

COSTCO WHOLESALE CORP /NEW

Form 10-K

October 19, 2012

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended September 2, 2012

or

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 0-20355

Costco Wholesale Corporation

(Exact name of registrant as specified in its charter)

Washington

(State or other jurisdiction of
incorporation or organization)

91-1223280

(I.R.S. Employer Identification No.)

999 Lake Drive, Issaquah, WA 98027

(Address of principal executive offices) (Zip Code)

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Registrant's telephone number, including area code: (425) 313-8100

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, \$.005 Par Value	The NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES NO

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES NO

The aggregate market value of the voting stock held by non-affiliates of the registrant as of February 10, 2012 was \$36,229,506,282

The number of shares outstanding of the registrant's common stock as of October 5, 2012 was 432,424,379

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company's Proxy Statement for the Annual Meeting of Shareholders to be held on January 24, 2013, are incorporated by reference into Part III of this Form 10-K.

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COSTCO WHOLESALE CORPORATION

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INFORMATION RELATING TO FORWARD LOOKING STATEMENTS

Certain statements contained in this Report constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. They include statements that address activities, events, conditions or developments that we expect or anticipate may occur in the future and may relate to such matters as sales growth, increases in comparable store sales, cannibalization of existing locations by new openings, price or fee changes, earnings performance, earnings per share, stock-based compensation expense, warehouse openings and closures, the effect of adopting certain accounting standards, future financial reporting, financing, margins, return on invested capital, strategic direction, expense controls, membership renewal rates, shopping frequency, litigation impact and the demand for our products and services. Forward-looking statements may also be identified by the words believe, project, expect, anticipate, estimate, intend, strategy, future, opportunity, plan, may, should, will, will likely result, and similar expressions. Forward-looking statements are based on current expectations and assumptions and are subject to risks and uncertainties that may cause actual results to differ materially from the forward-looking statements. 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, including, without limitation, the factors set forth in the section titled Item 1A Risk Factors, and other factors noted in the section titled Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations and in the consolidated financial statements and related notes in Item 8 of this Report. Forward-looking statements speak only as of the date they are made, and we do not undertake to update these forward-looking statements, except as required by law.

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PART I

Item 1 Business

Costco Wholesale Corporation and its subsidiaries (Costco or the Company) began operations in 1983 in Seattle, Washington. We are principally engaged in the operation of membership warehouses in the United States (U.S.) and Puerto Rico, Canada, the United Kingdom, Mexico, Japan, Australia, and through majority-owned subsidiaries in Taiwan and Korea. Our common stock trades on the NASDAQ Global Select Market under the symbol COST.

Historically, our operations in Mexico were through a 50% owned joint venture (Mexico). On July 10, 2012 we acquired the remaining 50% interest in Mexico from our joint venture partner. At the beginning of fiscal 2011, we began consolidating our Mexico joint venture due to the adoption of a new accounting standard. Mexico's results previously were accounted for under the equity method and our 50% share was included in interest income and other, net in the consolidated statements of income. In fiscal 2011 and 2012, Mexico's operations are fully consolidated and the joint venture partner's 50% share, through the acquisition date, is included in net income attributable to noncontrolling interest in the consolidated statement of income. After the acquisition date, 100% of Mexico's operations are included in net income attributable to Costco. See discussion in Note 1 to the consolidated financial statements included in Item 8 of this Report.

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 three 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). The material seasonal impact in our operations is an increased level of net sales and earnings during the winter holiday season. References to 2012 relate to the 53-week fiscal year ended September 2, 2012. References to 2011 and 2010 relate to the 52-week fiscal years ended August 28, 2011 and August 29, 2010, respectively.

