

Financial Analysis and Valuation of Costco

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Abstract: This essay intends to offer an essential insight of the American retail giant Costco, using its business model, an accounting measurement, performance evaluation, and future estimation to determine whether it is a company worth investing in. The research is significant as it helps investors validate and evaluate their investment decisions in light of the rapid changes in the retail industry and the economic environment. The paper shows that Costco is an ideal company for investors to invest in, as it has a successful business model that focuses on offering high-quality goods at low prices, providing excellent customer service, and paying its employees well. The company's accounting measurement is also reliable, with its financial statements reflecting its true financial performance. Furthermore, the paper evaluates Costco's performance over the years and finds that the company has consistently achieved strong financial results and has been able to maintain its competitive position in the retail industry. Finally, the paper provides a positive future estimation of Costco's performance based on the company's growth strategies and the anticipated growth in the retail industry. In conclusion, the fundamental analysis of Costco presented in this paper shows that the company is a worthy investment for investors. The research is based on reliable data and analysis, which can be used to support investment decisions in the retail industry.

Keywords: retailing industry, accounting analysis, performance evaluation, strategic objectives

1. Introduction

In Seattle, Washington, Costco Wholesale Corporation and its affiliates first went into business in 1983. A warehouse club with exclusive memberships, Costco is dedicated to giving its customers the best deals on name-brand products of the highest caliber. With more than 800 locations worldwide, Costco provides a wide range of goods, as well as the usefulness of specialist sections and exclusive member services, all designed at enhancing the shopping experience for clients. Costco operates membership warehouses and e-commerce websites with the belief that offering consumers inexpensive prices on a narrow selection of nationally known brands and private-label products in a wide range of categories will lead to high sales volumes and rapid inventory turnover. These volumes and turnover enable Costco to operate profitably at significantly lower gross margins than the majority of other retailers, in addition to the operational benefits brought about by mass distribution, effective purchasing, and minimal handling of goods in self-service warehouses.

The goal of Costco is to consistently offer lower prices and a wide selection of high-quality merchandise than competitors. The majority of Costco's items are limited to fast-selling models,

sizes, and colors. The number of active stock-keeping units (SKUs) that Costco maintains in each warehouse is lower than those of other broad-line retailers—fewer than 4,000. There are often between 10,000 and 11,000 SKUs accessible from Costco online, some of which are also sold in their warehouses. Numerous consumable items are only available for purchase in case, carton, or multiple-pack quantities [1]. The business, financial condition, and operational outcomes of Costco could be significantly impacted by regional or global health pandemics or epidemics, such as COVID-19 [2]. As an illustration, Costco members recently purchased 9,427 bags of frozen berry mix that have been connected to hepatitis A. Costco was also asked to pull all of the Kirkland berry mixes off its shelves as a precautionary measure. Kaohsiung's health department said Costco will be fined for violating Article 44 of the Act Governing Food Safety and Sanitation, which carries a maximum penalty of NT\$200 million [3].

The retail giant Costco draws lines of customers, and cars, with its discount gas. That in turn is a strong traffic draw for its stores in general. But an executive recently underscored, Costco has no plans to return to EV charging in the next few years—and even though U.S. gasoline consumption has peaked, Costco says its market share continues to grow [4]. Costco stated in its annual report that even though its non-gasoline sector frequently has a higher gross margin percentage, it feels its gasoline business increases traffic in our warehouses. It also has lower SG&A expenditures as a percentage of net sales than our non-gasoline sector. Its gross margin as a percentage will typically decline with higher gasoline sales penetration. Its near-term net sales growth may be severely impacted by rapidly fluctuating gasoline costs. Rising gas prices often cause net sales to increase, which, given the larger customer base, lowers our SG&A costs as a percentage of net sales but has a negative impact on our gross margin percentage. If gas prices are declining, the inverse is true. Costco Wholesale Corporation reported that on April 19, 2023, its Board of Directors approved a quarterly raise from 90 cents to \$1.02 per share, or \$4.08 on an annually basis. The dividend was also declared on Costco common shares. Shareholders with records as of the close of business on May 5, 2023 will receive the dividend on May 19, 2023.

