KROGER CO
Form 10-Q
July 03, 2007

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 May 26, 2007**
	OR
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from ____to____**

Commission file number 1-303

(Exact name of registrant as specified in its charter)

Ohio	**31-0345740**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1014 Vine Street, Cincinnati, OH 45202
(Address of principal executive offices)
(Zip Code)

(513) 762-4000
(Registrant's telephone number, including area code)

Unchanged
(Former name, former address and former fiscal year, if changed since last report)

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 o.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x.

There were 709,347,252 shares of Common Stock ($1 par value) outstanding as of June 29, 2007.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

THE KROGER CO.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in millions, except per share amounts)
(unaudited)

	First Quarter Ended	
	May 26, 2007	**May 20, 2006**
Sales	$ 20,726	$ 19,415
Merchandise costs, including advertising, warehousing, and transportation, excluding items shown separately below	15,834	14,659
Operating, general and administrative	3,609	3,528
Rent	189	196
Depreciation and amortization	404	388
Operating profit	690	644
Interest expense	146	155
Earnings before income tax expense	544	489
Income tax expense	207	183
Net earnings	$ 337	$ 306
Net earnings per basic common share	$ 0.48	$ 0.42
Average number of common shares used in basic calculation	706	722
Net earnings per diluted share	$ 0.47	$ 0.42
Average number of common shares used in diluted calculation	715	729

The accompanying notes are an integral part of the Consolidated Financial Statements.

THE KROGER CO.
CONSOLIDATED BALANCE SHEETS
(in millions, except per share amounts)
(unaudited)

	May 26, 2007	**F**
ASSETS		
Current assets		

Cash - In stores	$	150	$	
Cash - Temporary cash investments		38		
Total cash		188		
Deposits in-transit		571		
Receivables		719		
FIFO inventory		5,166		
LIFO credit		(470)		
Prefunded employee benefits		19		
Prepaid and other current assets		254		
Total current assets		6,447		
Property, plant and equipment, net		11,907		
Goodwill		2,120		
Other assets		522		
Total Assets	$	20,996	$	
LIABILITIES				
Current liabilities				
Current portion of long-term debt including obligations under capital leases and financing obligations	$	1,414	$	
Accounts payable		3,864		
Accrued salaries and wages		718		
Deferred income taxes		170		
Other current liabilities		1,836		
Total current liabilities		8,002		
Long-term debt including obligations under capital leases and financing obligations				
Face-value long-term debt including obligations under capital leases and financing obligations		5,160		
Adjustment to reflect fair-value interest rate hedges		17		
Long-term debt including obligations under capital leases and financing obligations		5,177		
Deferred income taxes		295		
Other long-term liabilities		2,262		
Total Liabilities		15,736		
Commitments and contingencies (see Note 9)				
SHAREOWNERS' EQUITY				
Preferred stock, $100 par, 5 shares authorized and unissued		—		
Common stock, $1 par, 1,000 shares authorized; 943 shares issued in 2007 and 937 shares issued in 2006		943		
Additional paid-in capital		2,910		
Accumulated other comprehensive loss		(247)		
Accumulated earnings		5,789		

Common stock in treasury, at cost, 235 shares in 2007 and 232 shares in 2006	(4,135)	(4,011)
Total Shareowners' Equity	5,260	4,923
Total Liabilities and Shareowners' Equity	$ 20,996	$ 21,215

The accompanying notes are an integral part of the Consolidated Financial Statements.

THE KROGER CO.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions and unaudited)

	Quarter En
	May 26, 2007
Cash Flows from Operating Activities	
Net earnings	$ 337
Adjustments to reconcile net earnings to net cash provided by operating activities:	
Depreciation and amortization	404
LIFO charge	20
Stock option expense	22
Expense for Company-sponsored pension plans	19
Deferred income taxes	(12)
Other	8
Changes in operating assets and liabilities net of effects from acquisitions of businesses:	
Store deposits in-transit	43
Receivables	50
Inventories	(109)
Prepaid expenses	286
Accounts payable	90
Accrued expenses	(162)
Income tax payables and receivables	158
Contribution to Company-sponsored pension plans	(50)
Other	5
Net cash provided by operating activities	1,109
Cash Flows from Investing Activities	
Payments for property and equipment	(608)
Proceeds from sale of assets	14
Other	(7)
Net cash used by investing activities	(601)
Cash Flows from Financing Activities	
Dividends paid	(46)
Proceeds from lease-financing transactions	3
Payments on long-term debt	(214)
Payments on bank revolver	(242)
Financing charges incurred	—

Proceeds from issuance of common stock		151	
Treasury stock purchases		(132)	
Decrease in book overdrafts		(29)	
Net cash used by financing activities		(509)	
Net increase (decrease) in total cash		(1)	
Total cash:			
Beginning of year		189	
End of quarter	$	188	$
Reconciliation of capital expenditures			
Payments for property and equipment	$	(608)	$

Changes in construction-in-progress payables		52		(30)
Total capital expenditures	$	(556)	$	(450)
Supplemental cash flow information				
Cash paid during the year for interest	$	140	$	179
Cash paid during the year for income taxes	$	20	$	24

The accompanying notes are an integral part of the Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

All amounts in the notes to Consolidated Financial Statements are in millions except per share amounts.

