760,537 |
| **LONG-TERM DEBT, excluding current portion** | 215,369 | 710,675 |
| **DEFERRED INCOME TAXES AND OTHER LIABILITIES** | 253,713 | 254,270 |
| Total liabilities | 8,288,273 | 7,725,482 |
| **COMMITMENTS AND CONTINGENCIES** | | |
| **MINORITY INTEREST** | 63,358 | 58,614 |
| **STOCKHOLDERS' EQUITY** | | |
| Preferred stock $.005 par value; 100,000,000 shares authorized; no shares issued and outstanding | — | — |
| Common stock $.005 par value; 900,000,000 shares authorized; 462,279,000 and 472,480,000 shares issued and outstanding | 2,312 | 2,362 |
| Additional paid-in capital | 2,822,652 | 2,096,554 |
| Accumulated other comprehensive income | 277,263 | 158,039 |
| Retained earnings | 6,041,212 | 6,624,154 |
| Total stockholders' equity | 9,143,439 | 8,881,109 |
| | $17,495,070 | $16,665,205 |

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

## COSTCO WHOLESALE CORPORATION

## CONSOLIDATED STATEMENTS OF INCOME
### (dollars in thousands, except per share data)

| | 53 weeks ended September 3, 2006 | 52 weeks ended August 28, 2005 | 52 weeks ended August 29, 2004 |
|---|---|---|---|
| **REVENUE** | | | |
| Net sales | $58,963,180 | $51,879,070 | $47,148,627 |
| Membership fees | 1,188,047 | 1,073,156 | 961,280 |
| Total revenue | 60,151,227 | 52,952,226 | 48,109,907 |
| **OPERATING EXPENSES** | | | |
| Merchandise costs | 52,745,497 | 46,346,961 | 42,092,016 |
| Selling, general and administrative | 5,732,141 | 5,061,339 | 4,600,792 |
| Preopening expenses | 42,504 | 53,230 | 30,451 |
| Provision for impaired assets and closing costs, net | 5,453 | 16,393 | 1,000 |
| Operating income | 1,625,632 | 1,474,303 | 1,385,648 |
| **OTHER INCOME (EXPENSE)** | | | |
| Interest expense | (12,570) | (34,437) | (36,651) |
| Interest income and other | 138,355 | 109,096 | 51,627 |
| **INCOME BEFORE INCOME TAXES** | 1,751,417 | 1,548,962 | 1,400,624 |
| Provision for income taxes | 648,202 | 485,870 | 518,231 |
| **NET INCOME** | $ 1,103,215 | $ 1,063,092 | $ 882,393 |
| **NET INCOME PER COMMON SHARE:** | | | |
| Basic | $ 2.35 | $ 2.24 | $ 1.92 |
| Diluted | $ 2.30 | $ 2.18 | $ 1.85 |
| Shares used in calculation (000's) | | | |
| Basic | 469,718 | 473,945 | 459,223 |
| Diluted | 480,341 | 492,035 | 482,459 |
| Dividends per share | $ 0.49 | $ 0.43 | $ 0.20 |

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

## COSTCO WHOLESALE CORPORATION

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (in thousands)

| | Common Stock | | Additional Paid-In Capital | Accumulated Other Comprehensive Income/(Loss) | Retained Earnings | Total |
|---|---|---|---|---|---|---|
| | Shares | Amount | | | | |
| BALANCE AT AUGUST 31, 2003 | 457,479 | $2,287 | $1,280,942 | $ (77,980) | $ 5,349,731 | $ 6,554,980 |
| Comprehensive Income: | | | | | | |
| Net Income | — | — | — | — | 882,393 | 882,393 |
| Foreign currency translation adjustment and other | — | — | — | 94,124 | — | 94,124 |
| Total comprehensive income | — | — | — | 94,124 | 882,393 | 976,517 |
| Stock options exercised, including income tax benefits and other | 5,153 | 26 | 148,785 | — | — | 148,811 |
| Conversion of convertible notes | 5 | — | 131 | — | — | 131 |
| Stock-based compensation | — | — | 36,508 | — | — | 36,508 |
| Cash dividends | — | — | — | — | (92,137) | (92,137) |
| BALANCE AT AUGUST 29, 2004 | 462,637 | 2,313 | 1,466,366 | 16,144 | 6,139,987 | 7,624,810 |
| Comprehensive Income: | | | | | | |
| Net Income | — | — | — | — | 1,063,092 | 1,063,092 |
| Foreign currency translation adjustment and other | — | — | — | 141,895 | — | 141,895 |
| Total comprehensive income | — | — | — | 141,895 | 1,063,092 | 1,204,987 |
| Stock options exercised, including income tax benefits and other | 9,138 | 46 | 323,545 | — | — | 323,591 |
| Conversion of convertible notes | 9,910 | 49 | 277,554 | — | — | 277,603 |
| Stock repurchase | (9,205) | (46) | (38,848) | — | (374,358) | (413,252) |
| Stock-based compensation | — | — | 67,937 | — | — | 67,937 |
| Cash dividends | — | — | — | — | (204,567) | (204,567) |
| BALANCE AT AUGUST 28, 2005 | 472,480 | 2,362 | 2,096,554 | 158,039 | 6,624,154 | 8,881,109 |
| Cumulative effect of adjustments resulting from the adoption of SAB No. 108, net of tax | — | — | 147,637 | — | (139,481) | 8,156 |
| Adjusted balance at August 28, 2005 | 472,480 | 2,362 | 2,244,191 | 158,039 | 6,484,673 | 8,889,265 |
| Comprehensive Income: | | | | | | |
| Net Income | — | — | — | — | 1,103,215 | 1,103,215 |
| Foreign currency translation adjustment and other | — | — | — | 119,224 | — | 119,224 |
| Total comprehensive income | — | — | — | 119,224 | 1,103,215 | 1,222,439 |
| Stock options exercised, including income tax benefits and other | 11,712 | 59 | 427,291 | — | — | 427,350 |
| Conversion of convertible notes | 6,505 | 33 | 188,902 | — | — | 188,935 |
| Stock repurchase | (28,418) | (142) | (145,129) | — | (1,316,465) | (1,461,736) |
| Stock-based compensation | — | — | 107,397 | — | — | 107,397 |
| Cash dividends | — | — | — | — | (230,211) | (230,211) |
| BALANCE AT SEPTEMBER 3, 2006 | 462,279 | $2,312 | $2,822,652 | $277,263 | $ 6,041,212 | $ 9,143,439 |

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

## COSTCO WHOLESALE CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS
## (dollars in thousands)

| | Fiscal Year Ended | | |
|---|---|---|---|
| | September 3, 2006 | August 28, 2005 | August 29, 2004 |
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Net income | $ 1,103,215 | $ 1,063,092 | $ 882,393 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 515,285 | 481,838 | 440,721 |
| Other | (5,888) | (11,186) | 74 |
| Accretion of discount on zero coupon notes | 4,828 | 11,855 | 18,421 |
| Stock-based compensation | 107,397 | 67,937 | 36,508 |
| Undistributed equity earnings in joint ventures | (28,180) | (26,459) | (23,517) |
| Net loss/(gain) on sale of property and equipment and other | 5,867 | 5,139 | (9,122) |
| Provision for impaired assets | — | 3,893 | — |
| Change in deferred income taxes | (38,311) | (64,690) | 32,496 |
| Excess tax benefit from exercise of stock options | (31,296) | — | — |
| Change in receivables, other current assets, deferred income, accrued and other current liabilities | 416,112 | 78,118 | 762,739 |
| Increase in merchandise inventories | (500,602) | (315,793) | (256,438) |
| Increase in accounts payable | 278,863 | 482,217 | 211,990 |
| Total adjustments | 724,075 | 712,869 | 1,213,872 |
| Net cash provided by operating activities | 1,827,290 | 1,775,961 | 2,096,265 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Additions to property and equipment | (1,212,567) | (995,431) | (705,620) |
| Proceeds from the sale of property and equipment | 15,740 | 19,432 | 55,400 |
| Investment in unconsolidated joint venture | (15,000) | (15,000) | — |
| Purchase of minority interests | — | (3,961) | (95,153) |
| Purchases of short-term investments | (2,598,355) | (3,741,429) | (387,223) |
| Maturities of short-term investments | 2,424,503 | 2,401,248 | — |
| Sales of short-term investments | 263,288 | 267,640 | 83,278 |
| Change in other assets and other, net | (31,169) | 15,988 | 3,355 |
| Net cash used in investing activities | (1,153,560) | (2,051,513) | (1,045,963) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| (Repayments of)/Proceeds from short-term borrowings, net | (12,929) | 33,433 | (31,492) |
| Net proceeds from issuance of long-term debt | 18,375 | 5,660 | — |
| Repayments of long-term debt | (7,586) | (303,877) | (6,602) |
| Change in bank checks outstanding | 33,559 | 85,829 | 212,251 |
| Cash dividend payments | (230,211) | (204,567) | (92,137) |
| Change in minority interests | 4,744 | (130) | 2,805 |
| Excess tax benefit from exercise of stock options | 31,296 | — | — |
| Exercise of stock options | 372,336 | 278,253 | 124,744 |
| Repurchases of common stock | (1,442,811) | (413,252) | — |
| Net cash (used in)/provided by financing activities | (1,233,227) | (518,651) | 209,569 |
| **EFFECT OF EXCHANGE RATE CHANGES ON CASH** | 7,851 | 33,653 | 17,825 |
| Net (decrease)/increase in cash and cash equivalents | (551,646) | (760,550) | 1,277,696 |
| **CASH AND CASH EQUIVALENTS BEGINNING OF YEAR** | 2,062,585 | 2,823,135 | 1,545,439 |
| **CASH AND CASH EQUIVALENTS END OF YEAR** | $ 1,510,939 | $ 2,062,585 | $ 2,823,135 |
| **SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:** | | | |
| Cash paid during the year for: | | | |
| Interest (excludes amounts capitalized) | $ 4,147 | $ 21,374 | $ 14,648 |
| Income taxes | $ 546,205 | $ 804,957 | $ 327,368 |
| **SUPPLEMENTAL DISCLOSURE OF NON-CASH FINANCING ACTIVITIES:** | | | |
| Common stock issued upon conversion of 3½% Zero Coupon Convertible Subordinated Notes | $ 190,871 | $ 280,811 | $ 133 |

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

COSTCO WHOLESALE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except per share data)

## Note 1—Summary of Significant Accounting Policies

### *Basis of Presentation*

The consolidated financial statements include the accounts of Costco Wholesale Corporation, a Washington corporation, and its subsidiaries ("Costco" or the "Company"). All material inter-company transactions between the Company and its subsidiaries have been eliminated in consolidation.

Costco operates membership warehouses that offer low prices on a limited selection of nationally branded and selected private label products in a wide range of merchandise categories in no-frills, self-service warehouse facilities. At September 3, 2006, Costco operated 487 warehouses: 354 in the United States and four in Puerto Rico; 68 in Canada; 18 in the United Kingdom; 5 in Korea; 4 in Taiwan; 5 in Japan; and 29 warehouses in Mexico (through a 50%-owned joint venture).

The Company's investments in the Costco Mexico joint venture and in other unconsolidated joint ventures that are less than majority owned are accounted for under the equity method. The investment in Costco Mexico is included in other assets and was $270,304 at September 3, 2006 and $232,402 at August 28, 2005. The equity in earnings of Costco Mexico is included in interest income and other in the accompanying consolidated statements of income, and for fiscal 2006, 2005 and 2004, was $26,646, $24,949 and $22,208, respectively. The amount of retained earnings that represents undistributed earnings of Costco Mexico was $159,877 and $133,231 at September 3, 2006 and August 28, 2005, respectively.

The Company, in accordance with Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" (SAB 108), adjusted its beginning retained earnings for fiscal 2006 in the accompanying consolidated financial statements. See Note 11 for additional information on the adoption SAB 108.