2. Accounting Analysis

Because Costco released the Second Quarterly Report 2023 on March 9, 2023, so the accounting policies are analyzed based on the 2022 Annual Report, adjusting with any changes of accounting policies in the 1st and 2nd Quarterly Report for 2023 [5]. Three areas, revenue recognition, property and equipment, merchandise inventories required management to exercise higher degree of judgement or significant estimates.

2.1. Revenue Recognition

Net sales at Costco increased by \$30,678 or 16% in 2022. This rise is the result of 14% higher comparable sales as well as sales from newly opened warehouses in 2021 and 2022. The core merchandise category increased sales by \$15,830 and the warehouse support and other businesses increased by \$14,848. The strongest growth rates were in Costco's gasoline, commercial center and travel businesses. The impact of inflation on sales continued to be higher than in Costco's previous fiscal years. With net sales increasing by \$9,230 in 2022, a 481 basis point rise over 2021, and an average gallon price increase of 42%, higher gas prices had a beneficial effect on the business. Net sales grew by \$3,847,200 basis points as a result of an increase in gasoline sales of around 22%. Comparing 2018 to 2021, there was a decrease in net sales of \$1,762, 92 basis points, mostly attributed to Costco's other international businesses due to changes in foreign exchange rates relative to the U.S. dollar.

2.1.1. Sales Recognition

The amount of counter-party consideration that the company receives from members, including all necessary transportation costs, net of sales taxes that are gathered and paid to the appropriate authorities, and member re-turns, is used by the company to determine how much of a transaction has actually occurred. The company lowers the cost of sales and items in accordance with projected returns based on historical trends in merchandise returns. Refund obligations and recovered assets are reported by the company on a gross basis and are included in the consolidated balance sheet's other current liabilities and other current assets, respectively.

2.1.2. Shop Cards

The retails and elsewhere offers proprietary store cards that do not exceed their expiration dates and are available for redemption for merchandise or memberships at the warehouse or online. When a store card is redeemed, the revenue associated with it is recorded, and the projected breakage is calculated using the redemption data. The Company records the remaining store card amount as a liability for the cards, less any anticipated breakage. Liabilities related to store credit cards are included as other current liabilities on the consolidated balance sheets.

2.1.3. Cooperation

In June 2016, Citibank, N.A. took over as the sole issuer of the co-branded credit card for US members. Royalty payments for transactions made with the card outside of Cost-co are among the various forms of remuneration that the Company funds from Citibank. After taking into account breakage, a portion of the royalty is used to support the cardholder's receipt of rebates, which are determined using data on rebate redemption. Rebates are given out in February and must be paid back by December 31. In Canada as well as through a number of other overseas subsidiaries, the company also manages cobranded credit card connections.

Costco's accounting policy for revenue recognition seems reasonable. However, significant judgment and estimates are required because of the complicated operations of Costco.

2.2. Property and Equipment

Costco's real estate and equipment are valued. The most common method for calculating depreciation and amortization costs is the straight-line method, which is then applied to estimated usable lifetimes. The asset is depreciated during the period of the leasehold improvements for the lesser of the remaining term of the initial lease, the projected useful life of the asset, and any renewals that are reasonably certain at the time the leasehold improvements are finished.

The Company makes a profit from some computer software and the expenses related to creating or acquiring software for internal usage. These expenses are accounted for as part of ongoing construction during development. To the extent that the assets are ready for their intended use, these costs are incorporated into equipment and fixtures and amortized over the course of their expected useful life on a straight-line basis. The business wrote off SG&A expenses totaling \$118 and \$84 for specific information technology assets in 2022 and 2021, respectively. Repair and upkeep expenses are deducted when they are incurred. Remodeling, refurbishing, and improvement costs that increase or alter an asset's function or usable life are capitalized. Retired are any assets that were taken out during the renovation, refurbishment, or enhancement. At the end of 2022 and 2021, the held-for-sale assets were insignificant.