General

We operate membership warehouses based on the concept that offering our members low prices on a limited selection of nationally branded and select private-label products in a wide range of merchandise categories will produce high sales volumes and rapid inventory turnover. This 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 shipment to our individual warehouses, generally in less than twenty-four hours. This process maximizes freight volume and handling efficiencies, eliminating many of the costs associated with traditional multiple-step distribution channels. Such traditional steps 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 sell inventory before we are required to pay many of our merchandise vendors, even though we take advantage of early payment discounts when available. To the extent that sales increase and inventory turnover becomes more rapid, a greater percentage of inventory is financed through payment terms provided by suppliers rather than by our working capital.

Table of Contents**Item 1 Business (Continued)**

Our typical warehouse format averages approximately 143,000 square feet; newer units tend to be slightly larger. 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 quality of merchandise and the availability of low prices, our warehouses are not elaborate facilities. By strictly controlling the entrances and exits of our warehouses and using a membership format, we have limited inventory losses (shrinkage) to amounts well below those of typical discount retail operations.

Marketing and promotional activities generally relate to new warehouse openings, occasional direct mail to prospective new members, and regular direct marketing programs (such as The Costco Connection, a magazine we publish for our members, coupon mailers, weekly emails from costco.com and costco.ca, and handouts) to existing members promoting selected merchandise. These practices result in lower marketing expenses as compared to typical retailers.

Our warehouses generally operate on a seven-day, 69-hour week, open weekdays between 10:00 a.m. and 8:30 p.m., with earlier weekend closing hours. 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 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, thereby reducing labor required for handling and stocking.

Our strategy is to provide our members with a broad range of high quality merchandise at prices consistently lower than they can obtain elsewhere. We seek to limit specific items in each product line to fast-selling models, sizes, and colors. Therefore, we carry an average of approximately 3,300 to 3,800 active stock keeping units (SKUs) per warehouse in our core warehouse business, as opposed to a significantly higher number of SKUs at discount retailers, supermarkets, and supercenters. Many consumable products are offered for sale in case, carton, or multiple-pack quantities only.

In keeping with our policy of member satisfaction, we generally accept returns of merchandise. On certain electronic items, we typically have a 90-day return policy and provide, free of charge, technical support services, as well as an extended warranty. Additional third-party warranty coverage is sold on certain electronic item purchases.

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

	2012	2011	2010 ¹
Sundries (including candy, snack foods, tobacco, alcoholic and nonalcoholic beverages and cleaning and institutional supplies)	22%	22%	23%
Hardlines (including major appliances, electronics, health and beauty aids, hardware, office supplies, cameras, garden and patio, sporting goods, toys, seasonal items and automotive supplies)	16%	17%	18%
Food (including dry and institutionally packaged foods)	21%	21%	21%
Softlines (including apparel, domestics, jewelry, housewares, media, home furnishings and small appliances)	10%	10%	10%
Fresh Food (including meat, bakery, deli and produce)	13%	12%	12%
Ancillary and Other (including gas stations, pharmacy, food court, optical, one-hour photo, hearing aid and travel)	18%	18%	16%

¹ Excludes Mexico

Table of Contents**Item 1 Business (Continued)**

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 in operation at fiscal year-end:

	2012	2011	2010 ²
Food Court	602	586	534
One-Hour Photo Centers	591	581	530
Optical Dispensing Centers	589	574	523
Pharmacies	544	529	480
Hearing-Aid Centers	469	427	357
Gas Stations	394	368	343
Print Shops and Copy Centers	10	10	10
Car Washes	7	7	7
Number of warehouses	608	592	540

² Excludes the 32 warehouses operated in Mexico

Our online businesses at costco.com in the U.S. 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 making further purchases until restitution is made.

We have direct buying relationships with many producers of national brand-name merchandise. We do not obtain a significant portion of merchandise from any one 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 substantial disruption of our business. We also purchase private label merchandise, as long as quality and customer demand are comparable and the value to our members is greater as compared to brand-name items.

Certain financial information for our segments and geographic areas is included in Note 12 to the consolidated financial statements included in Item 8 of this Report.

