COSTCO WHOLESALE CORP /NEW
Form 10-Q
March 18, 2009
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended February 15, 2009

OR

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

Commission file number 0-20355

Costco Wholesale Corporation

(Exact name of registrant as specified in its charter)

Washington	**91-1223280**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

999 Lake Drive, Issaquah, WA 98027

(Address of principal executive office)

(Zip Code)

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

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

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

Large accelerated filer x	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 Exchange Act). YES ¨ NO x

The number of shares outstanding of the issuer s common stock as of March 6, 2009 was 434,027,431

Table of Contents

COSTCO WHOLESALE CORPORATION

INDEX TO FORM 10-Q

Table of Contents

PART I FINANCIAL INFORMATION

Item 1 Financial Statements

COSTCO WHOLESALE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in millions, except par value and share data)

(unaudited)

	February 15, 2009	August 31, 2008
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 2,705	$ 2,619
Short-term investments	577	656
Receivables, net	880	748
Merchandise inventories	4,995	5,039
Deferred income taxes and other current assets	534	400
Total current assets	9,691	9,462
PROPERTY AND EQUIPMENT		
Land	3,189	3,217
Buildings, leasehold and land improvements	7,771	7,749
Equipment and fixtures	3,154	3,057
Construction in progress	371	306
	14,485	14,329
Less accumulated depreciation and amortization	(4,131)	(3,974)
Net property and equipment	10,354	10,355
OTHER ASSETS	692	865
	$ 20,737	$ 20,682
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Short-term borrowings	$ 134	$ 134
Accounts payable	5,000	5,225
Accrued salaries and benefits	1,405	1,321
Accrued sales and other taxes	295	283
Deferred membership fees	795	748
Current portion of long-term debt	39	6
Other current liabilities	1,330	1,157
Total current liabilities	8,998	8,874
LONG-TERM DEBT, excluding current portion	2,198	2,206
DEFERRED INCOME TAXES AND OTHER LIABILITIES	332	328

Total liabilities	11,528	11,408
COMMITMENTS AND CONTINGENCIES		
MINORITY INTEREST	88	82
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; 434,027,000 and 432,513,000 shares issued and outstanding	2	2
Additional paid-in capital	3,661	3,543
Accumulated other comprehensive (loss) income	(218)	286
Retained earnings	5,676	5,361
Total stockholders' equity	9,121	9,192
	$ 20,737	$ 20,682

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

Table of Contents

COSTCO WHOLESALE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(dollars in millions, except per share data)

(unaudited)

	12 Weeks Ended		24 Weeks Ended	
	February 15, 2009	February 17, 2008	February 15, 2009	February 17, 2008
REVENUE				
Net sales	$ 16,488	$ 16,616	$ 32,524	$ 32,088
Membership fees	355	343	714	681
Total revenue	16,843	16,959	33,238	32,769
OPERATING EXPENSES				
Merchandise costs	14,771	14,833	29,047	28,657
Selling, general and administrative	1,666	1,615	3,343	3,185
Preopening expenses	7	10	20	31
Provision for impaired assets and closing costs, net	1	(3)	8	(3)
Operating income	398	504	820	899
OTHER INCOME (EXPENSE)				
Interest expense	(25)	(23)	(50)	(46)
Interest income and other	8	41	26	74
INCOME BEFORE INCOME TAXES	381	522	796	927
Provision for income taxes	142	194	294	337
NET INCOME	$ 239	$ 328	$ 502	$ 590
NET INCOME PER COMMON SHARE:				
Basic	$ 0.55	$ 0.75	$ 1.16	$ 1.36
Diluted	$ 0.55	$ 0.74	$ 1.14	$ 1.33
Shares used in calculation (000 s)				
Basic	433,476	434,779	432,963	434,934
Diluted	439,688	444,925	440,095	445,148
Dividends per share	$ 0.16	$ 0.145	$ 0.32	$ 0.29

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

Table of Contents

COSTCO WHOLESALE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in millions)