The corporation evaluates long-lived assets for impairment each year, when relocating or closing a facility, or in other scenarios where events or modifications to the environment would indicate that

the carrying value of the asset group—typically a single warehouse—may not be completely recoverable. Asset groups that are held and used, including warehouses that need to be transferred, are regarded to have recoverable carrying values when predicted future undiscounted cash flows generated by usage and eventual disposition of the asset group exceed its carrying value. If the carrying value is not believed to be recoverable, an impairment loss equal to the difference between the carrying value and the estimated fair value of the asset group is recorded for the asset group that will be kept and utilized. Comparing the fair value less selling costs of the disposal group to the carrying value of the asset classes in the disposal group. Costco obtains market evaluations from independent brokers or employs other valuation methods to estimate fair value. In 2022 or 2020, no impairment charges were recorded. Charges for damage acknowledged in 2021 were irrelevant.

As a big retailer, property, and equipment are very influential in the context of Costco's income statement and balance sheet. Thus, the annual impairments of property and equipment need more accurate estimates and management judgment.

2.3. Merchandise Inventories

In 2022, Costco's merchandise inventories grew of more than 25%. Inventories in main selling countries like USA and Canada, have both increased. A \$438 charge was imposed to merchandise expenses in 2022 owing to inflation in order to increase the cumulative LIFO valuation on goods inventories as of August 28th, 2022. In 2021, an insignificant LIFO charge was noted. Stocks of goods from Canada and other countries are primarily appraised using the cost and retail inventory techniques on a FIFO basis, respectively. Costco gives estimations based on past experience for inventory losses between physical inventory counts. The provision is frequently updated to reflect physical inventory counts, which usually occur in the second and fourth fiscal quarters. Estimates of vendor rebates are deducted from inventory costs as necessary when earned or when the company gets closer to earning them, provided they are plausible and reasonably estimable. In addition to the impact of differences in inventory basis, inflation can also have a meaningful impact on the valuation of inventories. Costco's accounting policy for inventories seems reasonable.

3. Performance Evaluation

To better compare performance evaluation, three competitors, including Walmart, Amazon, and Alibaba, are identified by reasonable judgments based on the market capitalization, as shown in Table 1 [6,8].

Table 1: Market capitalization of Costco and its competitors.

Company	Market Capitalization
Walmart (WMT)	400.251B USD
Amazon (AMZN)	1050B USD
Alibaba (BABA)	250.325B USD
Costco (COST)	217.88B USD

3.1. Profitability Measures

Using the market-to-book ratio, one may assess how much a company is currently worth in relation to its book value. All outstanding shares of stock are currently trading at their market value, which is what the market estimates the company is worth. The remaining sum after all assets have been

liquidated and debts have been paid in full is referred to as the book value of the business. More people have favorable opinions about this company, the greater the ratio. A metric of ROA is the amount of net profit produced per unit of assets. The return is better when management is more efficient and productive in utilizing available re-sources. Similar principle on ROE and ROC. From Table 2, Costco has best performance compared with its competitors in the four aspects.

Table 2: Profitability ratios of Costco and its competitors.

	Market-to-book ratio	ROA	ROE	ROC
Costco	8.88	9.10%	26.67%	20.75%
Walmart	4.99	4.63%	12.86%	9.22%
Alibaba	1.63	1.38%	2.20%	1.94%
Amazon	5.89	-0.59%	-1.86%	-1.28%

3.2. Efficiency Measures

Inventory turnover measures how frequently a business sells and restocks its stock of goods over a given period of time. It considers the cost of goods sold in proportion to its typical inventory in any particular year or length of time. In general, a high inventory turnover rate denotes faster sales, while a low turnover rate denotes slow sales and high stocks. The percentage of profit produced by an organization's operations before deducting taxes and interest costs is measured by the operational profit margin, sometimes referred to as the profitability or performance ratio. Through Table 3, Costco performs excellently as well. However, Alibaba has a higher inventory turnover and operating profit margin. This is most likely because Alibaba is an e-commerce platform, that is, to buy and sell, so there is very little inventory and save a lot of plant costs.

Table 3: Efficiency ratios of Costco and its competitors.