Membership Policy

Our membership format is designed to reinforce member loyalty and provide a continuing source of membership fee revenue. Members can utilize their membership at any Costco warehouse location in any country. We have two primary types of members: Business and Gold Star (individual). Our member renewal rate was approximately 89.7% in the U.S. and Canada, and approximately 86.4% on a worldwide basis in 2012, consistent with recent years. The renewal rate is a trailing calculation that captures renewals during the period seven to eighteen months prior to the reporting date. 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 approximately \$55 for the primary card-holder, with add-on membership cards available for an annual fee of approximately \$55 each. Many of our business members also shop at Costco for their personal needs. Gold Star memberships are also available for an annual fee of approximately \$55 to individuals who may not qualify for a Business membership. All paid memberships include a free household card.

Table of Contents**Item 1 Business (Continued)**

Our membership was made up of the following (in thousands):

	2012	2011	2010 ¹
Gold Star	26,700	25,000	22,500
Business	6,400	6,300	5,800
Business, Add-on Primary	3,800	4,000	3,300
Total primary cardholders	36,900	35,300	31,600
Additional cardholders	30,100	28,700	26,400
Total cardholders	67,000	64,000	58,000

¹ Excludes approximately 2,900 cardholders in Mexico.

Executive membership is available to all members, with the exception of Business Add-on members, in the U.S., Canada, Mexico, and the United Kingdom for an annual fee of approximately \$110. This program, excluding Mexico, offers additional savings and benefits on various business and consumer services, such as check printing services, auto and home insurance, the Costco auto purchase program, online investing, and merchant credit-card processing. The services are generally provided by third-parties and vary by country and state. In addition, Executive members qualify for a 2% annual reward (which can be redeemed at Costco warehouses), up to a maximum of approximately \$750 per year, on qualified purchases. At the end of 2012, 2011, and 2010, Executive members represented 38%, 38%, and 36%, respectively, of our primary membership. Executive members generally spend more than other members, and the percentage of our net sales attributable to these members continues to increase.

Effective November 1, 2011, for new members, and January 1, 2012, for renewing members, we increased our annual membership fee by \$5 for U.S. Goldstar (individual), Business, Business Add-on and Canada Business members to \$55. Our U.S. and Canada Executive Membership annual fee increased from \$100 to \$110 annually and the Executive Membership 2% reward annual limit increased from \$500 to \$750. We account for membership fee revenue on a deferred basis, whereby revenue is recognized ratably over the one-year membership period.

Labor

Our employee count approximated:

	2012	2011	2010 ²
Full-time employees	96,000	92,000	82,000
Part-time employees	78,000	72,000	65,000
Total employees	174,000	164,000	147,000

² Excludes approximately 9,000 individuals employed in Mexico.

Approximately 13,700 hourly employees in certain of our locations in five states are represented by the International Brotherhood of Teamsters. All remaining employees are non-union. We consider our employee relations to be very good.

Competition

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Our industry is highly competitive, based on factors such as price, merchandise quality and selection, warehouse location and member service. We compete with over 800 warehouse club locations across

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Item 1 Business (Continued)

the U.S. and Canada (primarily Wal-Mart's Sam's Club and BJ's Wholesale Club), and every major metropolitan area has multiple club operations. In addition, we compete with a wide range of global, national and regional wholesalers and retailers, including supermarkets, supercenter stores, department and specialty stores, gasoline stations, and internet-based retailers. Competitors such as Wal-Mart, Target, Kohl's and Amazon.com are among our significant general merchandise retail competitors. We also compete with low-cost operators selling a single category or narrow range of merchandise, such as Lowe's, Home Depot, Office Depot, PetSmart, Staples, Kroger, Trader Joe's, Whole Foods, CVS, Walgreens and Best Buy. Our international operations face similar types of competitors.

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 higher prices, other retailers are also typically governed by the same restrictions, and we believe that compliance with such laws currently in effect do not have a material adverse effect on our operations.