(unaudited)

	24 Weeks Ended	
	February 15, 2009	**February 17, 2008**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 502	$ 590
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	316	287
Stock-based compensation	89	80
Undistributed equity earnings in joint ventures	(14)	(20)
Net loss / (gain) on sale of property, equipment and other	5	(4)
Provision on impaired assets	2	
Accretion of discount on long-term debt	1	1
Excess tax benefit on share based awards	(2)	(15)
Other-than-temporary impairment loss on short-term investments	7	3
Other non-cash items, net	30	5
Deferred income tax provision	(7)	(20)
Change in receivables, other current assets, deferred membership fees, accrued and other current liabilities	20	111
Increase in merchandise inventories	(120)	(319)
Increase / (decrease) in accounts payable	(7)	154
Net cash provided by operating activities	822	853
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to property and equipment, net of $12 and $39 of non-cash capital expenditures in the first half of fiscal 2009 and 2008, respectively	(671)	(779)
Proceeds from the sale of property and equipment	4	11
Purchases of short-term investments	(1,001)	(655)
Maturities of short-term investments	1,020	522
Sales of short-term investments	93	94
Change in certain other assets and other, net	(4)	(20)
Investments transferred from cash and cash equivalents		(371)
Net cash used in investing activities	(559)	(1,198)
CASH FLOWS FROM FINANCING ACTIVITIES		
Change in bank checks outstanding	(61)	61
Repayments of short-term borrowings	(1,344)	(1,050)
Proceeds from short-term borrowings	1,359	1,100
Proceeds from issuance of long-term debt, net		72
Repayments of long-term debt	(2)	(35)
Cash dividend payments	(69)	(63)
Change in minority interests	7	4
Excess tax benefit on share based awards	2	15
Proceeds from exercise of stock options	52	119
Repurchases of common stock	(67)	(407)
Net cash used in financing activities	(123)	(184)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(54)	16

Net increase / (decrease) in cash and cash equivalents	86	(513)
CASH AND CASH EQUIVALENTS BEGINNING OF YEAR	2,619	2,780
CASH AND CASH EQUIVALENTS END OF PERIOD	$ 2,705	$ 2,267
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest (reduced by $4 and $7 interest capitalized in the first half of fiscal 2009 and 2008, respectively)	$ 52	$ 57
Income taxes	$ 176	$ 286
SUPPLEMENTAL DISCLOSURE OF NON-CASH FINANCING ACTIVITIES:		
Cash dividend declared, but not yet paid	$ 69	$ 63
Common stock issued upon conversion of 3.5% Zero Coupon Convertible Subordinated Notes	$ 2	$

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

5

Table of Contents

COSTCO WHOLESALE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in millions, except as noted and per share data)

(unaudited)

NOTE (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q for interim financial reporting pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). While these statements reflect all normal recurring adjustments that are, in the opinion of management, necessary for fair presentation of the results of the interim period, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Therefore, the interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company s annual report filed on Form 10-K, as amended, for the fiscal year ended August 31, 2008.

The condensed 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 among 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 select private label products in a wide range of merchandise categories in no-frills, self-service facilities. At February 15, 2009, Costco operated a chain of 550 warehouses in 40 states and Puerto Rico (403 locations), nine Canadian provinces (76 locations), the United Kingdom (21 locations), Korea (six locations), Taiwan (five locations) and Japan (eight locations), as well as 31 warehouses in Mexico through a 50%-owned joint venture.

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. References to the second quarters of 2009 and 2008 relate to the 12-week fiscal quarters ended February 15, 2009 and February 17, 2008, respectively. References to the first half of 2009 and 2008 relate to the 24-weeks ended February 15, 2009 and February 17, 2008, respectively.