### *Fiscal Year End*

Costco operates on a 52/53 week fiscal year basis with the fiscal year ending on the Sunday closest to August 31. The fiscal year ended September 3, 2006 included 53 weeks, with the 53rd week falling in the fiscal fourth quarter. The fiscal years ended August 28, 2005 and August 29, 2004 each included 52 weeks.

### *Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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.

### *Reclassifications*

Certain reclassifications have been made to prior fiscal year amounts or balances to conform to the presentation adopted in the current fiscal year.

### *Cash and Cash Equivalents*

The Company considers as cash and cash equivalents all highly liquid investments with a maturity of three months or less at the date of purchase and proceeds due from credit and debit card transactions

with settlement terms of less than five days. Of the total cash and cash equivalents of $1,510,939 at September 3, 2006 and $2,062,585 at August 28, 2005, credit and debit card receivables were $593,645 and $521,634, respectively.

***Short-term Investments***

In general, short-term investments have a maturity of three months to five years at the date of purchase. Investments with maturities beyond five years may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. Short-term investments classified as available-for-sale are recorded at market value using the specific identification method with the unrealized gains and losses reflected in accumulated other comprehensive income until realized. The estimate of fair value is based on publicly available market information or other estimates determined by management. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis.

***Receivables, net***

Receivables consist primarily of vendor rebates and promotional allowances, receivables from government tax authorities, reinsurance receivables held by the Company's wholly-owned captive insurance subsidiary and other miscellaneous amounts due to the Company. Amounts are recorded net of an allowance for doubtful accounts of $2,423 at September 3, 2006 and $1,416 at August 28, 2005. Management determines the allowance for doubtful accounts based on historical experience and application of the specific identification method.

***Vendor Rebates and Allowances***

Periodic payments from vendors in the form of volume rebates or other purchase discounts that are evidenced by signed agreements are reflected in the carrying value of the inventory when earned or as the Company progresses towards earning the rebate or discount and as a component of cost of sales as the merchandise is sold. Other consideration received from vendors is generally recorded as a reduction of merchandise costs upon completion of contractual milestones, terms of the related agreement, or by other systematic and rational approach.

***Merchandise Inventories***

Merchandise inventories are valued at the lower of cost or market, as determined primarily by the retail method of accounting, 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 method of accounting 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 expected annual effect of inflation, and these estimates are adjusted to actual results determined at year-end. At both September 3, 2006 and August 28, 2005 merchandise inventories valued at LIFO approximated FIFO after considering the lower of cost or market principle.

| | September 3, 2006 | August 28, 2005 |
|---|---|---|
| Merchandise inventories consist of: | | |
| United States (primarily LIFO) | $3,620,903 | $3,155,462 |
| Foreign (FIFO) | 947,820 | 859,237 |
| Total | $4,568,723 | $4,014,699 |

The Company provides for estimated inventory losses between physical inventory counts as a percentage of net sales. The provision is adjusted periodically to reflect the actual physical inventory count results, which generally occur in the second and fourth fiscal quarters of the fiscal year.

Inventory cost, where appropriate, is reduced by estimates of vendor rebates when earned or as the Company progresses towards earning those rebates, provided they are probable and reasonably estimable. Other consideration received from vendors is generally recorded as a reduction of merchandise costs upon completion of contractual milestones, terms of agreement, or other systematic and rational approach.

***Property and Equipment***

Property and equipment are stated at cost. Depreciation and amortization expenses are computed using the straight-line method for financial reporting purposes. Estimated useful lives by major asset category are as follows:

| | Years |
|---|---|
| Buildings | 5 - 50 |
| Equipment and fixtures | 3 - 10 |
| Leasehold improvements | Shorter of useful life or lease term |
| Software acquisition and development | 3 - 6 |

Interest costs incurred on property during the construction period are capitalized. The amount of interest costs capitalized was $12,681 in fiscal 2006, $7,226 in fiscal 2005, and $4,155 in fiscal 2004.

***Impairment of Long-Lived Assets***

The Company periodically evaluates long-lived assets for impairment when management makes the decision to relocate or close a warehouse or when events or changes in circumstances occur that may indicate the carrying amount of the asset may not be fully recoverable. The Company evaluates the carrying value of the asset by comparing the estimated future undiscounted cash flows generated from the use of the asset and its eventual disposition with the asset's reported net carrying value. The Company recorded pre-tax, non-cash charge of $3,893 in fiscal 2005 reflecting its estimate of impairment relating to real property. The charge reflects the difference between the carrying value and fair value, which was based on estimated market valuations for those assets whose carrying value is not currently anticipated to be recoverable through future cash flows.

***Goodwill***

Goodwill resulting from certain business combinations is included in other assets, and totaled $72,953 at September 3, 2006 and $71,848 at August 28, 2005. The Company reviews previously reported goodwill for impairment on an annual basis, or more frequently if circumstances dictate. No impairment of goodwill has been incurred to date.

***Accounts Payable***

The Company's banking system provides for the daily replenishment of major bank accounts as checks are presented. Accordingly, included in accounts payable at September 3, 2006 and August 28, 2005 are $564,754 and $527,920, respectively, representing the excess of outstanding checks over cash on deposit at the banks on which the checks were drawn.

### *Insurance/Self Insurance Liabilities*

The Company uses a combination of insurance and self-insurance mechanisms, including a wholly-owned captive insurance entity and participation in a reinsurance pool, to provide for potential liabilities for workers' compensation, general liability, property damage, director and officers' liability, vehicle liability and employee health care benefits. Liabilities associated with the risks that are retained by the Company are not discounted and are estimated, in part, by considering historical claims experience and evaluations of outside expertise, demographic factors, severity factors and other actuarial assumptions. The estimated accruals for these liabilities could be significantly affected if future occurrences and claims differ from these assumptions and historical trends. As of the end of fiscal 2006 and 2005, these liabilities of $491,037 and $453,745, respectively, were included in accrued salaries and benefits, other current liabilities and accounts payable on the consolidated balance sheets.

The Company's wholly owned captive insurance subsidiary participates in a reinsurance pool. The member agreements and practices of the reinsurance pool limit any participating members' individual risk. Reinsurance revenues earned of $67,589, $61,697 and $67,903 during fiscal 2006, 2005 and 2004, respectively, were primarily related to premiums received from the reinsurance pool. Reinsurance costs of $65,760, $65,830 and $62,910 during fiscal 2006, 2005 and 2004, respectively, were primarily related to premiums paid to the reinsurance pool. Both revenues and costs were presented net in selling, general and administrative expenses in the consolidated statements of income.

### *Derivatives*

The Company has limited involvement with derivative financial instruments and uses them only to manage well-defined interest rate and foreign exchange risks. Forward foreign exchange contracts are used to hedge the impact of fluctuations of foreign exchange on inventory purchases and typically have very short terms. The aggregate notional amount, which approximates the fair value of foreign exchange contracts outstanding at September 3, 2006 and August 28, 2005, was $63,487 and $42,466, respectively. The majority of the forward foreign exchange contracts were entered into by the Company's wholly-owned United Kingdom subsidiary primarily to hedge U.S. dollar merchandise inventory purchases.

The Company also holds interest rate swaps to manage the interest rate risk associated with its borrowings and the mix of fixed-rate and variable-rate debt. As of September 3, 2006 and August 28, 2005, the Company had "fixed-to-floating" interest rate swaps with an aggregate notional amount of $300,000 and an aggregate fair value of $1,243 and $7,688, respectively. This amount was recorded in deferred income taxes and other current assets as of September 3, 2006 and in other assets as of August 28, 2005, on the Company's consolidated balance sheets. These swaps were entered into effective March 25, 2002, and are designated and qualify as fair value hedges of the Company's $300,000 5½% Senior Notes. As the terms of the swaps match those of the underlying hedged debt, the changes in the fair value of these swaps are offset by corresponding changes in the carrying amount of the hedged debt and result in no net earnings impact.

The Company is exposed to market risk for changes in utility commodity pricing, which it partially mitigates though the use of firm-price contracts with counterparties for approximately 19% of its locations. The effects of these arrangements were not significant for any period presented.

### *Equity Investments in Subsidiary and Joint Ventures*

During both fiscal 2006 and 2005, the Company contributed an additional $15,000 each year to its investment in Costco Mexico (a 50%-owned joint venture), which did not impact its percentage

ownership as the joint venture partner contributed a like amount. In addition, in fiscal 2005 the Company acquired the remaining 4% equity interest in CWC Travel Inc for cash of $3,961, bringing Costco's ownership in this entity to 100%. In conjunction with this purchase the Company recorded goodwill of $3,440.

### *Foreign Currency Translations*

The functional currencies of the Company's international subsidiaries are the local currency of the country in which the subsidiary is located. Assets and liabilities recorded in foreign currencies, as well as the Company's investment in the Costco Mexico joint venture, are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to accumulated other comprehensive income. Revenue and expenses of the Company's consolidated foreign operations are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in expenses and were not significant in fiscal 2006, 2005, or 2004.

### *Revenue Recognition*

The Company recognizes sales, net of estimated returns, at the time the customer takes possession of merchandise or receives services. When the Company collects payment from customers prior to the transfer of ownership of merchandise or the performance of services, the amount received is recorded as deferred revenue on the consolidated balance sheets until the sale or service is completed. The Company provides for estimated sales returns based on historical returns levels. The allowance for sales returns (sales returns net of merchandise costs) was $13,287 and $8,240 at September 3, 2006 and August 28, 2005, respectively.

The Company evaluates the criteria of the Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent," in determining whether it is appropriate to record the gross amount of merchandise sales and related costs or the net amount earned as commissions. Generally, when Costco is the primary obligor, is subject to inventory risk, has latitude in establishing prices and selecting suppliers, can influence product or service specifications, or has several but not all of these indicators, revenue is recorded on a gross basis. If the Company is not the primary obligor and does not possess other indicators of gross reporting as noted above, it records the net amounts as commissions earned, which is reflected in net sales.

Membership fee revenue represents annual membership fees paid by substantially all of the Company's members. The Company accounts for membership fee revenue on a deferred basis, whereby membership fee revenue is recognized ratably over one year. Membership fees received from members for fiscal years 2006, 2005 and 2004 were $1,264,929, $1,113,948 and $1,008,836, respectively. The Company's Executive members qualify for a 2% reward (which can be redeemed at Costco warehouses), up to a maximum of $500 per year, on all qualified purchases made at Costco. The Company accounts for this 2% reward as a reduction in sales, with the related liability being classified within other current liabilities. The sales reduction and corresponding liability are computed after giving effect to the estimated impact of non-redemptions based on historical data. The reduction in sales for the fiscal years ended September 3, 2006, August 28, 2005, and August 29, 2004, and the related liability as of those dates were as follows:

| | Fiscal Year Ended | | |
|---|---|---|---|
| | September 3, 2006 | August 28, 2005 | August 29, 2004 |
| Two-percent reward sales reduction . . . . . . . . . . | $418,466 | $319,336 | $244,487 |
| Two-percent unredeemed reward liability . . . . . . | $299,519 | $229,574 | $170,941 |

### *Merchandise Costs*

Merchandise costs consist of the purchase price of inventory sold, inbound shipping charges and all costs related to the Company's depot operations, including freight from depots to selling warehouses. Merchandise costs also include salaries, benefits, depreciation on production equipment, and other related expenses incurred by the Company's cross-docking depot facilities and in certain fresh foods and ancillary departments.

### *Selling, General and Administrative Expenses*

Selling, general and administrative expenses consist primarily of salaries, benefits and workers' compensation costs for warehouse employees, other than depots, fresh foods and certain ancillary businesses, as well as all regional and home office employees, including buying personnel. Selling, general and administrative expenses also include utilities, bank charges and substantially all building and equipment depreciation, as well as other operating costs incurred to support warehouse operations.

### *Marketing and Promotional Expenses*

Costco's policy is generally to limit marketing and promotional expenses to new warehouse openings, occasional direct mail marketing to prospective new members and direct mail marketing programs to existing members promoting selected merchandise. Marketing and promotional costs are expensed as incurred and are included in selling, general and administrative expense in the accompanying consolidated statements of income.

### *Preopening Expenses*

Preopening expenses related to new warehouses, major remodels/expansions, new regional offices and other startup operations are expensed as incurred.