Intellectual Property

We believe that, to varying degrees, our trademarks, trade names, copyrights, proprietary processes, trade secrets, patents, trade dress, domain names and similar intellectual property add significant value to our business and are important factors in our success. We have invested significantly in the development and protection of our well-recognized brands, including the Costco Wholesale® series of trademarks and our private label brand, Kirkland Signature®. We believe that Kirkland Signature products are premium products offered to our members at prices that are generally lower than those for national brand products and that they help lower costs, differentiate our merchandise offerings from other retailers, and generally earn higher margins. We expect to increase the sales penetration of our private label items in the future.

We rely on trademark and copyright laws, trade secret protection, and confidentiality and license agreements with our suppliers, employees and others to protect our proprietary rights. The availability and duration of trademark registrations vary from country to country; however, trademarks are generally valid and may be renewed indefinitely as long as they are in use and their registrations are properly maintained.

Available Information

Our internet website is www.costco.com. We make available through the Investor Relations section of that site, 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 materials with, or furnishing such documents to, the Securities and Exchange Commission (SEC). The information found on our website is not part of this or any other report filed with or furnished to the SEC. In addition, the public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an internet site that contains reports, proxy and information statements, and other information regarding issuers, such as the Company, that file electronically with the SEC at www.sec.gov.

We have 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

Table of Contents**Item 1 Business (Continued)**

Corporation, 999 Lake Drive, Issaquah, WA 98027. If the Company makes any amendments to this code (other than technical, administrative, or non-substantive amendments) or grants any waivers, including implicit waivers, from this code to the CEO, chief financial officer or controller, we will disclose (on our website or in a Form 8-K report filed with the SEC) the nature of the amendment or waiver, its effective date, and to whom it applies.

Executive Officers of the Registrant

The executive officers of Costco, their position, and ages are listed below. All executive officers have 25 or more years of service with the Company. Effective January 1, 2012, Jim Sinegal retired as our Chief Executive Officer but is continuing with the Company in an advisory role until February 2013. In addition, he will continue to serve on the Board of Directors.

Name	Position	Executive Officer Since	Age
W. Craig Jelinek	President and Chief Executive Officer. Mr. Jelinek has been President and Chief Executive Officer since January 2012 and has been a director since February 2010. He was President and Chief Operating Officer from February 2010 to December 2011. Prior to that he was Executive Vice President, Chief Operating Officer, Merchandising since 2004.	1995	60
Jeffrey H. Brotman	Chairman of the Board. Mr. Brotman is a co-founder of Costco and has been a director since its inception.	1983	70
Richard A. Galanti	Executive Vice President and Chief Financial Officer. Mr. Galanti has been a director since January 1995.	1993	56
Franz Lazarus	Executive Vice President, Administration. Mr. Lazarus was Senior Vice President, Administration-Global Operations since 2006.	2012	65
John McKay	Executive Vice President, Chief Operating Officer, Northern Division. Mr. McKay was Senior Vice President, General Manager, Northwest Region from 2000 to March 2010.	2010	55
Paul G. Moulton	Executive Vice President of Information Systems. Mr. Moulton was Executive Vice President, Real Estate Development until March 2010.	2001	61
James P. Murphy	Executive Vice President, International. Mr. Murphy was Senior Vice President, International, from September 2004 to October 2010.	2011	59
Joseph P. Portera	Executive Vice President, Chief Operating Officer, Eastern and Canadian Divisions. Chief Diversity Officer since 2010.	1994	60
Douglas W. Schutt	Executive Vice President, Chief Operating Officer, Merchandising. Mr. Schutt was Executive Vice President, Chief Operating Officer, Northern Division and Midwest Region from 2004 to March 2010.	2004	53
Thomas K. Walker	Executive Vice President, Construction and Distribution.	2004	72
Dennis R. Zook	Executive Vice President, Chief Operating Officer, Southwest Division and Mexico.	1993	63

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Item 1A Risk Factors

The risks described below could materially and adversely affect our business, financial condition and results of operations. These risks are not the only risks that we face. We could also be affected by additional factors that apply to all companies operating in the U.S. and globally, as well as other risks that are not presently known to us or that we currently consider to be immaterial. You should review these Risk Factors carefully in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 and our consolidated financial statements and related notes in Item 8 of this Report.