Merchandise Inventories

Merchandise inventories are valued at the lower of cost or market, as determined primarily by the retail inventory method, and are stated using the last-in, first-out (LIFO) method for substantially all U.S. merchandise inventories. Merchandise inventories for all foreign operations are primarily valued by the retail inventory method and are stated using the first-in, first-out (FIFO) method. The Company believes the LIFO method more fairly presents the results of operations by more closely matching current costs with current revenues. The Company records an adjustment each quarter, if necessary, for the expected annual effect of inflation or deflation, and these estimates are adjusted to actual results determined at year-end. During the second quarter and first half of 2009, the LIFO inventory adjustment increased ending inventory and gross margin by $7 and $9, respectively, lowering the LIFO reserve to $23 at the end of the second quarter, as compared to $32 at the end of fiscal 2008. These LIFO adjustments excluded the effect of gas deflation that occurred during the first half of 2009 because of uncertainty whether such deflation will continue through the end of the fiscal year. If gas prices remain significantly lower than prices at the end of fiscal 2008, the Company may record further reductions to the LIFO inventory reserve. There was no LIFO adjustment in the first half of 2008.

Table of Contents

NOTE (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Other Assets

The Company adjusts the carrying value of its life insurance contracts to the cash surrender value at the end of each reporting period. The adjustment reflects changes in the market values of the underlying investment securities and is included in selling, general and administrative expenses. The performance of the investment portfolio associated with these contracts is subject to conditions generally affecting equity and debt markets. The adjustment to cash surrender value was a nominal amount during the second quarter of 2009 and a $5 decrement in the second quarter of 2008. The adjustment to the cash surrender value as of the first half of 2009 was a $29 decrement and a $5 decrement in the first half of 2008, and is reflected in other non-cash items, net, in cash flows from operations in the accompanying condensed consolidated statements of cash flows.

Derivatives

Effective November 24, 2008, the beginning of the Company s second quarter of 2009, the Company adopted the disclosure requirements of Statement of Financial Accounting Standards (SFAS) No. 161, Disclosures about Derivative Instruments and Hedging Activities an Amendment of FASB Statement No. 133 (SFAS 161). The Company follows SFAS 133, Accounting for Derivative Instruments and Hedging Activities (as amended) (SFAS 133), in accounting for derivative and hedging activities. The Company is exposed to foreign currency exchange-rate fluctuations in the normal course of its business, which the Company manages through the use of forward foreign exchange contracts. Forward foreign exchange contracts (instruments) are used to hedge the impact of fluctuations of foreign exchange on known future expenditures denominated in a foreign currency. Currently, these instruments do not qualify for derivative hedge accounting. The Company uses these instruments to mitigate risk and does not intend to engage in speculative transactions. The forward foreign exchange contracts are entered into by the Company primarily to hedge U.S. dollar merchandise inventory expenditures. The aggregate notional amount of forward foreign exchange contracts was $97 and $90 at February 15, 2009 and August 31, 2008, respectively. These contracts do not contain any credit-risk-related contingent features.

The Company seeks to manage the counterparty risk associated with these forward foreign exchange contracts by limiting transactions to counterparties with which the Company has an established banking relationship. In addition, the contracts are limited to a time period of less than one year. See Note 3, Fair Value Measurement, for information on the fair value of these contracts.

At February 15, 2009, the fair value of the Company s derivatives, which do not qualify for hedge accounting under SFAS 133, was as follows:

	Asset	Liability
Forward foreign exchange contracts (1)	$ 6	$
Total derivatives	$ 6	$

(1) The asset and the liability values are included in deferred income taxes and other current assets and other current liabilities, respectively, in the accompanying condensed consolidated balance sheets.

7

Table of Contents

NOTE (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The following table summarizes the amount of gain or (loss) recognized in interest income and other in the accompanying condensed consolidated statements of income:

	12 Weeks Ended		24 Weeks Ended	
	February 15, 2009	**February 17, 2008**	**February 15, 2009**	**February 17, 2008**
Forward foreign exchange contracts	$ (5)	$ 2	$ 2	$ 3
Total	$ (5)	$ 2	$ 2	$ 3

The Company is exposed to risks due to fluctuations in energy prices, particularly electricity, which it partially mitigates through the use of fixed-price contracts with counterparties for approximately 21% of its warehouses as well as other facilities in the U.S. and Canada. The Company has also entered into variable-priced derivative contracts for some purchases of natural gas and fuel for its gas stations on an index basis. These contracts qualify for treatment as normal purchase or normal sales under SFAS 133 and require no mark-to-market adjustment.