### *Stock-Based Compensation*

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R) at the beginning of fiscal 2006, which requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. In addition, the adoption of SFAS No. 123R required additional accounting and disclosure related to income tax and cash flow effects resulting from stock-based compensation.

Previously, at the beginning of fiscal 2003, the Company adopted SFAS 123, "Accounting for Stock-Based Compensation" and all employee stock option grants made since the beginning of fiscal 2003 have or will be expensed ratably over the related vesting period based on the fair value at the date the options were granted. Prior to fiscal 2003, the Company applied Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for stock options. No compensation cost was recognized for option grants in periods prior to fiscal 2003, since the Company historically treated its stock options as having been granted at the fair market value on the date of grant, (however, see "Review of Stock Option Grant Practices" in Note 11, for a discussion of a special committee review of historical grant practices which resulted in, among other things, the use of new measurement dates for certain grants).

Under SFAS 123R, the Company is required to select a valuation technique or option-pricing model that meets the criteria as stated in the standard, which includes a binomial model and the Black-Scholes model. At present, the Company is continuing to use the Black-Scholes model, which requires the input of subjective assumptions. These assumptions include estimating the length of time

employees will retain their vested stock options before exercising them ("expected term"), the estimated volatility of the Company's common stock price over the expected term ("volatility"), the risk-free interest rate and the dividend yield. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation.

The Company adopted SFAS 123R using the modified prospective method, which requires the Company to recognize stock options granted prior to its adoption of SFAS 123 under the fair value method and expense these amounts over the remaining vesting period of the stock options. This resulted in the Company expensing $13,192 in fiscal 2006 for stock options granted in fiscal 2001 and fiscal 2002. Prior to the adoption of SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the consolidated statement of cash flows, in accordance with the provision of the Emerging Issues Task Force (EITF) Issue No. 00-15, "Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option." SFAS 123R requires, on a prospective basis, the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows. This amount is shown as excess tax benefit from exercise of stock options on the consolidated statements of cash flows.

The following table presents the impact of the Company's adoption of SFAS 123R on selected line items from its consolidated financial statements for fiscal 2006:

| | Fiscal 2006 | |
|---|---|---|
| | As Reported | Pro-forma under SFAS 123 |
| Income before income taxes | $ 1,751,417 | $ 1,764,609 |
| Net income | $ 1,103,215 | $ 1,112,050 |
| Net income per share: | | |
| Basic | $ 2.35 | $ 2.37 |
| Diluted | $ 2.30 | $ 2.32 |
| Cash flows from operating activities | $ 1,827,290 | $ 1,858,586 |
| Cash flows from financing activities | $(1,233,227) | $(1,264,523) |

Had compensation costs for the Company's stock-based compensation been determined based on the fair value at the grant dates for awards made prior to fiscal 2003, consistent with SFAS No. 123R, the Company's net income and net income per share would have been adjusted to the proforma amounts indicated below:

| | Fiscal Year Ended | |
|---|---|---|
| | August 28, 2005 | August 29, 2004 |
| Net income, as reported | $1,063,092 | $882,393 |
| Add: Stock-based compensation expense included in reported net income, net of related tax effects | 43,344 | 23,000 |
| Deduct: Total stock-based compensation expense determined under fair value-based methods for all awards, net of related tax effects | (63,012) | (58,388) |
| Pro-forma net income | $1,043,424 | $847,005 |
| Net Income per share: | | |
| Basic—as reported | $ 2.24 | $ 1.92 |
| Basic—pro-forma | $ 2.20 | $ 1.84 |
| Diluted—as reported | $ 2.18 | $ 1.85 |
| Diluted—pro-forma | $ 2.12 | $ 1.78 |

Disclosures for fiscal year 2006 are not presented because the amounts are recognized in the consolidated financial statements. Amounts presented above do not include incremental stock-based compensation that would have been recorded if the Company had reflected the adjusted measurement dates used to determine the cumulative-effect adjustment discussed in Note 11.

### *Fair Value of Financial Instruments*

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. Short-term investments classified as available-for-sale are recorded at market value with unrealized gains or losses reflected in accumulated other comprehensive income. Short-term investments designated as "hold-to-maturity" securities are recorded at cost and approximated market value at September 3, 2006 and August 28, 2005. The fair value of fixed rate debt at September 3, 2006 and August 28, 2005 was $574,426 and $841,399, respectively, including the senior debt for which the Company entered into "fixed-to-floating" interest rate swap agreements. The carrying value of fixed rate debt at September 3, 2006 and August 28, 2005 was $523,892 and $713,900, respectively.

### *Closing Costs*

Warehouse closing costs incurred relate principally to the Company's relocation of certain warehouses that were not otherwise impaired to larger and better-located facilities. The provision for fiscal 2006 included charges of $3,762 for warehouse closing expenses and $1,691 for net losses related to the sale of real property. The fiscal 2005 provision included charges of $11,619 for warehouse closing expenses and net losses of $881 related to the sale of real property. As of September 3, 2006, the Company's reserve for warehouse closing costs was $7,041, of which $5,950 related to future lease obligations. This compares to a reserve for warehouse closing costs of $9,556 at August 28, 2005, of which $9,118 related to future lease obligations.

### *Interest Income and Other*

Interest income and other includes:

| | Fiscal Year Ended | | |
|---|---|---|---|
| | September 3, 2006 | August 28, 2005 | August 29, 2004 |
| Interest income | $113,712 | $ 81,915 | $31,537 |
| Earnings of affiliates/minority interest and other | 24,643 | 27,181 | 20,090 |
| Total | $138,355 | $109,096 | $51,627 |

### *Income Taxes*

The Company accounts for income taxes under the provisions of SFAS No. 109, "Accounting for Income Taxes." That standard requires companies to account for deferred income taxes using the asset and liability method.

Under the asset and liability method of SFAS No. 109, deferred tax assets and liabilities are recognized for the future tax consequences attributed to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax credits and loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences and carry-forwards are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is established when necessary to reduce deferred tax assets to amounts expected to be realized.

Significant judgment is required in determining income tax provisions and evaluating tax positions. The Company establishes reserves for income taxes when, despite the belief that its tax positions are fully supportable, there remain certain positions that are not probable of being sustained. The consolidated tax provision and related accruals include the impact of such reasonably estimable losses and related interest as deemed appropriate. To the extent that the probable tax outcome of these matters changes, such changes in estimate will impact the income tax provision in the period in which such determination is made.

***Net Income per Common Share***

The computation of basic net income per share is based on the weighted average number of shares that were outstanding during the period. The computation of diluted earnings per share is based on the weighted average number of shares used in the basic net income per share calculation plus the number of common shares that would be issued assuming exercise of all potentially dilutive common shares outstanding using the treasury stock method, consisting of certain shares subject to stock options, restricted stock units and convertible notes.

***Stock Repurchase Programs***

Share repurchases are not displayed separately as treasury stock on the consolidated balance sheets or consolidated statements of stockholders' equity in accordance with the Washington Business Corporation Act, which requires the retirement of repurchased shares. The par value of repurchased shares is deducted from common stock and the remaining excess repurchase price over par value is deducted from additional paid-in capital and retained earnings. See Note 5 for additional information.

***Recent Accounting Pronouncements***

In September 2006, the Securities and Exchange Commission (SEC) issued SAB No. 108, which addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in current-year financial statements. SAB 108 requires an entity to quantify misstatements using a balance sheet and income-statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. The Company early-adopted SAB 108 as of August 29, 2005, the beginning of our fiscal year. See Note 11 for further discussion.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair-value measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 is effective for the Company's fiscal year 2008. The Company is currently evaluating the impact of adopting SFAS 157.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective beginning in fiscal 2008. The Company is currently evaluating the impact of adopting FIN 48.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force (EITF) Issue No. 06-03, "How Sales Taxes Collected from Customers and Remitted to Governmental Authorities

Should Be Presented in the Income Statement (that is, Gross Versus Net Presentation).” The EITF reached a consensus that the presentation of taxes on either a gross or net basis is an accounting policy decision that requires disclosure. EITF 06-03 is effective for the first interim or annual reporting period beginning after December 15, 2006. Amounts collected from members, which under common trade practices are referred to as sales taxes, are and have been recorded on a net basis. The Company has no intention of modifying this accounting policy. Therefore, the adoption of EITF 06-03 will not have any effect on the Company’s financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections, a Replacement of Accounting Principles Board Opinion No. 20, and FASB Statement No. 3.” SFAS 154 requires retrospective application to prior periods’ financial statements for changes in accounting principles, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will adopt the provisions of SFAS 154 beginning in fiscal 2007. The Company does not believe the adoption will have a significant effect on its future consolidated financial statements.

**Note 2—Short-term Investments**

Short-term investments, which consist entirely of debt securities, at September 3, 2006 and August 28, 2005, were as follows:

| | Fiscal 2006 | | | |
|---|---|---|---|---|
| | Cost Basis | Unrealized Gains | Unrealized Losses | Recorded Basis |
| Available-for-sale securities | | | | |
| Money market mutual funds | $ 38,366 | $ — | $ — | $ 38,366 |
| U.S. government and agency securities | 651,984 | 396 | (5,630) | 646,750 |
| Corporate notes and bonds | 505,739 | 605 | (2,785) | 503,559 |
| Asset and mortgage backed securities | 71,801 | 121 | (484) | 71,438 |
| Total available-for-sale securities | 1,267,890 | 1,122 | (8,899) | 1,260,113 |
| Held-to-maturity | | | | |
| Certificates of deposit | 55,185 | — | — | 55,185 |
| Money market mutual funds | 6,883 | — | — | 6,883 |
| Total held-to-maturity securities | 62,068 | — | — | 62,068 |
| Total short-term investments | $1,329,958 | $1,122 | $(8,899) | $1,322,181 |

| | Fiscal 2005 | | | |
|---|---|---|---|---|
| | Cost Basis | Unrealized Gains | Unrealized Losses | Recorded Basis |
| Available-for-sale securities | | | | |
| Money market mutual funds | $ 49,372 | $ — | $ — | $ 49,372 |
| U.S. government and agency securities | 562,370 | 25 | (4,630) | 557,765 |
| Corporate notes and bonds | 480,742 | 66 | (2,289) | 478,519 |
| Asset and mortgage backed securities | 52,782 | 21 | (431) | 52,372 |
| Total available-for-sale securities | 1,145,266 | 112 | (7,350) | 1,138,028 |
| Held-to-maturity | | | | |
| Certificates of deposit | 36,940 | — | — | 36,940 |
| Money market mutual funds | 6,779 | — | — | 6,779 |
| Corporate notes and bonds | 215,525 | — | — | 215,525 |
| Total held-to-maturity securities | 259,244 | — | — | 259,244 |
| Total short-term investments | $1,404,510 | $112 | $(7,350) | $1,397,272 |

For available-for-sale securities, proceeds from sales were $263,288, $267,639, and $83,278 in fiscal years 2006, 2005 and 2004, respectively. Gross realized gains from sales were $170, $90 and $128 in fiscal years 2006, 2005 and 2004, respectively, and gross realized losses from sales were $1,252, $825 and $167 in fiscal years 2006, 2005 and 2004, respectively.

The following tables present the length of time available-for-sale securities were in continuous unrealized loss positions, but were not deemed to be other-than-temporarily impaired (in thousands):

| | Less than 12 Months | | Greater than or Equal to 12 Months | |
|---|---|---|---|---|
| | Gross Unrealized Holding Losses | Fair Value | Gross Unrealized Holding Losses | Fair Value |
| **September 3, 2006** | | | | |
| U.S. government and agency securities | $(1,879) | $278,360 | $(3,751) | $282,033 |
| Corporate notes and bonds | (1,251) | 193,902 | (1,534) | 103,907 |
| Asset and mortgage backed securities | (83) | 16,485 | (401) | 21,802 |
| | $(3,213) | $488,747 | $(5,686) | $407,742 |
| **August 28, 2005** | | | | |
| U.S. government and agency securities | $(4,302) | $525,598 | $ (328) | $ 18,121 |
| Corporate notes and bonds | (1,860) | 411,346 | (429) | 21,299 |
| Asset and mortgage backed securities | (291) | 40,951 | (140) | 5,295 |
| | $(6,453) | $977,895 | $ (897) | $ 44,715 |

Gross unrealized holding losses of $3,213 for investments held less than twelve months and $5,686 for investments held greater than or equal to twelve months as of September 3, 2006, pertain to 211 and 247 fixed income securities, respectively, and were primarily attributable to changes in interest rates. The Company currently has the financial ability to hold short-term investments with an unrealized loss until maturity and not incur any recognized losses. Management does not believe any unrealized losses represent an other-than-temporary impairment based on an evaluation of available evidence as of September 3, 2006.