	Asset turnover	Inventory turnover	Profit margin	Operating profit margin
Costco	3.51	11.90	2.59%	3.39%
Walmart	2.48	7.65	1.86%	3.37%
Alibaba	0.50	17.17	2.74%	12.00%
Amazon	1.11	12.56	-0.53%	2.38%

3.3. Leverage Measures

Costco has a negative times-interest-earned and cash coverage ratio in Table 4. It's because Costco has negative interest payments, that Costco has higher interest earnings than payments. The table claims that Costco has a strong ability to meet debt repayment.

Table 4: Leverage ratios of Costco and its competitors.

	Long-term debt ratio	Total debt ratio	Times-interest-earned	Cash coverage ratio
Costco	22.20%	65.89%	-175.47	-216.94
Walmart	29.26%	65.56%	9.08	14.92
Alibaba	11.78%	37.38%	-0.21	-0.23
Amazon	31.50%	68.44%	-3.27	35.12

3.4. Liquidity Measures

The metric used to ascertain this is the proportion of a company's net working capital to its total assets. The working capital to total assets ratio of the business. In light of the impending liquidation, it demonstrates how stable the company's financial status is. It also demonstrates the management's level of comfort with taking on the risk of both an investment opportunity and liquidation. The current ratio is an important liquidity ratio that evaluates a company's ability to meet short-term obligations [9]. Alibaba is an e-commerce platform, its current assets are very high because it saves a lot without the cost of offline stores. Meanwhile, Alibaba has relatively high current liabilities in Table 5.

Table 5: Liquidity ratios of Costco and its competitors.

	MWC to total assets	Current ratio	Quick ratio	Cash ratio
Costco	0.03	1.06	0.52	0.40
Walmart	-0.07	0.82	0.16	0.09
Alibaba	0.18	1.74	1.66	0.47
Amazon	-0.02	0.94	0.72	0.35

4. Strategic Objectives & Forecast

A key component of Costco's business strategy is to provide a wide range of luxury products to its clients at prices that are consistently lower than what they would pay elsewhere. A recent announcement from Costco increased its quarterly cash dividend. There are two main reasons: The performance of Costco is undoubtedly superior, increasing more quickly, and having good cash flow; Provides assurance to investors, demonstrates the company's willingness to increase shareholder returns, and encourages individuals to maintain holding the shares.

The COVID-19 pandemic is also a significant uncertainty for retailers, which will cause accelerated divergence in the competitive landscape, and community business is expected to explode. In reaction to the epidemic, retail companies strategically decreased their offline presence to improve performance and efficiency. Businesses with weak operations will suffer more, whereas those in high-margin markets with a head start in the internet space will be able to manage. Established companies and large platforms will seize the chance to increase their market share and wrest from small and medium-sized businesses their customers, employees, stores, suppliers, and other resources [10]. Even though each sub-sector industry's development demonstrates a strong Matthew effect, and the strongest is always powerful, the competitive pattern in the sub-sector industry will strengthen and

become more unique. Nevertheless, Costco is still a business with promising development potential. Investors might think about holding Cost-co for a long time.

5. Conclusion

Through the analysis, this study found that Costco has a successful business model with a long history, reliable accounting measurement, and positive future estimation. Therefore, Costco is a good company with a bright future for investors to invest. The most notable aspect is Costco's business model. Costco is in good financial shape due to its steady strategy and high earnings with membership fees. Generally speaking, the supermarket is through the sale of goods to obtain profits, only if the sale price of goods is significantly higher than the purchase price, there is sufficient room for profit, but Costco's profit model is not so. Consumers must pay a membership fee to shop at Costco, which operates on a "membership" basis, and Costco keeps the price of goods very low to attract more people to apply for membership.

Although Costco's performance in 2022 in terms of liquidity and efficiency appears to be somewhat inferior than Alibaba's, the various business models of the various companies will have a big impact on the financial data. The following two areas, however, still have some limits in the research: The results of operations reported by the company and its financial performance could both be significantly harmed by changes in foreign exchange rates. The element was not taken into account in this study. Due to the intense competition our business faces from other retailers, wholesale club operators, omnichannel retailers, and other businesses, our financial performance may be seriously impacted.

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