Stock Repurchase Programs

Shares repurchased are retired, in accordance with the Washington Business Corporation Act. The par value of repurchased shares is deducted from common stock and the remaining excess of 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 Financial Accounting Standards Board (FASB) issued SFAS 157, Fair Value Measurements (SFAS 157), which establishes a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. In February 2008, the FASB issued FASB Staff Position (FSP) FAS 157-2, Effective Date of FASB Statement 157 (FSP 157-2), which allows for the deferral of the adoption date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company elected to defer the adoption of SFAS 157 for the assets and liabilities within the scope of FSP FAS 157-2. In October 2008, the FASB issued SFAS 157-3, Determining the Fair Value of a Financial Asset in a Market That Is Not Active (FSP 157-3), which clarifies the application of SFAS 157 when the market for a financial asset is inactive. The adoption of SFAS 157 for those assets and liabilities not subject to the deferral permitted by FSP FAS 157-2 did not have a material impact on the Company s financial position or results of operations and is summarized in Note 3, Fair Value Measurements, of this Form 10-Q. The Company does not expect the adoption of SFAS 157 for non-financial assets and liabilities to have a material impact on its consolidated financial statements.

In June 2008, the FASB issued Staff Position EITF 03-06-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (FSP EITF 03-06-1). FSP EITF 03-06-1 provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method in SFAS No. 128, Earnings per Share . This FSP must be adopted for reporting periods beginning after December 15, 2008. The Company s unvested RSUs are not eligible to receive dividends; therefore, EITF 03-06-1 will not have any impact on the Company s consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an Amendment of Accounting Research Bulletin No 51 (SFAS 160). SFAS 160 establishes

Table of Contents

NOTE (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, changes in a parent s ownership of a noncontrolling interest, calculation and disclosure of the consolidated net income attributable to the parent and the noncontrolling interest, changes in a parent s ownership interest while the parent retains its controlling financial interest and fair value measurement of any retained noncontrolling equity investment. SFAS 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company must adopt these new requirements in its first quarter of fiscal 2010.

In December 2007, the FASB issued SFAS No. 141R, Business Combinations (SFAS 141R), which establishes principles and requirements for the reporting entity in a business combination, including recognition and measurement in the financial statements of the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, and interim periods within those fiscal years. The Company must adopt these new requirements in its first quarter of fiscal 2010.

The Company is in the process of evaluating the impact that adoption of SFAS Nos. 160 and 141R will have on its future consolidated financial statements.

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, which did not have any impact to consolidated net income or stockholders equity amounts previously reported.

NOTE (2) INVESTMENTS

In December 2007, one of the Company s enhanced money fund investments, Columbia Strategic Cash Portfolio Fund (Columbia), ceased accepting cash redemption requests and changed to a floating net asset value. In light of the restricted liquidity, the Company elected to receive a pro-rata allocation of the underlying securities in a separately managed account. The Company assesses the fair value of the underlying securities in this account through market quotations and review of current investment ratings, as available, coupled with an evaluation of the liquidation value of each investment and its current performance in meeting scheduled payments of principal and interest. During the second quarter of 2009 and 2008, the Company recognized $1 and $3, respectively, of other-than-temporary impairment losses related to these securities. During the first half of 2009 and 2008, the Company recognized $7 and $3, respectively, of other-than-temporary impairment losses related to these securities. The losses are included in interest income and other in the accompanying condensed consolidated statements of income. At February 15, 2009 and August 31, 2008, the balance of the Columbia fund was $65 and $104, respectively, on the condensed consolidated balance sheets.