The maturities of available-for-sale and held-to-maturity debt securities at September 3, 2006 are as follows:

| | Available-For-Sale | | Held-To-Maturity | |
|---|---|---|---|---|
| | Cost Basis | Fair Value | Cost Basis | Fair Value |
| Due in one year or less | $ 554,455 | $ 552,003 | $62,068 | $62,068 |
| Due after one year through five years | 705,401 | 699,990 | — | — |
| Due after five years | 8,034 | 8,120 | — | — |
| Total | $1,267,890 | $1,260,113 | $62,068 | $62,068 |

## Note 3—Debt

### *Bank Credit Facilities and Commercial Paper Programs (all amounts stated in U.S. dollars)*

A wholly-owned Canadian subsidiary has a $180,900 commercial paper program ($167,400 at August 28, 2005) supported by a $54,200 bank credit facility ($50,200 at August 28, 2005) with a Canadian bank, which is guaranteed by the Company and expires in March 2007. At both September 3, 2006 and August 28, 2005, there were no amounts outstanding under the Canadian commercial paper program or the bank credit facility. Applicable interest rates on the credit facility at September 3, 2006 and August 28, 2005, were 4.65% and 4.25%, respectively. At September 3, 2006, standby letters of credit totaling $20,800 issued under the bank credit facility left $33,400 available for commercial paper support. At August 28, 2005, standby letters of credit totaling $23,200 issued under the bank credit facility left $27,000 available for commercial paper support.

The Company's wholly-owned Japanese subsidiary has a short-term $12,800 bank line of credit ($13,700 at August 28, 2005) that expires in February 2007. At September 3, 2006 and August 28, 2005, $2,500 and $5,500, respectively, were borrowed under the line of credit, and $4,300 and $3,700, respectively, were used to support standby letters of credit. A second $12,800 bank line of credit also expires in February 2007. At September 3, 2006 and August 28, 2005, $900 and $9,100, respectively, were borrowed under the second facility. Applicable interest rates on the credit facilities at September 3, 2006 and August 28, 2005, were .95% and .84%, respectively.

The Company's Korean subsidiary has a short-term $12,500 bank line of credit, which expires in February 2007. At September 3, 2006 and August 28, 2005, no amounts were borrowed under the line of credit and $2,000 and $1,700, respectively, were used to support standby letters of credit. Applicable interest rates on the credit facility at September 3, 2006 and August 28, 2005 were 5.48% and 4.51%, respectively.

The Company's Taiwan subsidiary has a $5,200 bank revolving credit facility that expires in January 2007. At September 3, 2006 and August 28, 2005, no amounts were borrowed under the credit facility and $1,900 and $2,500, respectively, were used to support standby letters of credit. A second $15,200 bank revolving credit facility is in place, which expires in August 2007. At September 3, 2006 and August 28, 2005, no amounts were borrowed under the second credit facility and $2,000 and $800, respectively, were used to support standby letters of credit. Applicable interest rates on the credit facility at September 3, 2006 and August 28, 2005, were 4.00% and 3.75%, respectively.

The Company's wholly-owned United Kingdom subsidiary has a $113,900 bank revolving credit facility expiring in February 2007, and a $66,500 bank overdraft facility renewable on a yearly basis in March 2007. At September 3, 2006, $38,000 was outstanding under the revolving credit facility with an applicable interest rate of 5.32% and no amounts were outstanding under the bank overdraft facility. At August 28, 2005, $39,800 was outstanding under the revolving credit facility with an applicable interest rate of 5.30% and no amounts were outstanding under the bank overdraft facility.

On November 15, 2005, upon the expiration of the Company's $150,000 bank credit facility in the U.S. with a group of nine banks, the Company terminated its $500,000 commercial paper program. At August 28, 2005, no amounts were outstanding under the commercial paper program and no amounts were outstanding under the credit facility. The applicable interest rate on the credit facility at August 28, 2005, was 3.92%.

### *Letters of Credit*

The Company has letter of credit facilities (for commercial and standby letters of credit), totaling $399,900. The outstanding commitments under these facilities at September 3, 2006 and August 28, 2005 totaled $84,900 and $131,200, respectively, including $54,900 and $64,500, respectively, in standby letters of credit.

### *Short-Term Borrowings*

The weighted average borrowings, maximum borrowings and weighted average interest rate under all short-term borrowing arrangements were as follows for fiscal 2006 and 2005:

| Category of Aggregate Short-term Borrowings | Maximum Amount Outstanding During the Fiscal Year | Average Amount Outstanding During the Fiscal Year | Weighted Average Interest Rate During the Fiscal Year |
|---|---|---|---|
| **Fiscal year ended September 3, 2006** | | | |
| Bank borrowings: | | | |
| Canadian | $11,254 | $ 313 | 5.32% |
| United Kingdom | 61,852 | 38,179 | 5.06 |
| Japan | 17,850 | 10,463 | 0.74 |
| Bank overdraft facility: | | | |
| United Kingdom | 13,100 | 1,892 | 5.51 |
| **Fiscal year ended August 28, 2005** | | | |
| Bank borrowings: | | | |
| Canadian | $12,841 | $ 338 | 4.24% |
| United Kingdom | 41,576 | 20,394 | 5.22 |
| Japan | 14,606 | 8,702 | 0.84 |
| Bank overdraft facility: | | | |
| United Kingdom | 22,957 | 1,339 | 5.73 |

### *Long-Term Debt*

Long-term debt at September 3, 2006 and August 28, 2005 consisted of the following:

| | 2006 | 2005 |
|---|---|---|
| 5½% Senior Notes due March 2007 | $301,243 | $307,688 |
| 2.070% Promissory notes due October 2007 | 29,810 | 31,952 |
| 1.187% Promissory notes due July 2008 | 25,551 | 27,387 |
| 0.88% Promissory notes due November 2009 | 25,551 | 27,387 |
| 0.92% Promissory notes due April 2010 | 34,069 | 36,516 |
| 3½% Zero Coupon convertible subordinated notes due August 2017 | 88,028 | 274,071 |
| Capital lease obligations and other | 19,640 | 8,899 |
| Total long-term debt | 523,892 | 713,900 |
| Less current portion | 308,523 | 3,225 |
| Long-term debt, excluding current portion | $215,369 | $710,675 |

In March 2002, the Company issued $300,000 of 5½% Senior Notes due in March 2007. Interest is payable semi-annually on March 15 and September 15. Simultaneous with the issuance of the 5½% Senior Notes, the Company entered into interest rate swap agreements converting the interest to a floating rate indexed to LIBOR. As of September 3, 2006, the 5½% Senior Notes are reported in the current portion of long-term debt on the consolidated balance sheets. As of September 3, 2006, the Company was in compliance with all restrictive covenants.

In October 2000, the Company's wholly-owned Japanese subsidiary issued 2.070% promissory notes in the aggregate amount of $29,810, through a private placement. Interest is payable annually and principal is due in October 2007.

In July 2001, the Company's wholly-owned Japanese subsidiary issued 1.187% promissory notes in the aggregate amount of $25,551, through a private placement. Interest is payable semi-annually and principal is due in July 2008.

In November 2002, the Company's wholly-owned Japanese subsidiary issued promissory notes bearing interest at 0.88% in the aggregate amount of $25,551, through a private placement. Interest is payable semi-annually and principal is due in November 2009.

In April 2003, the Company's wholly-owned Japanese subsidiary issued promissory notes bearing interest at 0.92% in the aggregate amount of $34,069, through a private placement. Interest is payable semi-annually and principal is due in April 2010.

The Company guarantees all of the promissory notes issued by its wholly-owned Japanese subsidiary.

In August 1997, the Company completed the sale of $900,000 principal amount at maturity Zero Coupon Convertible Subordinated Notes (Notes) due in August 2017. The Notes were priced with a yield to maturity of 3½%, resulting in gross proceeds to the Company of $449,640. The current Notes outstanding are convertible into a maximum of 2,925,057 shares of Costco Common Stock shares at an initial conversion price of $22.71. Holders of the Notes may require the Company to purchase the Notes (at the discounted issue price plus accrued interest to date of purchase) in August 2007, or 2012. The Company, at its option, may redeem the Notes (at the discounted issue price plus accrued interest to date of redemption) any time in or after August 2002. As of September 3, 2006, $771,210 in principal amount of the Zero Coupon Notes had been converted by note holders to shares of Costco Common Stock, of which $286,456 and $436,402 in principal were converted in fiscal 2006 and 2005, respectively.

In February 1996, the Company filed with the Securities and Exchange Commission a shelf registration statement for $500,000 of senior debt securities. In October 2001, an additional $100,000 in debt securities was registered, bringing the total amount of debt registered under the shelf registration to $600,000. The $300,000 of 5½% Senior Notes issued in March 2002 reduced the amount of registered securities available for future issuance to $300,000. In April 2006, remaining amounts of the shelf registration were cancelled.

At September 3, 2006, the fair value of the 5½% Senior Notes, based on market quotes, was approximately $300,000. The Senior Notes are not redeemable prior to maturity. The fair value of the 3½% Zero Coupon Subordinated Notes at September 3, 2006, based on market quotes, was approximately $139,415. The fair value of other long-term debt approximates carrying value.

Maturities of long-term debt during the next five fiscal years and thereafter are as follows:

| | |
|---|---|
| 2007 | $308,523 |
| 2008 | 58,867 |
| 2009 | 898 |
| 2010 | 60,553 |
| 2011 | 969 |
| Thereafter | 94,082 |
| Total | $523,892 |

**Note 4—Leases**

The Company leases land and/or warehouse buildings at 99 of the 458 warehouses open at September 3, 2006, and certain other office and distribution facilities under operating leases. The remaining terms of these operating leases range from approximately one to 42 years, with the exception of one lease in the U.S. that has a remaining life of 78 years and one lease in the Company's United Kingdom subsidiary, which has a remaining lease term of 145 years. These leases generally contain one or more of the following options which the Company can exercise at the end of the initial lease term: (a) renewal of the lease for a defined number of years at the then-fair market rental rate; (b) purchase of the property at the then-fair market value; or (c) right of first refusal in the event of a third party purchase offer. Certain leases provide for periodic rental increases based on the price indices, and some of the leases provide for rents based on the greater of minimum guaranteed amounts or sales volume. Contingent rents have not been material. The Company accounts for its leases with step-rent provisions on a straight-line basis over the original term of the lease.

Aggregate rental expense for fiscal 2006, 2005 and 2004 was $134,406, $127,770 and $113,681, respectively. The amount for 2005 excludes $15,999 in rent expense associated with the correction made in the second quarter of fiscal 2005 to the Company's method of accounting for ground leases that did not require rental payments during the period of construction.

Future minimum payments, net of sub-lease income of $162,120 for all years combined, during the next five fiscal years and thereafter under non-cancelable leases with terms of at least one year, at September 3, 2006, were as follows:

| | |
|---|---|
| 2007 | $ 130,259 |
| 2008 | 122,829 |
| 2009 | 114,544 |
| 2010 | 102,807 |
| 2011 | 97,245 |
| Thereafter | 1,079,999 |
| Total minimum payments | $1,647,683 |

The Company has sub-leases related to certain of its operating lease agreements. During fiscal 2006, 2005 and 2004, the Company recognized sub-lease income of $12,687, $10,484 and $9,510, respectively, included in interest income and other in the consolidated Statements of Income.

