KROGER CO
Form 10-Q
December 14, 2006

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 November 4, 2006**
	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

THE KROGER CO.
(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 707,962,629 shares of Common Stock ($1 par value) outstanding as of December 8, 2006.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	Third Quarter Ended		Three Quarters Ended	
	November 4, 2006	November 5, 2005	November 4, 2006	November 5, 2005
Sales	$ 14,699	$ 14,020	$ 49,252	$ 45,833
Merchandise costs, including advertising, warehousing, and transportation, excluding items shown separately below	11,131	10,596	37,387	34,503
Operating, general and administrative	2,685	2,556	8,862	8,380
Rent	139	166	488	514
Depreciation and amortization	295	287	973	969
Operating profit	449	415	1,542	1,467
Interest expense	107	114	372	394
Earnings before income tax expense	342	301	1,170	1,073
Income tax expense	127	116	440	397
Net earnings	$ 215	$ 185	$ 730	$ 676
Net earnings per basic common share	$ 0.30	$ 0.26	$ 1.02	$ 0.93
Average number of common shares used in basic calculation	712	724	718	725
Net earnings per diluted share	$ 0.30	$ 0.25	$ 1.01	$ 0.92
Average number of common shares used in diluted calculation	720	732	725	731

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)

	November 4, 2006	January 28, 2006
ASSETS		
Current assets		
Cash - In stores	$ 141	$ 147

Cash - Temporary cash investments	—	63
Total cash	141	210
Deposits in-transit	596	488
Receivables	718	686
FIFO inventory	5,421	4,886
LIFO credit	(453)	(400
Prefunded employee benefits	—	300
Prepaid and other current assets	250	296
Total current assets	6,673	6,466
Property, plant and equipment, net	11,553	11,365
Goodwill	2,192	2,192
Other assets	503	459
Total Assets	$ 20,921	$ 20,482
LIABILITIES		
Current liabilities		
Current portion of long-term debt including obligations under capital leases and financing obligations	$ 814	$ 554
Accounts payable	3,847	3,550
Accrued salaries and wages	705	780
Deferred income taxes	217	217
Other current liabilities	2,006	1,614
Total current liabilities	7,589	6,715
Long-term debt including obligations under capital leases and financing obligations		
Face-value long-term debt including obligations under capital leases and financing obligations	6,127	6,651
Adjustment to reflect fair-value interest rate hedges	20	27
Long-term debt including obligations under capital leases and financing obligations	6,147	6,678
Deferred income taxes	778	843
Other long-term liabilities	1,796	1,856
Total Liabilities	16,310	16,092
Commitments and contingencies		
SHAREOWNERS' EQUITY		
Preferred stock, $100 par, 5 shares authorized and unissued	—	—
Common stock, $1 par, 1,000 shares authorized; 934 shares issued in 2006 and 927 shares issued in 2005	934	927
Additional paid-in capital	2,658	2,536
Accumulated other comprehensive loss	(238)	(243
Accumulated earnings	5,162	4,573
Common stock in treasury, at cost, 227 shares in 2006 and 204 shares in 2005	(3,905)	(3,403
Total Shareowners' Equity	4,611	4,390

Total Liabilities and Shareowners' Equity	$ 20,921	$ 20,482

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

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

	Three Quarters Ended	
	November 4, 2006	Novembe 5, 2005
Cash Flows from Operating Activities		
Net earnings	$ 730	$ 676
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	973	969
LIFO charge	53	27
Stock option expense	55	6
Pension expense for Company-sponsored plans	131	109
Deferred income taxes	(91)	(62)
Other	(1)	35
Changes in operating assets and liabilities net of effects from acquisitions of businesses		
Store deposits in-transit	(108)	(56)
Receivables	(38)	(3)
Inventories	(535)	(457)
Prepaid expenses	277	321
Accounts payable	332	344
Accrued expenses	51	116
Income taxes receivable (payable)	188	346
Contribution to Company-sponsored pension plans	(150)	(300)
Other	(36)	(22)
Net cash provided by operating activities	1,831	2,049
Cash Flows from Investing Activities		
Payments for property and equipment	(1,178)	(1,011)
Proceeds from sale of assets	126	61
Other	(40)	(22)
Net cash used by investing activities	(1,092)	(972)
Cash Flows from Financing Activities		
Dividends paid	(94)	—
Proceeds from issuance of long-term debt	—	13
Proceeds from lease-financing transactions	15	—
Payments on long-term debt	(543)	(61)
Borrowings (payments) on bank revolver	265	(629)
Proceeds from issuance of capital stock	89	76
Treasury stock purchases	(527)	(202)
Decrease in book overdrafts	(35)	(181)
Other	22	—

Net cash used by financing activities		(808)		(984)
Net increase (decrease) in total cash		(69)		93
Total cash:				
Beginning of year		210		144
End of quarter	$	141	$	237
Reconciliation of capital expenditures				
Payments for property and equipment	$	(1,178)	$	(1,011)
Changes in construction-in-progress payables		(48)		2
Total capital expenditures	$	(1,226)	$	(1,009)
Supplemental cash flow information				
Cash paid during the year for interest	$	412	$	442
Cash paid during the year for income taxes	$	292	$	112

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

All amounts 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 January 28, 2006 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 fiscal 2005 Annual Report on Form 10-K of The Kroger Co. filed with the SEC on April 7, 2006.

The unaudited information in the Consolidated Financial Statements for the third quarter and three quarters ended November 4, 2006 and November 5, 2005 includes the results of operations of the Company for the 12-week and 40-week periods then ended.