In December 2007, two other enhanced money fund investments, BlackRock Cash Strategies, LLC (BlackRock) and Merrill Lynch Capital Reserve Fund, LLC (Merrill Lynch), ceased accepting redemption requests. During the second quarter of 2009, BlackRock was liquidated and the Company

Table of Contents

NOTE (2) INVESTMENTS (Continued)

received the remaining $21 balance of its investment. Merrill Lynch is still in the process of being liquidated with periodic distributions, and the expectation is that the fund will be substantially liquidated by 2010. To date, Merrill Lynch has maintained a $1.00 per unit net asset value. As of February 15, 2009 and August 31, 2008, the balance of the Merrill Lynch fund was $26 and $43, respectively, on the condensed consolidated balance sheets. As of August 31, the balance of the BlackRock fund was $82 on the condensed consolidated balance sheet.

During fiscal 2008, the Company reclassified a portion of these three funds from cash and cash equivalents. At February 15, 2009, $63 remained in short-term investments and $28 remained in other assets on the condensed consolidated balance sheets, reflecting the timing of the expected distributions. These amounts represent the remaining investment balance in the Merrill Lynch and Columbia Fund. At August 31, 2008, $161 remained in short-term investments and $68 remained in other assets on the condensed consolidated balance sheets.

The markets relating to these investments remain uncertain, and there may be further declines in the value of these investments that may cause additional losses in future periods.

On September 18, 2008, one of the Company s government agency money market funds, The Reserve U.S. Government Fund (the Fund), ceased accepting redemption requests. At the time of the redemption suspension, the Company had $317 invested in the Fund. The Company received cash redemptions from the Fund of $132 and $185 in the first and second quarters of 2009, respectively. As of February 15, 2009, the entire fund principal had been redeemed, with no loss of principal.

NOTE (3) FAIR VALUE MEASUREMENT

The Company adopted SFAS 157, as amended by FSP 157-1, FSP 157-2, and FSP 157-3 (collectively referred to as SFAS 157), on September 1, 2008, for all financial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis or on a nonrecurring basis during the reporting period. While the Company adopted the provisions of SFAS 157 for nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis, no such assets or liabilities existed at the balance sheet date. The Company, in accordance with FSP 157-2, delayed implementation of SFAS 157 for all nonfinancial assets and liabilities recognized or disclosed at fair value in the financial statements on a nonrecurring basis. Nonfinancial nonrecurring assets and liabilities included on the Company s condensed consolidated balance sheets include items, such as goodwill and long lived assets, that are measured at fair value to test for and measure an impairment charge, when necessary.

SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. SFAS 157 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs when measuring fair value. The standard describes three levels of inputs:

Level 1: Quoted market prices in active markets for identical assets or liabilities.
Level 2: Observable market-based inputs or unobservable inputs that are corroborated by market data.
Level 3: Unobservable inputs that are not corroborated by market data.

The following valuation techniques are used to measure fair value:

Level 1 primarily consists of financial instruments, such as money market mutual funds, whose value is based on quoted market prices, such as quoted net asset values published by the fund as supported in an active market, exchange-traded instruments and listed equities.

Table of Contents

NOTE (3) FAIR VALUE MEASUREMENT (Continued)

Level 2 includes assets and liabilities with observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The Company's Level 2 assets and liabilities primarily include U.S. Government and agency securities, investments in corporate notes and bonds, asset and mortgage-backed securities, the cash surrender value of life insurance policies covering employees, and forward foreign exchange contracts. Valuation methodologies are based on consensus pricing, using market prices from a variety of industry-standard data providers or pricing that considers various assumptions, including time value, yield curve, volatility factors, credit spreads, default rates, loss severity, current market and contractual prices for the underlying instruments or debt, broker and dealer quotes, as well as other relevant economic measures. All are observable in the market or can be derived principally from or corroborated by observable market data, for which the Company typically receives independent external valuation information.