**Note 5—Stockholders' Equity**

***Dividends***

In fiscal 2006, the Company paid quarterly cash dividends totaling $0.49 per share. In fiscal 2005, the Company paid quarterly cash dividends totaling $0.43 per share. The Company's current quarterly dividend rate is $0.13 per share or $0.52 per share on an annualized basis.

Payment of future dividends is subject to declaration by the Board of Directors. Factors considered in determining the size of the dividends are profitability and expected capital needs of the Company. The Company presently expects to continue to pay dividends on a quarterly basis.

### *Stock Repurchase Programs*

The Company's Board of Directors has approved the following stock repurchase programs:

| | Amount Approved | Amount Remaining |
|---|---|---|
| August 2005 | $1,000,000 | $ — |
| January 2006(1) | 1,000,000 | 625,534 |
| July 2006(2) | 2,000,000 | 2,000,000 |
| Total | $4,000,000 | $2,625,534 |

(1) Expires in January 2009.

(2) Expires in July 2009.

During fiscal 2005, the Company repurchased 9,205,000 shares of common stock at an average price of $44.89, totaling approximately $413,252, including commissions. During fiscal 2006, the Company repurchased 28,407,000 shares at an average price of $51.44, totaling approximately $1,461,217, including commissions. Purchases are made from time-to-time as conditions warrant in the open market or in block purchases, or pursuant to share repurchase plans under SEC Rule 10b5-1. Repurchased shares are retired.

### *Comprehensive Income*

Comprehensive income includes net income, plus certain other items that are recorded directly to stockholders' equity. Accumulated other comprehensive income reported on the Company's consolidated balance sheets consists of foreign currency translation adjustments and unrealized gains and losses on short-term investments.

The following table shows the components of comprehensive income, net of related tax effects:

| | September 3, 2006 | August 28, 2005 | August 29, 2004 |
|---|---|---|---|
| Net income | $1,103,215 | $1,063,092 | $882,393 |
| Unrealized losses on short-term investments, net of tax benefit of $210, $2,719 and $0 in 2006, 2005, and 2004, respectively | (330) | (4,378) | (140) |
| Foreign currency translation adjustment and other, net of tax provision of $4,088, $6,037 and $0 in 2006, 2005 and 2004, respectively | 119,554 | 146,273 | 94,264 |
| Total comprehensive income | $1,222,439 | $1,204,987 | $976,517 |

The favorable translation adjustments during fiscal years 2006, 2005 and 2004 were primarily due to stronger foreign currencies.

The components of accumulated other comprehensive income, net of tax, were as follows:

| | September 3, 2006 | August 28, 2005 |
|---|---|---|
| Foreign currency translation adjustments and other | $282,112 | $162,558 |
| Unrealized losses on short-term investments | (4,849) | (4,519) |
| Accumulated other comprehensive income | $277,263 | $158,039 |

**Note 6—Stock-Based Compensation Plans**

The Company's 1993 Combined Stock Grant and Stock Option Plan (1993 Plan) provided for the issuance of up to 60 million shares of its common stock upon the exercise of stock options and up to 3,333,332 shares through stock grants. During fiscal 2002, the 2002 Stock Incentive Plan (2002 Plan) was adopted following shareholder approval. The 2002 Plan authorized 30 million shares of common stock for issuance, subject to adjustment. For future grants, the 2002 Plan replaces the 1993 Plan and the 1993 Plan has been amended to provide that no more options or stock grants may be issued under such plan. All shares under the 1993 Plan that were available for future option grants (and any additional shares that subsequently become available through cancellation of unexercised options outstanding) are to be added to the number of shares available for grant under the 2002 Plan. The 2002 Plan authorizes the Company to grant stock options to eligible employees, directors and consultants.

In January 2005, the 2002 Plan was amended following shareholder approval and is referred to as the Amended and Restated 2002 Stock Incentive Plan (Amended and Restated 2002 Plan). The Amended and Restated 2002 Plan authorized the issuance of an additional 10 million shares for option grants and authorized the award of stock bonuses or stock units in addition to stock option grants currently authorized. The number of shares issued as stock bonuses or stock units is limited to one-third of those available for option grants.

In January 2006, the Amended and Restated 2002 Plan was amended following shareholder approval and is now referred to as the Second Restated 2002 Plan. The Second Restated 2002 Plan authorizes the issuance of an additional 10 million shares for future grants in addition to grants currently authorized. Stock options generally vest over five years and have a ten-year term. Each share issued in respect of stock bonuses or stock units would be counted as 1.75 shares toward the share limit and each share issued in respect of options would be counted as one share.

In conjunction with the adoption of SFAS 123 at the beginning of fiscal 2003, the Company changed its method of attributing the value of stock-based compensation expense from the accelerated multiple-option approach to the straight-line single-option method. Compensation expense for all stock-based awards granted prior to fiscal 2003 will continue to be recognized using the accelerated multiple option approach, while compensation expense for all stock-based awards granted subsequent to fiscal 2002 will be recognized using the straight-line single-option method. Additionally, SFAS 123R requires the estimation of the number of stock-based awards that will ultimately not complete their vesting requirements (forfeitures), and requires that the compensation expense recognized equals or exceeds the number of stock-based awards vested. While options and restricted stock units (RSUs) generally vest over five years with an equal amount vesting on each anniversary of the grant date, the Company's plans allow for daily vesting of the pro-rata number of shares that would vest on the next anniversary of the grant date in the event of retirement or voluntary termination. As such, the Company does not reduce stock-based compensation for an estimate of forfeitures because this would result in less compensation expense recognized than the number of stock-based awards vested.

The Company issues new shares of common stock upon exercise of stock options and vesting of RSUs.

***Summary of Stock Option Activity***

The following table summarizes the stock option transactions during fiscal 2006 (number of options in thousands):

| | Shares (in 000's) | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (in Years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at August 28, 2005 | 51,285 | $36.14 | | |
| Granted | 794 | 46.46 | | |
| Exercised | (11,712) | 31.79 | | |
| Forfeited or expired | (499) | 39.78 | | |
| Outstanding at September 3, 2006 | 39,868 | 37.57 | 6.00 | $391,847 |
| Exercisable at September 3, 2006 | 22,289 | $35.92 | 4.64 | $256,655 |

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2006, 2005, and 2004:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Expected volatility | 28% | 38% | 44% |
| Expected term | 5.2 years | 6.6 years | 6.2 years |
| Risk free interest rate | 4.33% | 4.28% | 3.38% |
| Expected dividend yield | 0.99% | 1.11% | 1.04% |
| Weighted-average fair value per option granted | $13.87 | $18.01 | $16.01 |

In fiscal 2006, the expected volatility was based primarily on the historical volatility of the Company's stock and to a lesser extent the six-month implied volatility of its traded options. Prior to the adoption of SFAS 123R, expected stock price volatility was estimated using only historical volatility. In fiscal 2006, the expected term is the average of the life of all historical grants that have been exercised and the term at which the historical average intrinsic gain is reached. Prior to adoption of SFAS 123R, the expected term was calculated as the average term between grant and exercise dates for those options where at least 40% of the original grant was exercised. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant with an equivalent remaining term. The expected dividend yield is based on the annual dividend rate at the time of grant.

The Company recorded stock-based compensation expense related to stock options of $102,473, $67,937 and $36,508 in fiscal 2006, 2005, and 2004, respectively. The related total tax benefit was $32,665, $22,539 and $12,325 in fiscal 2006, 2005, and 2004, respectively. The remaining unrecognized compensation cost related to unvested options at September 3, 2006, was $241,000 and the weighted-average period of time over which this cost will be recognized is 2.9 years. During fiscal 2006, the total intrinsic value of stock options exercised was $240,200. The actual tax benefit realized from the tax deductions for stock options exercised totaled $54,937, $44,946 and $22,712 in fiscal 2006, 2005, & 2004.

The following is a summary of stock options outstanding as of September 3, 2006 (number of options in thousands):

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Range of Prices | Number | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number | Weighted-Average Exercise Price |
| $9.00–$27.13 | 2,669 | 1.26 | $20.46 | 2,669 | $20.46 |
| $30.41–$30.41 | 5,133 | 6.58 | 30.41 | 2,249 | 30.41 |
| $31.55–$34.28 | 4,321 | 4.86 | 33.92 | 3,815 | 34.08 |
| $36.00–$36.91 | 2,990 | 2.74 | 36.78 | 2,990 | 36.78 |
| $37.35–$37.35 | 5,902 | 7.58 | 37.35 | 1,840 | 37.35 |
| $37.44–$39.65 | 4,321 | 5.67 | 38.81 | 3,033 | 38.85 |
| $43.00–$43.00 | 3,132 | 3.52 | 43.00 | 3,132 | 43.00 |
| $43.79–$43.79 | 8,530 | 8.58 | 43.79 | 1,483 | 43.79 |
| $44.97–$46.46 | 2,498 | 7.33 | 45.93 | 706 | 45.28 |
| $52.50–$52.50 | 372 | 3.58 | 52.50 | 372 | 52.50 |
| | 39,868 | 6.00 | $37.57 | 22,289 | $35.92 |

At August 28, 2005 and August 29, 2004, there were 25,987 and 27,513 options exercisable at weighted average exercise prices of $33.66 and $31.84, respectively.

***Summary of Restricted Stock Unit Activity***

In the fourth quarter of fiscal 2006, the Company ceased the granting of stock options in favor of RSUs. Generally, RSUs vest over five years; however, the Company also provides for accelerated vesting upon retirement for recipients that have attained certain years of service with the Company. Recipients are not entitled to vote or receive dividends on unvested shares. Accordingly, the fair value of RSUs is the quoted market value of the Company's common stock on the date of grant less the present value of the expected dividends forgone during the vesting period. At September 3, 2006, 10.6 million RSUs were available to be granted to eligible employees, directors and consultants under the Second Restated 2002 Plan.

The following table summarizes information about outstanding RSUs:

| | Number of Units (in 000's) | Weighted-Average Grant Date Fair Value |
|---|---|---|
| Non-vested at August 28, 2005 | — | $ — |
| Granted | 1,408 | 52.31 |
| Vested | — | — |
| Forfeited | — | — |
| Non-vested at September 3, 2006 | 1,408 | $52.31 |

The Company recorded stock-based compensation expense related to RSUs of $4,924 in fiscal 2006. The related total tax benefit was $1,623 in fiscal 2006. The remaining unrecognized compensation cost related to non-vested restricted stock units at September 3, 2006, was $67,000 and the weighted-average period of time over which this cost will be recognized is 4.8 years.

### Note 7—Retirement Plans

The Company has a 401(k) Retirement Plan that is available to all U.S. employees who have completed 90 days of employment. For all U.S. employees, with the exception of California union employees, the plan allows pre-tax deferral against which the Company matches 50% of the first one thousand dollars of employee contributions. In addition, the Company will provide each eligible participant an annual contribution based on salary and years of service.

California union employees participate in a defined benefit plan sponsored by their union. The Company makes contributions based upon its union agreement. For all the California union employees, the Company sponsored 401(k) plan currently allows pre-tax deferral against which the Company matches 50% of the first five hundred dollars of employee contributions. In addition, the Company will provide each eligible participant a contribution based on hours worked and years of service. The Company has a defined contribution plan for Canadian and United Kingdom employees and contributes a percentage of each employee's salary. The Company complies with government requirements related to retirement benefits for other international operations and accrues expenses based on a percentage of each employee's salary as appropriate.

Amounts expensed under these plans were $233,595, $191,651 and $169,664 for fiscal 2006, 2005 and 2004, respectively. The Company has defined contribution 401(k) and retirement plans only, and thus has no liability for post-retirement benefit obligations.