Certain prior-year amounts have been reclassified to conform to current-year presentation.

1. ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation

The accompanying financial statements include the consolidated accounts of The Kroger Co. and its subsidiaries. The February 3, 2007 balance sheet was derived from audited financial statements and, due to its summary nature, does not include all disclosures required by generally accepted accounting principles (“GAAP”). Significant intercompany transactions and balances have been eliminated. References to the “Company” in these Consolidated Financial Statements mean the consolidated company.

In the opinion of management, the accompanying unaudited Consolidated Financial Statements include all normal, recurring adjustments that are necessary for a fair presentation of results of operations for such periods but should not be considered as indicative of results for a full year. The financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted, pursuant to SEC regulations. Accordingly, the accompanying Consolidated Financial

Statements should be read in conjunction with the 2006 Annual Report on Form 10-K of The Kroger Co. filed with the SEC on April 4, 2007.

The unaudited information in the Consolidated Financial Statements for the first quarters ended May 26, 2007 and May 20, 2006 includes the results of operations of the Company for the 16-week periods then ended.

Store Closing and Other Expense Allowances

All closed store liabilities related to exit or disposal activities initiated after December 31, 2002, are accounted for in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The Company provides for closed store liabilities relating to the present value of the estimated remaining noncancellable lease payments after the closing date, net of estimated subtenant income. The Company estimates the net lease liabilities using a discount rate to calculate the present value of the remaining net rent payments on closed stores. The closed store lease liabilities usually are paid over the lease terms associated with the closed stores, which generally have remaining terms ranging from one to 20 years. Adjustments to closed store liabilities primarily relate to changes in subtenant income and lease buyouts. Adjustments are made for changes in estimates in the period in which the change becomes known. Store closing liabilities are reviewed quarterly to ensure that any accrued amount that is not a sufficient estimate of future costs, or that no longer is needed for its originally intended purpose, is adjusted to income in the proper period.

Owned stores held for disposal are reduced to their estimated net realizable value. Costs to reduce the carrying values of property, equipment and leasehold improvements are accounted for in accordance with the Company's policy on impairment of long-lived assets. Inventory write-downs, if any, in connection with store closings, are classified in "Merchandise costs." Costs to transfer inventory and equipment from closed stores are expensed as incurred.

The following table summarizes accrual activity for future lease obligations of stores closed in the normal course of business.

	Future Lease Obligations	
	2007	**2006**
Balance at beginning of year	$ 33	$ 65
Additions	2	—
Payments	(4)	(2)
Adjustments	(1)	—
Balance at end of first quarter	$ 30	$ 63

In addition, the Company maintains a $47 liability for facility closure costs for locations closed in California prior to the Fred Meyer merger in 1999 and an $8 liability for store closing costs related to two distinct, formalized plans that coordinated the closing of several locations over relatively short periods of time in 2000 and 2001.

2. DEBT OBLIGATIONS

Long-term debt consists of:

	May 26, 2007	**February 3, 2007**
Credit Facility and Commercial Paper borrowings	$ 110	$ 352
4.95% to 9.20% Senior Notes and Debentures due through 2031	5,716	5,916
5.00% to 9.95% mortgages due in varying amounts through 2034	163	169
Other	145	144

Total debt, excluding capital leases and financing obligations	6,134	6,581
Less current portion	(1,387)	(878)
Total long-term debt, excluding capital leases and financing obligations	$ 4,747	$ 5,703

3. COMPREHENSIVE INCOME

Comprehensive income is as follows:

	First Quarter Ended May 26, 2007	First Quarter Ended May 20, 2006
Net earnings	$ 337	$ 306
Unrealized gain on hedging activities, net of tax[1]	4	18
Amortization of amounts included in net periodic pension expense[2]	7	—
Other	1	—
Comprehensive income	$ 349	$ 324

(1) Amount is net of tax of $2 for the first quarter of 2007 and $11 for the first quarter of 2006.