Level 3 is comprised of unobservable inputs that are supported by little, infrequent, or no market activity. Limited amounts of the Company s investments in asset and mortgage-backed securities and corporate notes and bonds are classified as Level 3. Assets and liabilities are considered Level 3 when their fair value inputs are unobservable or not available, including situations involving limited market activity, where determination of fair value requires significant judgment or estimation. At February 15, 2009, these investment securities were measured at fair value primarily using information provided by the portfolio managers that considered quoted market prices where available, quoted prices of comparable securities, as well as estimates of fair value based on assumptions regarding credit quality, liquidity and expected future cash flows for interest and principal payments based on expected maturities and the timing of future payments.

Valuation techniques utilized, during the reporting period, in the fair value measurement of assets and liabilities presented on the Company s balance sheet were not changed from previous practice.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents information about the Company s financial assets and financial liabilities that are measured at fair value on a recurring basis as of February 15, 2009, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value:

	Level 1	Level 2	Level 3
Assets:			
Money market mutual funds	$ 1,578	$	$
Investment in U.S. government and agency securities		382	
Investment in corporate notes and bonds		72	5
Investment in asset and mortgage-backed securities		66	15
Cash surrender value of life insurance policies		61	
Forward foreign exchange contracts [(1)]		6	
Total	$ 1,578	$ 587	$ 20

(1) See Note 1 for additional information on derivative instruments.

Table of Contents

NOTE (3) FAIR VALUE MEASUREMENT (Continued)

The table below provides a summary of the changes in fair value, including net transfers, of all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the second quarter and first half of 2009:

	12 Weeks ended February 15, 2009		
	Investment in corporate notes and bonds	Investment in asset and mortgage-backed securities	Total
Balance, beginning of period	$ 5	$ 15	$ 20
Total realized and unrealized gains (losses):			
Included in other comprehensive (loss) income			
Included in other income (expense)		(1)	(1)
Change in accrued interest included in other income (expense)			
Purchases, issuances, and (settlements)			
Transfers in (out)		1	1
Balance, end of period	$ 5	$ 15	$ 20
Change in unrealized gains (losses) included in other income (expense) related to assets held as of February 15, 2009	$	(1)	(1)

	24 Weeks ended February 15, 2009		
	Investment in corporate notes and bonds	Investment in asset and mortgage-backed securities	Total
Balance, beginning of period	$ 12	$ 6	$ 18
Total realized and unrealized gains (losses):			
Included in other comprehensive (loss) income	(1)		(1)
Included in other income (expense)	(4)	(3)	(7)
Change in accrued interest included in other income (expense)			
Purchases, issuances, and (settlements)	(7)		(7)
Transfers in (out)	5	12	17
Balance, end of period	$ 5	$ 15	$ 20
Change in unrealized gains (losses) included in other income (expense) related to assets held as of February 15, 2009	$ (4)	(3)	(7)

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

As discussed in Note 2, the Company holds enhanced money fund investments that are liquidating. These holdings are classified as held-to-maturity investments and are therefore not adjusted to market value at the end of each reporting period. Fair value would only be determined on a nonrecurring basis when these investments are deemed to be other-than-temporarily impaired. The Company has not recorded any other-than-temporary impairment losses on these investments during the reporting period.

NOTE (4) LONG-TERM DEBT

During the second quarter of 2009, $3 in face amount of the Company s 3.5% Zero Coupon Convertible Subordinated Notes (Zero Coupon Notes) was converted by note holders into 70,000 shares of

Table of Contents

NOTE (4) LONG-TERM DEBT (Continued)

common stock; and during the first half of 2009, $3.3 in face amount of Zero Coupon Notes was converted by note holders into 77,000 shares of common stock. During the second quarter and first half of 2008, a nominal amount of face value of Zero Coupon Notes was converted by note holders into 3,000 and 6,000 shares of common stock, respectively.

These amounts differ from those in the supplemental disclosure of non-cash items in the condensed consolidated statements of cash flows due to the related discount and issuance costs.