### Note 8—Income Taxes

Income before income taxes is comprised of the following:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Domestic (including Puerto Rico) | $1,433,954 | $1,225,741 | $1,194,548 |
| Foreign | 317,463 | 323,221 | 206,076 |
| Total | $1,751,417 | $1,548,962 | $1,400,624 |

The provisions for income taxes for fiscal 2006, 2005 and 2004 are as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Federal: | | | |
| Current | $442,039 | $306,527 | $ 238,136 |
| Deferred | (23,799) | (48,070) | 116,390 |
| Total federal | 418,240 | 258,457 | 354,526 |
| State: | | | |
| Current | 67,959 | 75,063 | 49,852 |
| Deferred | (7,806) | (14,699) | 20,479 |
| Total state | 60,153 | 60,364 | 70,331 |
| Foreign: | | | |
| Current | 118,040 | 123,969 | 171,006 |
| Deferred | (3,168) | (1,866) | (100,344) |
| Total foreign | 114,872 | 122,103 | 70,662 |
| Tax benefits allocated to contributed capital | 54,937 | 44,946 | 22,712 |
| Total provision for income taxes | $648,202 | $485,870 | $ 518,231 |

The reconciliation between the statutory tax rate and the effective rate for fiscal 2006, 2005 and 2004 is as follows:

| | 2006 | | 2005 | | 2004 | |
|---|---|---|---|---|---|---|
| Federal taxes at statutory rate | $612,996 | 35.00% | $542,137 | 35.00% | $490,218 | 35.00% |
| State taxes, net | 42,338 | 2.42 | 39,193 | 2.53 | 48,157 | 3.44 |
| Foreign taxes, net | 1,701 | 0.10 | (15,506) | (1.00) | (5,729) | (0.41) |
| Transfer pricing settlement | — | 0.00 | (54,155) | (3.50) | — | 0.00 |
| Tax benefit on unremitted earnings | (11,978) | (0.68) | (30,602) | (1.98) | — | 0.00 |
| Translation gain on unremitted earnings | 5,333 | 0.30 | 10,010 | 0.65 | — | 0.00 |
| Other | (2,188) | (0.13) | (5,207) | (0.33) | (14,415) | (1.03) |
| Total | $648,202 | 37.01% | $485,870 | 31.37% | $518,231 | 37.00% |

The components of the deferred tax assets and liabilities are as follows:

| | September 3, 2006 | August 28, 2005 |
|---|---|---|
| Stock options | $ 73,148 | $ 30,480 |
| Deferred income/membership fees | 69,704 | 36,594 |
| Excess foreign tax credits | 4,177 | 30,602 |
| Accrued liabilities and reserves | 237,079 | 266,337 |
| Other | 23,578 | 3,880 |
| Total deferred tax assets | 407,686 | 367,893 |
| Property and equipment | 295,424 | 273,794 |
| Merchandise inventories | 95,868 | 91,407 |
| Translation gain | 1,532 | 16,047 |
| Total deferred tax liabilities | 392,824 | 381,248 |
| Net deferred tax assets (liabilities) | $ 14,862 | $ (13,355) |

The deferred tax accounts at September 3, 2006 and August 28, 2005 include current deferred income tax assets of $162,534 and $159,197, respectively, included in deferred income taxes and other current assets; non-current deferred income tax assets of $12,109 and $7,962, respectively, included in other assets; and non-current deferred income tax liabilities of $159,781 and $180,514, respectively, included in deferred income taxes and other liabilities. Income taxes payable at September 3, 2006 and August 28, 2005 are $69,154 and $27,695, respectively, included in other current liabilities.

The effective income tax rate on earnings was 37.0% in fiscal 2006, 31.4% in fiscal 2005 and 37.0% in fiscal 2004. The decrease in the effective income tax rate in fiscal 2005 from fiscal 2004 is primarily attributable to a $54,155 income tax benefit resulting from the settlement of a transfer pricing dispute between the United States and Canada (covering the years 1996-2003) and a net tax benefit on unremitted foreign earnings of $20,592. The Company recognized a tax benefit of $30,602, resulting from excess foreign tax credits on unremitted foreign earnings, and recognized a tax expense of $10,010, resulting from tax expense on translation gains accumulated to the date that the Company determined that certain unremitted foreign earnings were no longer permanently reinvested. The net benefit of $20,592 related to that portion of unremitted foreign earnings that the Company planned to repatriate in the foreseeable future. Excluding these benefits the effective income tax rate on earnings in fiscal 2005 was 36.2%. During the third quarter of fiscal 2006, the Company distributed $427,296 from its Canadian operations.

The Company has not provided for U.S. deferred taxes on cumulative undistributed earnings of non-U.S. affiliates aggregating $907,090 and $865,579 at September 3, 2006, and August 28, 2005, respectively, as such earnings are deemed permanently reinvested. Because of the availability of U.S. foreign tax credits and complexity of the computation, it is not practicable to determine the U.S. federal income tax liability or benefit associated with such earnings if such earnings were not deemed to be permanently reinvested.

### Note 9—Net Income Per Common and Common Equivalent Share

The following data show the amounts used in computing net income per share and the effect on income and the weighted average number of shares of dilutive potential common stock.

| | Fiscal Year Ended | | |
|---|---|---|---|
| | September 3, 2006 | August 28, 2005 | August 29, 2004 |
| Net income available to common stockholders used in basic net income per share | $1,103,215 | $1,063,092 | $882,393 |
| Interest on convertible notes, net of tax | 3,040 | 7,672 | 11,607 |
| Net income available to common stockholders after assumed conversions of dilutive securities | $1,106,255 | $1,070,764 | $894,000 |
| Weighted average number of common shares used in basic net income per share (000's) | 469,718 | 473,945 | 459,223 |
| Stock options and restricted stock units (000's) | 5,944 | 6,000 | 3,892 |
| Conversion of convertible notes (000's) | 4,679 | 12,090 | 19,344 |
| Weighted number of common shares and dilutive potential common stock used in diluted net income (000's) per share | 480,341 | 492,035 | 482,459 |

The diluted share base calculation for fiscal years ended September 3, 2006, August 28, 2005 and August 29, 2004, excludes 11,142,000, 12,575,000 and 24,748,000 stock options and restricted stock units outstanding, respectively. These equity instruments are excluded due to their anti-dilutive effect.

### Note 10—Commitments and Contingencies

#### *Legal Proceedings*

The Company is involved from time to time in claims, proceedings and litigation arising from its business and property ownership. The Company is a defendant in the following matters, among others:

Two actions purportedly brought as class actions on behalf of certain present and former Costco managers in California, in which plaintiffs principally allege that they have not been properly compensated for overtime work. Scott M. Williams v. Costco Wholesale Corp., United States District Court (San Diego), Case No. 02-CV-2003 NAJ (JFS); Superior Court for the County of San Diego, Case No. GIC-792559; Greg Randall v. Costco Wholesale Corp., Superior Court for the County of Los Angeles, Case No. BC-296369.

An overtime compensation case brought as a class action on behalf of present and former hourly employees in California, in which plaintiffs principally allege that Costco's semi-annual bonus formula is improper with regard to retroactive overtime pay. Anthony Marin v. Costco Wholesale Corp., Superior Court for the County of Alameda, Case No. RG-04150447.

An action purportedly brought as a class action on behalf of present and former hourly employees in California, in which plaintiffs principally allege that Costco did not properly compensate and record hours

worked by employees and failed to provide meal and rest breaks. Kevin Doty and Sarah Doty v. Costco Wholesale Corp., United States District Court (Los Angeles), Case No. CV-05-3241 FMC (JWJ).

An action purportedly brought as a class action on behalf of present and former hourly employees in California, in which the plaintiff principally alleges that Costco did not properly compensate and record time worked by employees during the security searches and routine closing procedures. Elizabeth Alvarado v. Costco Wholesale Corp., United States District Court (San Francisco), Case No. C-06-04015-MJJ.

Claims in these five actions are made under various provisions of the California Labor Code and the California Business and Professions Code. Plaintiffs seek restitution/disgorgement, compensatory damages, various statutory penalties, punitive damages, interest, and attorneys' fees.

An action purportedly brought as a class action on behalf of certain present and former female managers, in which plaintiffs allege denial of promotion based on gender in violation of Title VII of the Civil Rights Act of 1964 and California state law. Shirley "Rae" Ellis v. Costco Wholesale Corp., United States District Court (San Francisco), Case No. C-04-3341-MHP. Plaintiffs seek compensatory damages, punitive damages, injunctive relief, interest and attorneys' fees.

Class actions stated to have been brought on behalf of certain present and former Costco members. In Barmak v. Costco Wholesale Corp., et al., No. BC348857 (Superior Court for the County of Los Angeles), it is asserted that the Company violated various provisions of the common law and California statutes in connection with its former practice of paying Executive Members who downgraded or terminated their memberships a 2% Reward for less than twelve months of eligible purchases. Plaintiff seeks compensatory damages, restitution, injunctive relief, attorneys' fees and costs, prejudgment interest, and punitive damages. The Company has filed a motion to dismiss the complaint on the ground that the challenged practice, while it was still in effect, was appropriately disclosed to Executive Members. Counsel for the plaintiff in Barmak has also sent a letter purporting to invoke consumer protection statutes in Massachusetts and Texas.

In Evans, et ano., v. Costco Wholesale Corp., No. BC351869 (commenced in the Superior Court for the County of Los Angeles and removed to the United States District Court for the Central District of California), and Dupler v. Costco Wholesale Corp., Index No. 06-007555 (commenced in the Supreme Court of Nassau County, New York and removed to the United States District Court for the Eastern District of New York), it is asserted that the Company violated various provisions of California and New York common law and statutes in connection with a membership renewal practice. Under that practice, members who pay their renewal fees late generally have their twelve-month membership renewal periods commence at the time of the prior year's expiration rather than the time of the late payment. Plaintiffs in these two actions seek compensatory damages, restitution, disgorgement, preliminary and permanent injunctive and declaratory relief, attorneys' fees and costs, prejudgment interest, and punitive damages.

The Company does not believe that any 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 cases, however unlikely, could result in a charge that might be material to the results of an individual quarter.

On October 4, 2006, the Company received a grand jury subpoena from the United States Attorney's Office for the Central District of California, seeking records relating to the Company's receipt and handling of hazardous merchandise returned by Costco members and other records. On October 10, the Company learned that the grand jury intends to subpoena at least two individuals who are employed at one of the Company's warehouses. The Company is cooperating with the United States Attorney's Office and at this time cannot reasonably estimate any loss that may arise from this matter.

**Note 11—Staff Accounting Bulletin No. 108**

As discussed under Recent Accounting Pronouncements in Note 1, in September 2006, the SEC released SAB 108. The transition provisions of SAB 108 permit the Company to adjust for the cumulative effect on retained earnings of immaterial errors relating to prior years. SAB 108 also requires the adjustment of any prior quarterly financial statements within the fiscal year of adoption for the effects of such errors on the quarters when the information is next presented. Such adjustments do not require previously filed reports with the SEC to be amended. Effective the beginning of the fiscal year ended September 3, 2006, the Company elected to early-adopt SAB 108. In accordance with SAB 108, the Company has adjusted beginning retained earnings for fiscal 2006 in the accompanying consolidated financial statements for the items described below. The Company considers these adjustments to be immaterial to prior periods.

***Review of Stock Option Grant Practices***

Following publicity regarding the granting of stock options, the Company initiated an internal review of its historical stock option grant practices to determine whether the stated grant dates of options were supported by the Company's books and records. As a result of this preliminary review, a special committee of independent directors was formed. The Company filed a Form 8-K dated October 12, 2006, which provides details regarding the special committee's review. The special committee engaged independent counsel and forensics experts, and comprehensively reviewed all equity grants made during the years 1996 through 2005. In late September 2006, the special committee reported its conclusions and recommendations to the board of directors, which, after further review, adopted these conclusions and recommendations. The review identified no evidence of fraud, falsification of records, concealment of actions or documentation, or intentional deviation from generally accepted accounting principles. The review indicated that, in several instances, it was impossible to determine with precision the appropriate measurement date for specific grants. For these grants it was feasible only to identify a range of dates that included the appropriate measurement dates, where some dates in the range were after the recorded grant date.