We face strong competition from other retailers and warehouse club operators, which could adversely affect our business, financial condition and results of operations.

The retail business is highly competitive. We compete for members, employees, sites, products and services and in other important respects with a wide range of local, regional and national wholesalers and retailers, both in the United States and in foreign countries, including other warehouse club operators, supermarkets, supercenter stores, department and specialty stores, gasoline stations, and internet-based retailers. Such retailers and warehouse club operators compete in a variety of ways, including merchandise pricing, selection and availability, services, location, convenience, and store hours. Our inability to respond effectively to competitive pressures, changes in the retail markets and member expectations could result in lost market share and negatively affect our financial results. 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 business, financial condition and results of operations.

Higher energy costs, inflation, levels of unemployment, healthcare costs, consumer debt levels, foreign currency exchange rates, unsettled financial markets, weaknesses in housing and real estate markets, reduced consumer confidence, changes related to government fiscal and tax policies, sovereign debt crises, and other economic factors could adversely affect demand for our products and services or require a change in the mix of products we sell. Prices of certain commodity products, including gasoline and other food products, are historically volatile and are subject to fluctuations arising from changes in domestic and international supply and demand, labor costs, competition, market speculation, government regulations, taxes and periodic delays in delivery. Rapid and significant changes in commodity prices may affect our sales and profit margins. These factors could also increase our merchandise costs and/or selling, general and administrative expenses, and otherwise adversely affect our operations and financial results. General economic conditions can also be affected by the outbreak of war, acts of terrorism, or other significant national or international events.

We are highly dependent on the financial performance of our U.S. and Canadian operations.

Our financial and operational performance is highly dependent on our U.S. and Canadian operations, which comprised 88% and 83% of consolidated net sales and operating income in 2012, respectively. Within the U.S., we are highly dependent on our California operations, which comprised 24% of consolidated net sales in 2012. Our California market, in general, has a larger percentage of higher volume warehouses as compared to our other markets. Any substantial slowing or sustained decline in these operations could materially adversely affect our business and financial results. Declines in financial performance of our U.S. operations, particularly in California, and our Canadian operations could arise from, among other things: failing to meet targets for warehouse openings; declines in actual or estimated comparable warehouse sales growth rates and expectations; negative trends in operating expenses, including increased labor, healthcare and energy costs; cannibalizing existing locations with

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Item 1A Risk Factors (Continued)

new warehouses; shifts in sales mix toward lower gross margin products; changes or uncertainties in economic conditions in our markets, including higher levels of unemployment and depressed home values; and failing to consistently provide high quality products and innovative new products to retain our existing member base and attract new members.

We may be unsuccessful implementing our growth strategy, including expanding our business, both in existing markets and in new markets, which could have an adverse impact on our business, financial condition and results of operations.

Our future growth is dependent, in part, on our ability to acquire property, and build or lease new warehouses. We compete with other retailers and businesses for suitable locations. Local land use and other regulations restricting the construction and operation of our warehouses, as well as local community actions opposed to the location of our warehouses at specific sites and the adoption of local laws restricting our operations and environmental regulations may impact our ability to find suitable locations, and increase the cost of constructing, leasing and operating our warehouses. We also may have difficulty negotiating leases or real estate purchase agreements on acceptable terms. In addition, certain jurisdictions have enacted or proposed laws and regulations that would prevent or restrict the operation or expansion plans of certain large retailers and warehouse clubs, including us, within their jurisdictions. Failure to manage these and other similar factors effectively may affect our ability to timely build or lease new warehouses, which could have a material adverse affect on our future growth and 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 existing warehouses and adversely affect comparable warehouse sales performance and member traffic at those existing warehouses.