NOTE (5) STOCKHOLDERS EQUITY

Dividends

The Company s current quarterly cash dividend rate is $0.16 per share. On January 28, 2009, the Board of Directors declared a quarterly cash dividend of $0.16 per share to shareholders of record on February 13, 2009. The dividend was paid on February 27, 2009.

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 stock repurchase activity during the second quarter and first half of 2009 and 2008 is summarized in the following table:

	Shares Repurchased (000 s)	Average Price per Share	Total Expenditure
Second quarter of 2009		$	$
First half of 2009	845	$ 65.32	$ 55
Second quarter of 2008	1,973	$ 65.51	$ 129
First half of 2008	6,362	$ 62.93	$ 400

These amounts differ from the stock repurchase balances in the condensed consolidated statements of cash flows to the extent that repurchases had not settled at the end of the quarter. The remaining amount available for stock repurchases under the approved plans was approximately $2,004 at February 15, 2009. Purchases are made from time-to-time as conditions warrant in the open market or in block purchases, and pursuant to share repurchase plans under SEC Rule 10b5-1. Repurchased shares are retired.

Comprehensive Income (Loss)

Comprehensive income (loss) includes net income plus certain other items that are recorded directly to stockholders equity. Accumulated other comprehensive (loss) income reported on the Company s condensed consolidated balance sheets consists of foreign currency translation adjustments and unrealized gains and losses on investments and their related tax effects.

Table of Contents

NOTE (5) STOCKHOLDERS EQUITY (Continued)

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

	12 Weeks Ended		24 Weeks Ended	
	February 15, 2009	February 17, 2008	February 15, 2009	February 17, 2008
Unrealized gain on short-term investments	$ 3	$ 4	$	$ 8
Tax provision	(1)	(2)		(3)
Unrealized gain on short-term investments, net of tax	2	2		5
Foreign currency translation adjustment and other	20	(50)	(504)	53
Tax benefit on translation gain in relation to earnings subject to repatriation				1
Comprehensive income (loss) adjustments, net	22	(48)	(504)	59
Net income	239	328	502	590
Total comprehensive income (loss)	$ 261	$ 280	$ (2)	$ 649

NOTE (6) STOCK-BASED COMPENSATION PLANS

The Company grants restricted stock units (RSUs) under the Fourth Restated 2002 Stock Incentive Plan (Fourth Restated 2002 Plan). Each share issued in respect of stock bonuses or stock units will be counted as 1.75 shares toward the limit of shares made available under the Fourth Restated 2002 Plan. The Company issues new shares of common stock upon exercise of stock options and vesting of RSUs.

Under the Fourth Restated 2002 Plan, which was amended in July 2008 by the Board of Directors, prospective grants of RSUs will be subject, upon certain terminations of employment, to quarterly, as opposed to daily vesting. Additionally, employees who attain certain years of service with the Company will receive shares under the accelerated vesting provisions on the annual vesting date rather than upon qualified retirement. These changes were effective for the grant of RSUs that occurred in the first quarter of fiscal 2009.

Compensation expense for all stock-based awards granted subsequent to fiscal 2002 is recognized using the straight-line method. SFAS No. 123R, Share-Based Payment (as amended) (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 cumulative compensation expense recognized equals the number of stock-based awards vested at the end of each reporting period. While options and RSUs generally vest over five years, with an equal amount vested on each anniversary of the grant date, all grants allow for daily or quarterly vesting of the pro-rata number of stock-based awards that would vest on the next anniversary of the grant date in the event of retirement or voluntary termination. Additionally, the historical experience rate of actual forfeitures has been minimal. 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 expected to vest. The impact of actual forfeitures arising in the event of involuntary termination is recognized as actual forfeitures occur, which generally is infrequent.