(2) Amount is net of tax of $5 for the first quarter of 2007

During 2007 and 2006, other comprehensive income consisted of reclassifications of unrealized gains on cash flow hedges into net earnings as well as market value adjustments to reflect cash flow hedges at fair value as of the respective balance sheet dates.

4. BENEFIT PLANS

The following table provides the components of net periodic benefit costs for the Company-sponsored pension plans and other post-retirement benefits for the first quarter of 2007 and 2006.

	First Quarter			
	Pension Benefits		Other Benefits	
	2007	2006	2007	2006
Components of net periodic benefit cost:				
Service cost	$ 13	$ 41	$ 5	$ 4
Interest cost	45	41	6	6
Expected return on plan assets	(51)	(47)	—	—
Amortization of:				
Prior service cost	1	2	(2)	(2)
Actuarial (gain) loss	11	12	—	—
Net periodic benefit cost	$ 19	$ 49	$ 9	$ 8

Net periodic benefit cost decreased in the first quarter of 2007 compared to the first quarter of 2006 due to participants in the cash balance formula of the consolidated retirement benefit plan being moved to a 401(k) retirement savings account plan effective January 1, 2007. The 401(k) retirement savings account plan will provide both Company matching contributions and other Company contributions based upon length of service, to eligible employees.

The Company contributed $50 and $150 to Company-sponsored pension plans in the first quarter of 2007 and 2006, respectively.

The Company also contributes to various multi-employer pension plans based on obligations arising from most of its collective bargaining agreements. These plans provide retirement benefits to participants based on their service to contributing employers. The Company recognizes expense in connection with these plans as contributions are funded, in accordance with SFAS No. 87, *Employers Accounting for Pensions.*

5. INCOME TAXES

Effective February 4, 2007, the Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN No. 48), which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The effect of adoption was to increase retained earnings by $4 and to decrease our accrual for uncertain tax positions by a corresponding amount. Additionally, we decreased goodwill and accrual for uncertain tax positions by $72 to reflect the measurement under the rules of FIN No. 48 of an uncertain tax position related to previous business combinations.

As of adoption, the total amount of unrecognized tax benefits for uncertain tax positions, including positions affecting only the timing of tax benefits, was $694. The amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was $119.

To the extent interest and penalties would be assessed by taxing authorities on any underpayment of income tax, such amounts have been accrued and classified as a component of income tax expense in our Condensed Consolidated Statements of Operations. This accounting policy election is a continuation of the Companys historical policy. As of February 4, 2007, the amount of accrued interest and penalties included on the Condensed Consolidated Balance Sheets was $118.

The Internal Revenue Service (IRS) is currently conducting a field examination of our 2002 2004 U.S. tax returns. The examination is scheduled to be completed in late 2007. An examination of our 1999 2001 U.S. tax returns was completed in 2005. The Company currently is contesting two issues at the appellate level of the IRS. We anticipate that these matters may be resolved within the next 12 months. In the opinion of management, the ultimate disposition of the items noted above will not have a significant effect on our consolidated financial position, liquidity, or results of operations. Additionally, the Company has a case in the U.S. Tax Court. A decision on this case is not expected within the next 12 months. In connection with this case, the Company has extended the statute of limitations on its tax years after 1991.

As of May 26, 2007, there have been no material changes to the disclosures noted above.

The effective income tax rate was 38.1% for the first quarter of 2007 and 37.4% for the first quarter of 2006. The 2007 and 2006 effective income tax rates both differed from the federal statutory rate primarily due to the effect of state taxes.

6. EARNINGS PER COMMON SHARE

Earnings per basic common share equals net earnings divided by the weighted average number of common shares outstanding. Earnings per diluted common share equals net earnings divided by the weighted average number of common shares outstanding, after giving effect to dilutive stock options, restricted stock and warrants.

The following tables provide a reconciliation of net earnings and shares used in calculating earnings per basic common share to those used in calculating earnings per diluted common share:

	First Quarter Ended May 26, 2007			First Quarter End May 20, 2006	
	Earnings (Numerator)	Shares (Denominator)	Per Share Amount	Earnings (Numerator)	Shares (Denominator
Earnings per basic common share	$ 337	706	$ 0.48	$ 306	72
Dilutive effect of stock options, restricted stock and warrants		9			
Earnings per diluted common share	$ 337	715	$ 0.47	$ 306	72

The Company had options outstanding for approximately 33 shares during the first quarter of 2006, that were excluded from the computations of earnings per diluted common share because their inclusion would have had an anti-dilutive effect on earnings per share. At the end of the first quarter of 2007, the Company did not have a material amount of options excluded from the computation of earnings per diluted common share.

7. RECENTLY ISSUED ACCOUNTING STANDARDS

In September 2006, the FASB issued SFAS No. 157, *Fair Value*