The subject grants were made to over one thousand of the Company's employees, including, among others, the Company's warehouse managers and buyers. None of the options in which the review identified imprecision in the grant process were issued to the Company's chief executive officer, chairman, or non-employee directors, except in April 1997 both the chief executive officer and the chairman received, as part of a broad grant to hundreds of employees, one grant subject to imprecision that may have benefited each by up to approximately $200. Other grants subject to imprecision were made to a director who serves as executive vice president and chief financial officer and to a director who had no role in the determination of any grant date, but who serves as senior executive vice president and chief operating officer.

Given the lack of historical documentation, it was not possible to precisely determine the amount of the adjustments that should be made. Based on the recommendation of the special committee, which was based on the documentation that was available, the Company has recorded an adjustment to transfer $116,157 from retained earnings to paid-in capital, representing previously unrecorded after-tax compensation expense, and to increase the deferred tax asset account by $31,480. In those cases where the committee was unable to identify the likely grant date of the options, the latest date on which the decision could have been made was used. The Company also recorded $1,701 for the estimated federal income tax consequences stemming from the probable disallowance of compensation deductions claimed related to the subject option grants. The Company has informed the SEC of the special committee's investigation and conclusions and will cooperate fully in the event of any inquiry.

The special committee and management do not believe that the net effects of this adjustment were material, either quantitatively or qualitatively, in any of the years covered by the review. In reaching that determination, the following quantitative measures were considered:

| Year | Net after-tax effect of adjustment | Reported net income(1) | Percent of reported net income |
|---|---|---|---|
| 2005 | $ 3,954 | $1,063,092 | 0.37% |
| 2004 | 6,430 | 882,393 | 0.73% |
| 2003 | 9,092 | 721,000 | 1.26% |
| 2002 | 14,872 | 699,983 | 2.12% |
| 1996-2001 | 81,809 | 2,769,678 | 2.95% |
| Total | $116,157 | $6,136,146 | 1.89% |

(1) Excludes cumulative effect of accounting change related to membership fees of $118,023 (net of tax), reported in fiscal 1999.

### *Accounting for Reinsurance Agreements*

The Company adjusted its beginning retained earnings for fiscal 2006 related to a correction in the historical accounting treatment of certain finite risk arrangements. Because of the limited amount of risk transfer included in the agreements, historical premium payments should have been accounted for as a deposit asset rather than expensed over the policy term.

### *Deferred Tax Liability Adjustment*

The Company also adjusted its beginning retained earnings for fiscal 2006 for a historical misstatement in deferred taxes related to unreconciled differences in the detailed records supporting the deferred tax liability for depreciation of property and equipment. These differences had accumulated over a period of several years. This resulted in an overstatement of the tax basis and a corresponding understatement of the Company's net deferred tax liability.

### *Impact of Adjustments*

The impact of each of the items noted above, net of tax, on fiscal 2006 beginning balances are presented below:

| | Cumulative Effect as of August 29, 2005 | | | | |
|---|---|---|---|---|---|
| | Stock option grant practices | Income tax reserve for excess compensation | Deposit accounting | Deferred taxes | Total |
| Deferred income taxes and other current assets | $ — | $ — | $ 16,427 | $ — | $ 16,427 |
| Other current liabilities | — | (1,701) | — | — | (1,701) |
| Deferred income taxes and other liabilities | 31,480 | — | (6,383) | (31,667) | (6,570) |
| Additional paid-in-capital | (147,637) | — | — | — | (147,637) |
| Retained earnings | 116,157 | 1,701 | (10,044) | 31,667 | 139,481 |
| Total | $ — | $ — | $ — | $ — | $ — |

## Note 12—Segment Reporting

The Company and its subsidiaries are principally engaged in the operation of membership warehouses in the United States, Canada, Japan and the United Kingdom and through majority owned subsidiaries

in Taiwan and Korea and through a 50%-owned joint venture in Mexico. The Company's reportable segments are based on management responsibility. The investment in the Mexico joint venture is only included in total assets under United States Operations in the table below, as it is accounted for under the equity method and its operations are not consolidated in the Company's financial statements.

| | United States Operations | Canadian Operations | Other International Operations | Total |
|---|---|---|---|---|
| **Year Ended September 3, 2006** | | | | |
| Total revenue | $48,465,918 | $8,121,728 | $3,563,581 | $60,151,227 |
| Operating income | 1,245,835 | 292,512 | 87,285 | 1,625,632 |
| Depreciation and amortization | 413,235 | 61,232 | 40,818 | 515,285 |
| Capital expenditures | 933,952 | 188,303 | 90,312 | 1,212,567 |
| Property and equipment | 6,676,417 | 1,032,439 | 855,439 | 8,564,295 |
| Total assets | 14,009,262 | 1,913,945 | 1,571,863 | 17,495,070 |
| Net assets | 7,189,831 | 1,043,384 | 910,224 | 9,143,439 |
| **Year Ended August 28, 2005** | | | | |
| Total revenue | $43,064,452 | $6,732,305 | $3,155,469 | $52,952,226 |
| Operating income | 1,167,736 | 241,503 | 65,064 | 1,474,303 |
| Depreciation and amortization | 389,172 | 50,938 | 41,728 | 481,838 |
| Capital expenditures | 733,718 | 139,735 | 121,978 | 995,431 |
| Property and equipment | 6,170,553 | 833,637 | 786,002 | 7,790,192 |
| Total assets | 13,202,937 | 2,034,420 | 1,427,848 | 16,665,205 |
| Net assets | 6,769,222 | 1,284,829 | 827,058 | 8,881,109 |
| **Year Ended August 29, 2004** | | | | |
| Total revenue | $39,430,386 | $6,042,955 | $2,636,566 | $48,109,907 |
| Operating income | 1,121,122 | 214,518 | 50,008 | 1,385,648 |
| Depreciation and amortization | 364,432 | 40,220 | 36,069 | 440,721 |
| Capital expenditures | 560,387 | 89,748 | 55,485 | 705,620 |
| Property and equipment | 5,853,103 | 675,871 | 690,855 | 7,219,829 |
| Total assets | 12,107,613 | 1,717,962 | 1,266,973 | 15,092,548 |
| Net assets | 5,871,177 | 1,011,665 | 741,968 | 7,624,810 |

The accounting policies of the segments are the same as those described in Note 1. All inter-segment total revenue and expenses are immaterial and have been eliminated in computing total revenue and operating income.

## Note 13—Quarterly Financial Data (Unaudited)

The two tables that follow reflect the unaudited quarterly results of operations for fiscal 2006 and 2005.

| | 53 Weeks Ended September 3, 2006 | | | | |
|---|---|---|---|---|---|
| | First Quarter 12 Weeks | Second Quarter 12 Weeks | Third Quarter 12 Weeks | Fourth Quarter 17 Weeks | Total 53 Weeks |
| **REVENUE** | | | | | |
| Net sales | $12,670,792 | $13,789,246 | $13,007,415 | $19,495,727 | $58,963,180 |
| Membership fees | 262,554 | 269,766 | 276,233 | 379,494 | 1,188,047 |
| Total revenue | 12,933,346 | 14,059,012 | 13,283,648 | 19,875,221 | 60,151,227 |
| **OPERATING EXPENSES** | | | | | |
| Merchandise costs | 11,330,171 | 12,303,850 | 11,635,052 | 17,476,424 | 52,745,497 |
| Selling, general and administrative | 1,264,092 | 1,317,804 | 1,282,276 | 1,867,969 | 5,732,141 |
| Preopening expenses | 12,377 | 4,614 | 10,431 | 15,082 | 42,504 |
| Provision for impaired assets and closing costs, net | 1,211 | 1,428 | 1,182 | 1,632 | 5,453 |
| Operating income | 325,495 | 431,316 | 354,707 | 514,114 | 1,625,632 |
| **OTHER INCOME (EXPENSE)** | | | | | |
| Interest expense | (3,724) | (2,923) | (2,679) | (3,244) | (12,570) |
| Interest income and other | 25,540 | 35,225 | 33,751 | 43,839 | 138,355 |
| **INCOME BEFORE INCOME TAXES** | 347,311 | 463,618 | 385,779 | 554,709 | 1,751,417 |
| Provision for income taxes | 131,493 | 167,415 | 150,184 | 199,110 | 648,202 |
| **NET INCOME** | $ 215,818 | $ 296,203 | $ 235,595 | $ 355,599 | $ 1,103,215 |
| **NET INCOME PER COMMON SHARE:** | | | | | |
| Basic | $ 0.46 | $ 0.63 | $ 0.50 | $ 0.76 | $ 2.35 |
| Diluted | $ 0.45 | $ 0.62 | $ 0.49 | $ 0.75 | $ 2.30 |
| Shares used in calculation (000's) | | | | | |
| Basic | 472,717 | 471,889 | 470,516 | 465,542 | 469,718 |
| Diluted | 486,367 | 482,127 | 480,533 | 474,449 | 480,341 |
| Dividends per share | $ 0.115 | $ 0.115 | $ 0.13 | $ 0.13 | $ 0.49 |

Certain reclassifications have been made to conform to the presentation adopted in the fourth quarter of fiscal 2006.

| | 52 Weeks Ended August 28, 2005 | | | | |
|---|---|---|---|---|---|
| | First Quarter 12 Weeks | Second Quarter 12 Weeks | Third Quarter 12 Weeks | Fourth Quarter 16 Weeks | Total 52 Weeks |
| **REVENUE** | | | | | |
| Net sales | $11,342,611 | $12,415,442 | $11,750,892 | $16,370,125 | $51,879,070 |
| Membership fees | 238,059 | 245,499 | 249,787 | 339,811 | 1,073,156 |
| Total revenue | 11,580,670 | 12,660,941 | 12,000,679 | 16,709,936 | 52,952,226 |
| **OPERATING EXPENSES** | | | | | |
| Merchandise costs | 10,132,487 | 11,056,064 | 10,503,661 | 14,654,749 | 46,346,961 |
| Selling, general and administrative | 1,134,353 | 1,187,986 | 1,168,404 | 1,570,596 | 5,061,339 |
| Preopening expenses | 10,385 | 22,996(a) | 9,475 | 10,374 | 53,230 |
| Provision for impaired assets and closing costs, net | 2,800 | 4,000 | 3,000 | 6,593 | 16,393 |
| Operating income | 300,645 | 389,895 | 316,139 | 467,624 | 1,474,303 |
| **OTHER INCOME (EXPENSE)** | | | | | |
| Interest expense | (9,642) | (8,980) | (8,476) | (7,339) | (34,437) |
| Interest income and other | 15,590 | 24,779 | 30,159 | 38,568 | 109,096 |
| **INCOME BEFORE INCOME TAXES** | 306,593 | 405,694 | 337,822 | 498,853 | 1,548,962 |
| Provision for income taxes | 113,440 | 100,242(b) | 128,034 | 144,154(c) | 485,870 |
| **NET INCOME** | $ 193,153 | $ 305,452 | $ 209,788 | $ 354,699 | $ 1,063,092 |
| **NET INCOME PER COMMON SHARE:** | | | | | |
| Basic | $ 0.41 | $ 0.64 | $ 0.44 | $ 0.74 | $ 2.24 |
| Diluted | $ 0.40 | $ 0.62 | $ 0.43 | $ 0.73 | $ 2.18 |
| Shares used in calculation (000's) | | | | | |
| Basic | 465,869 | 474,221 | 478,248 | 476,636 | 473,945 |
| Diluted | 489,284 | 493,700 | 493,282 | 491,392 | 492,035 |
| Dividends per share | $ 0.100 | $ 0.100 | $ 0.115 | $ 0.115 | $ 0.430 |

(a) Includes a cumulative pre-tax, non-cash charge of $15,999 related to a correction of the Company's method of accounting for ground leases (entered into over the past twenty years) that did not require rental payments during the period of construction.

(b) Includes a $52,064 income tax benefit resulting primarily from the settlement of a transfer pricing dispute between the United States and Canada (covering the years 1996-2003). An additional benefit of $2,091 was booked in the fourth quarter bringing the cumulative benefit to $54,155.

(c) Includes a $20,592 net tax benefit with respect to unremitted earnings and a tax benefit of $13,895 associated with lower state tax rates.