Table of Contents

NOTE (6) STOCK-BASED COMPENSATION PLANS (Continued)

Summary of Stock Option Activity

The following table summarizes stock option transactions during the first half of 2009:

	Shares (in 000 s)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value[1]
Outstanding at August 31, 2008	21,394	$ 40.04		
Granted				
Exercised	(1,312)	38.33		
Forfeited or expired	(78)	38.80		
Outstanding at February 15, 2009 [2]	20,004	$ 40.15	4.44	$ 69
Exercisable at February 15, 2009	14,813	$ 39.38	3.93	$ 62

(1) The difference between the exercise price and market value at February 15, 2009.

(2) Stock options generally vest over five years and have a ten-year term.

The tax benefits realized and intrinsic value related to total stock options exercised during the first half of 2009 and 2008 are provided in the following table:

	24 Weeks Ended	
	February 15, 2009	February 17, 2008
Actual tax benefit realized for stock options exercised	$ 6	$ 29
Intrinsic value of stock options exercised [1]	$ 16	$ 91

(1) The difference between the original exercise price and market value of common stock measured at each individual exercise date.

U.S. Attorney s Office Investigation on Certain Stock Options

As previously disclosed, in 2006, a special committee of independent directors was formed to determine whether the stated grant dates of options were supported by the Company s books and records. In March 2007, the Company was informed by the U.S. Attorney s Office in the Western District of Washington that the office was conducting an investigation of the Company s past stock option granting practices to determine whether there had been any violations of federal law. As part of this investigation, the U.S. Attorney s Office served a grand jury subpoena on the Company, seeking documents and information relating to its historic stock option grants. On February 12, 2009, the U.S. Attorney s Office publicly announced that it had closed its investigation. See Note 8, Commitments and Contingencies, for additional information.

Employee Tax Consequences on Certain Stock Options

The Company is examining alternatives to mitigate the potential adverse tax consequences associated with effected unexercised options held by Canadian employees that were the subject of an accounting adjustment in 2006. The related liability as of February 15, 2009 and August 31, 2008 was $2 and $9, respectively.

Table of Contents

NOTE (6) STOCK-BASED COMPENSATION PLANS (Continued)

Summary of Restricted Stock Unit Activity

RSUs granted to employees and to non-employee directors generally vest over five and three years, respectively; however, the Company provides for accelerated vesting for recipients that have attained certain years of service with the Company. Recipients are not entitled to vote or receive dividends on unvested shares. The fair value of RSUs, for financial statement purposes, is the market value of the common stock on the date of grant less the present value of the expected dividends forgone during the vesting period. At February 15, 2009, 5,234,000 RSUs were available to be granted to eligible employees and directors under the Fourth Restated 2002 Plan.

The following awards were outstanding at the end of the first half of 2009:

8,302,500 shares of time-based RSUs, in which the restrictions lapse upon the achievement of continued employment over a specified period of time;

699,500 performance RSUs, of which 305,000 were approved in the first quarter of fiscal 2009 and will formally be granted to certain executive officers of the Company upon the achievement of specified performance targets for fiscal 2009. Once formally granted, restrictions lapse upon achievement of continued employment over a specified period of time.

The following table summarizes RSU transactions during the first half of 2009:

	Number of Units (in 000 s)	Weighted-Average Grant Date Fair Value
Unvested at August 31, 2008	6,705	$ 56.97
Granted	3,691	50.85
Vested	(1,340)	56.63
Forfeited	(54)	55.49
Unvested at February 15, 2009	9,002	$ 54.52

Summary of Stock-Based Compensation

The following table summarizes stock-based compensation expense and the related tax benefits:

	12 Weeks Ended		24 Weeks Ended	
	February 15, 2009	February 17, 2008	February 15, 2009	February 17, 2008
Restricted stock units	$ 31	$ 25	$ 62	$ 45
Stock options	14	17	27	35
Total stock-based compensation expense before income taxes	45	42	89	80
Income tax benefit	(15)	(14)	(30)	(26)

Total stock-based compensation expense, net of income tax	$ 30	$ 28	$ 59	$ 54

The remaining unrecognized compens