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, attracting members of other wholesale club operators currently operating in the new market, 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. In new markets, we cannot ensure that our new warehouses will be profitably deployed and, as a result, our future profitability could be delayed or otherwise materially adversely affected.

We may not timely identify or effectively respond to consumer trends, which could negatively 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. Our success depends, in part, on our ability to identify and respond to trends in demographics and consumer preferences. Failure to timely identify or effectively respond to changing consumer tastes, preferences (including those relating to sustainability of product sources) and spending patterns could negatively affect our relationship with our members, the demand for our products and services and our market share. If we are not successful at predicting our sales trends and adjusting our purchases accordingly, we may have excess inventory, which could result in additional markdowns and reduce our operating performance. This could have an adverse effect on margins (net sales less merchandise costs) and operating income.

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Item 1A Risk Factors (Continued)

Our failure to maintain positive membership loyalty and brand recognition could adversely affect our results of operations.

Membership loyalty is essential to our business model. Damage to our brands or reputation may negatively impact comparable warehouse sales, lower employee morale and productivity, diminish member trust, and reduce member renewal rates and, accordingly, membership fee revenues, resulting in a reduction in shareholder value.

In addition, we sell many products under our owned and exclusive Kirkland Signature brand. Maintaining consistent product quality, competitive pricing, and availability of our Kirkland Signature products for our customers is essential to developing and maintaining customer loyalty. These products also generally carry higher margins than national brand products and represent a growing portion of our overall sales. If the Kirkland Signature brand experiences a loss of consumer acceptance or confidence, our sales and gross margin results could be adversely affected.

Vendors may be unable to supply us with quality merchandise at the right prices in a timely manner or may fail to adhere to our high standards resulting in adverse affects on our business, merchandise inventories, sales and profit margins.

We depend heavily on our ability to purchase merchandise in sufficient quantities at competitive prices. We have no assurances of continued supply, pricing or access to new products, and any vendor could at any time change the terms upon which it sells to us or discontinue selling to us. Member demands may lead to out-of-stock positions of our merchandise leading to loss of sales and profits.

We purchase our merchandise from numerous domestic and foreign manufacturers and importers and have thousands of vendor relationships. Our inability to acquire suitable merchandise on acceptable terms or the loss of key vendors could negatively affect us. We may not be able to develop relationships with new vendors, and products from alternative sources, if any, may be of a lesser quality or more expensive than those from existing vendors. Because of our efforts to adhere to high quality standards for which available supply may be limited, particularly for certain food items, the large volume we demand may not be consistently available.

Our suppliers are subject to risks, including labor disputes, union organizing activities, financial liquidity, inclement weather, natural disasters, supply constraints, and general economic and political conditions that could limit their ability to timely provide us with acceptable merchandise. For these or other reasons, one or more of our suppliers might not adhere to our quality control, legal or regulatory standards. These deficiencies may delay or preclude delivery of merchandise to us and might not be identified before we sell such merchandise to our members. This failure could lead to litigation and recalls, which could damage our reputation and our brands, increase our costs, and otherwise adversely impact our business.

Disruptions in our depot operations could adversely affect sales and member satisfaction.

We depend on the orderly operation of the merchandise receiving and distribution process, primarily through our depots. Although we believe that our receiving and distribution process is efficient, unforeseen disruptions in operations due to fires, hurricanes, earthquakes or other catastrophic events, labor shortages or shipping problems, may result in delays in the delivery of merchandise to our warehouses, which could adversely affect sales and the satisfaction of our members.

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Item 1A Risk Factors (Continued)

Natural disasters or other catastrophic events could negatively affect our business, financial condition and results of operations.

Natural disasters, such as hurrican