Certain reclassifications have been made to conform to the presentation adopted in the fourth quarter of fiscal 2006.

# DIRECTORS AND OFFICERS

## DIRECTORS

**Jeffrey H. Brotman**
Chairman of the Board, Costco

**Dr. Benjamin S. Carson, Sr., M.D.**
Director of Pediatric Neurosurgery, Johns Hopkins University

**Susan L. Decker**
Chief Financial Officer, Yahoo! Inc.

**Richard D. DiCerchio**
Senior Executive Vice President, COO – Global Operations, Distribution and Construction, Costco

**Daniel J. Evans**
Chairman, Daniel J. Evans Associates; Former U.S. Senator and Governor of the State of Washington

**Richard A. Galanti**
Executive Vice President and Chief Financial Officer, Costco

**William H. Gates**
Co-Chair of the Bill and Melinda Gates Foundation

**Hamilton E. James**
President, The Blackstone Group

**Richard M. Libenson**
Former COO and Vice Chairman of the Board, The Price Company

**John W. Meisenbach**
President of MCM, A Meisenbach Company

**Charles T. Munger**
Vice Chairman of the Board of Berkshire Hathaway, Inc.; Chairman of the Board of Daily Journal Corporation; and Chairman and CEO of Westco Financial Corporation

**Jill S. Ruckelshaus**
Director, Costco

**James D. Sinegal**
President and Chief Executive Officer, Costco

## EXECUTIVE AND SENIOR OFFICERS

**Joel Benoliel**
Senior Vice President, Administration & Chief Legal Officer

**Jeffrey H. Brotman**
Chairman of the Board

**Don Burdick**
Senior Vice President, Information Systems

**Charles V. Burnett**
Senior Vice President, Pharmacy

**Roger A. Campbell**
Senior Vice President, General Manager – Southeast Region

**Richard C. Chavez**
Senior Vice President, Costco Wholesale Industries & Business Development

**Richard D. DiCerchio**
Senior Executive Vice President, COO – Global Operations, Distribution & Construction

**John B. Gaherty**
Senior Vice President, General Manager – Midwest Region

**Richard A. Galanti**
Executive Vice President, Chief Financial Officer

**Jaime Gonzalez**
Senior Vice President, General Manager – Mexico

**Bruce Greenwood**
Senior Vice President, General Manager – Los Angeles Region

**Robert D. Hicok**
Senior Vice President, General Manager – San Diego Region

**Dennis A. Hoover**
Senior Vice President, General Manager – Bay Area Region

**W. Craig Jelinek**
Executive Vice President, COO – Merchandising

**Dennis E. Knapp**
Senior Vice President, GMM – Non-Foods

**Franz Lazarus**
Senior Vice President, Administration – Global Operations

**Jeffrey R. Long**
Senior Vice President, General Manager – Northeast Region

**Jeffrey Lyons**
Senior Vice President, Merchandising – Fresh Foods

**John Matthews**
Senior Vice President, Human Resources & Risk Management

**John McKay**
Senior Vice President, General Manager – Northwest Region

**Russ Miller**
Senior Vice President, General Manager – Western Canada Region

**Ali Moayeri**
Senior Vice President, Construction

**Paul G. Moulton**
Executive Vice President, Real Estate Development

**James P. Murphy**
Senior Vice President, International Operations

**David S. Petterson**
Senior Vice President, Corporate Controller

**Joseph P. Portera**
Executive Vice President, COO – Eastern & Canadian Divisions

**Pierre Riel**
Senior Vice President, General Manager – Eastern Canada Region

**Ginnie Roeglin**
Senior Vice President, Ecommerce & Publishing

**Timothy L. Rose**
Senior Vice President, Merchandising – Foods & Sundries

**Douglas W. Schutt**
Executive Vice President, COO – Northern & Midwest Divisions

**James D. Sinegal**
President and Chief Executive Officer

**John Thelan**
Senior Vice President, Operations – Depots

**Thomas K. Walker**
Executive Vice President, Construction & Distribution

**Louise Wendling**
Senior Vice President, Country Manager – Canada

**Dennis R. Zook**
Executive Vice President, COO – Southwest Division & Mexico

## VICE PRESIDENTS

**Jeffrey Abadir**
Operations – Bay Area Region
**Sandi Babins**
GMM – Foods & Sundries – Western Canada Region
**Joe F. Basse**
GMM – Corporate Non-Foods
**Bryan Blank**
Operations – San Diego Region
**John Booth**
Operations – Bay Area Region
**Andree Brien**
Senior GMM – Non-Foods – Canadian Division
**Alan Bubitz**
GMM – Food Services & Food Court
**Debbie Cain**
GMM – Foods – Northwest Region
**Deborah Calhoun**
GMM – Foods – San Diego Region
**Patrick Callans**
Member Services
**Richard Chang**
Country Manager – Taiwan
**Jeff Cole**
U.S. Gas Purchasing & Operations
**Victor Curtis**
Pharmacy
**Richard Delie**
GMM – Corporate Non-Foods
**Gerard Dempsey**
GMM – Non-Foods – Southeast Region
**Preston Draper**
Country Manager – Korea
**George Ed Dwyer**
Operations – Depots
**John T. Eagan**
GMM – Foods – Los Angeles Region
**Liz Elsner**
Ecommerce Merchandising & Marketing
**Frank Farcone**
Operations – Los Angeles Region
**Timothy K. Farmer**
GMM – Corporate Non-Foods
**Murray Fleming**
GMM – Hardlines – Canadian Division
**Jack S. Frank**
Real Estate Development – West
**Caton Frates**
Operations – Midwest Region
**Gary Giacomi**
GMM – Non-Foods – Northwest Region
**Cynthia Glaser**
GMM – Corporate Non-Foods
**Joseph Grachek III**
Merchandise Accounting Controller
**Nancy Griese**
GMM – Corporate Foods
**Isaac Hamaoui**
GMM – Hardlines – Canadian Division
**Bill Hanson**
GMM – Foods – Midwest Region
**Doris Harley**
GMM – Foods – Southeast Region
**David Harruff**
Operations – Northwest Region
**Daniel M. Hines**
Financial Accounting Controller
**Mitzi Hu**
GMM – Imports
**Ross Hunt**
Human Resources, Finance & IS – Canadian Division
**Arthur D. Jackson, Jr.**
Administration & Community Giving
**Harold E. Kaplan**
Corporate Treasurer
**James Klauer**
GMM – Corporate Non-Foods
**Gary Kotzen**
GMM – Corporate Foods
**Paul Latham**
Marketing, Membership & Costco Travel
**Robert Leuck**
Operations – Northeast Region
**Gerry Liben**
GMM – Ancillaries – Canadian Division
**Phil Lind**
Business Centers
**Steve Mantanona**
GMM – Merchandising – Mexico
**Tracy Mauldin-Avery**
GMM – Foods – Bay Area Region
**Mark Maushund**
Operations – Los Angeles Region
**Susan McConnaha**
Director of Bakery Operations
**John Minola**
Real Estate Development
**Robert E. Nelson**
Financial Planning & Investor Relations
**Pietro Nenci**
GMM – Foods – Eastern Canada Region
**David Nickel**
GMM – Non-Foods – Western Canada Region
**Patrick Noone**
Operations – Western Canada Region
**Gary Ojendyk**
GMM – Corporate Non-Foods
**Richard J. Olin**
Legal, General Counsel
**Mario Omoss**
Operations – Texas Region
**Steve Pappas**
Country Manager – United Kingdom
**Shawn Parks**
Operations – Los Angeles Region
**Mike Parrott**
Corporate Purchasing, Business Centers and Costco Home
**Mike Pollard**
Ecommerce Operations
**Steve Powers**
Operations – Southeast Region
**Robert L. Pugmire**
GMM – Corporate Non-Foods
**Paul Pulver**
Operations – Northeast Region
**Aldyn Royes**
Operations – Southeast Region
**Yoram Rubanenko**
Operations – Northeast Region
**James W. Rutherford**
Information Systems
**Drew Sakuma**
Operations – United Kingdom
**Janet Shanks**
GMM – Fresh Foods – Canadian Division
**Michael Sinegal**
Country Manager – Japan
**David Skinner**
Operations – Eastern Canada Region
**Kimberley L. Suchomel**
GMM – International
**Gary Swindells**
Operations – Eastern Canada Region
**Mauricio Talayero**
Chief Financial Officer – Mexico
**Keith H. Thompson**
Construction
**Adrian Thummler**
Operations – Mexico
**Scott Tyler**
Operations – Western Canada Region
**Ron Vachris**
Operations – San Diego Region
**Azmina Virani**
GMM – Softlines – Canadian Division
**Richard Webb**
Operations – Midwest Region
**Jack Weisbly**
GMM – Corporate Non-Foods
**Charlie A. Winters**
Operations – Fresh Meat & Service Deli

## ADDITIONAL INFORMATION

A copy of Costco's annual report to the Securities and Exchange Commission on Form 10-K and quarterly reports on Form 10-Q will be provided to any shareholder upon written request directed to Investor Relations, Costco Wholesale Corporation, 999 Lake Drive, Issaquah, Washington 98027. Internet users can access recent sales and earnings releases, the annual report and SEC filings, as well as our Costco Online web site, at www.costco.com. E-mail users may direct their investor relations questions to investor@costco.com. All of the Company's filings with the SEC may be obtained at the SEC's Public Reference Room at Room 1580, 100 F Street NE, Washington, DC 20549. For information regarding the operation of the SEC's Public Reference Room, please contact the SEC at 1-800-SEC-0330. Additionally, the SEC maintains an internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at www.sec.gov.

### Corporate Office

999 Lake Drive
Issaquah, WA 98027
(425) 313-8100

### Division Offices

**Northern Division**

***Northwest Region***
1045 Lake Drive
Issaquah, WA 98027

***Bay Area Region***
2820 Independence Drive
Livermore, CA 94550

***Midwest Region***
1901 West 22nd Street, 2nd Floor
Oak Brook, IL 60523

**Eastern Division**

***Northeast Region***
45940 Horseshoe Drive, Suite 150
Sterling, VA 20166

***Southeast Region***
3980 Venture Drive NW, #W100
Duluth, GA 30096

**Southwest Division**

***Los Angeles Region***
11000 Garden Grove, #201
Garden Grove, CA 92843

***San Diego Region***
4649 Morena Blvd.
San Diego, CA 92117

***Texas Region***
1701 Dallas Parkway, Suite 201
Plano, TX 75093

**Canadian Division**

***Eastern Region***
415 Hunt Club Road West
Ottawa, ON K2E 1C5

***Western Region***
3550 Brighton St.
Burnaby, BC V5A 4W3

**International Division**

***United Kingdom Region***
Hartspring Lane
Watford, England, (WD25 8JS)

***Japan Region***
5F Mitsui-Sumitomo
Bank Building
1-3-1, Nakane, Meguro-ku
Tokyo, Japan 152-0031

***Korea Region***
65, 3-Ka Yangpyung-Dong
Youngdeungpo-Gu
Seoul, Korea 150-963

***Taiwan Region***
255, Min Shan Street
Neihu, Taipei 114, Taiwan

***Mexico Region***
Boulevard Magnocentro #4
Col. San Fernando
La Herradura 52760
Huixquilucan, Mexico

**Annual Meeting**
Wednesday, January 31, 2007 at 4:00 PM
Meydenbauer Center
11100 NE 6th Street
Bellevue, Washington 98004

**Independent Public Accountants**
KPMG LLP
801 Second Avenue, Suite 900
Seattle, WA 98104

**Transfer Agent**
Mellon Investor Services, L.L.C.
Costco Shareholder Relations
P. O. Box 3315
South Hackensack, New Jersey 07606
Telephone: (800) 249-8982
TDD for Hearing Impaired: (800) 231-5469
Outside U.S.: (201) 680-6610
Website: www.melloninvestor.com/isd

**Stock Exchange Listing**
NASDAQ Stock Market
Stock Symbol: COST

PRINTED ON RECYCLED PAPER