Stock-Based Compensation Expense

Effective January 29, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, using the modified prospective transition method and, therefore, has not restated results for prior periods. Under this method, the Company recognizes compensation expense for all share-based payments granted after January 29, 2006, as well as all share-based payments granted prior to, but not yet vested as of, January 29, 2006, in accordance with SFAS No.

123(R). Under the fair value recognition provisions of SFAS No. 123(R), the Company recognizes share-based compensation expense, net of an estimated forfeiture rate, over the requisite service period of the award. Prior to the adoption of SFAS No. 123(R), the Company accounted for share-based payments under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and the disclosure provisions of SFAS No. 123. For further information regarding the adoption of SFAS No. 123(R), see Note 2 to the Consolidated Financial Statements.

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 up 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	
	2006	**2005**
Balance at beginning of year	$ 65	$ 65
Additions	7	19
Payments	(6)	(11)
Adjustments	(22)	(4)
Balance at end of third quarter	$ 44	$ 69

The Company recorded asset impairments in the normal course of business totaling $6 in the third quarter of 2006 and $10 in the third quarter of 2005. During the first three quarters of 2006 and 2005, the Company recorded asset impairments in the normal course of business totaling $44 and $38, respectively.

In addition, the Company maintains a $48 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. STOCK OPTION PLANS

Prior to January 29, 2006, the Company applied Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB No. 25) and related interpretations, in accounting for its stock option plans and provided the required pro-forma disclosures of SFAS No. 123. APB No. 25 provided for recognition of compensation expense for employee stock awards based on the intrinsic value of the award on the grant date.

The Company grants options for common stock (stock options) to employees, as well as to its non-employee directors, under various plans at an option price equal to the fair market value of the stock at the date of grant. Although equity awards may be made throughout the year, it has been the Companys practice typically to make an annual grant in conjunction with the May meeting of its Board of Directors.

Stock options typically expire 10 years from the date of grant. Stock options vest in one year to five years from the date of grant or, for certain stock options, the earlier of the Companys stock reaching certain pre-determined and appreciated market prices or nine years and six months from the date of grant. Under APB No. 25, the Company did not recognize compensation expense for these stock option grants. At November 4, 2006, approximately 18 shares of common stock were available for future options under these plans.

In addition to the stock options described above, the Company awards restricted stock to employees under various plans. The restrictions on these awards generally lapse in one year to five years from the date of the awards and expense is recognized over the lapsing cycle. Under APB No. 25, the Company generally recorded expense for restricted stock awards in an amount equal to the fair market value of the underlying stock on the date of award. As of November 4, 2006, approximately six shares of common stock were available for future restricted stock awards under the 2005 Long-Term Incentive Plan (the Plan). The Company has the ability to convert shares available for issuance under the Plan to shares available for restricted stock awards. Four shares available for other awards can be converted into one share available for restricted stock awards.

All awards become immediately exercisable upon certain changes of control of the Company.

Historically, stock option awards were granted to various employees throughout the organization. Restricted stock awards, however, were limited to approximately 150 associates, including members of the Board of Directors and certain members of senior management. Beginning in 2006, the Company began issuing a combination of stock option and restricted stock awards to those employees who previously received only stock option awards, in an effort to further align those employees interests with those of the Companys non-employee shareholders. As a result, the number of stock option awards granted in 2006 decreased and the number of restricted stock awards granted increased.

Changes in options outstanding under the stock option plans are summarized below.

Stock Options

	Shares subject to option	**Weighted-average exercise price**
Outstanding, January 28, 2006	59.3	$ 19.03
Granted	3.2	$ 19.99
Exercised	(7.2)	$ 12.75
Canceled or Expired	(1.0)	$ 21.02
Outstanding, November 4, 2006	54.3	$ 19.88

A summary of stock options outstanding and exercisable at November 4, 2006 follows:

	Options Outstanding			**Options Exercisable**	
Range of exercise prices	**Number outstanding**	**Weighted-average remaining contractual life (in years)**	**Weighted-average exercise price**	**Options exercisable**	**Weighted-average exercise price**
$7.94 -$14.93	9.5	4.26	$ 14.23	7.9	$ 14.10

$14.94 - $16.39	6.2	8.41	$ 16.35	2.2	$ 16.31
$16.40 - $17.31	10.7	5.55	$ 16.96	7.4	$ 16.90
$17.32 - $22.99	9.5	4.42	$ 20.95	5.2	$ 21.38
$23.00 - $31.91	18.4	4.00	$ 25.13	15.2	$ 25.18
$7.94 - $31.91	54.3	4.93	$ 19.88	37.9	$ 20.22

The weighted-average remaining contractual life for options exercisable at November 4, 2006 was approximately 4.2 years.

Restricted Stock

	Restricted shares outstanding	Weighted-average grant-date fair value
Outstanding, January 28, 2006	0.7	$ 17.85
Granted	2.2	$ 20.06
Lapsed	(0.3)	$ 17.25
Canceled or Expired	(0.1)	$ 19.31
Outstanding, November 4, 2006	2.5	$ 19.86

Adoption of SFAS No. 123(R)

Effective January 29, 2006, the Company adopted the provisions of SFAS No. 123(R), *Share-Based Payment*, using the modified-prospective transition method. Under this method, the Company recognizes compensation expense for all share-based awards granted prior to, but not yet vested as of, January 29, 2006 based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. For all share-based awards granted on or after January 29, 2006, the Company recognizes compensation expense based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R).

In accordance with the provisions of the modified-prospective transition method, results for prior periods have not been restated. Compensation expense for all share-based awards described above was recognized using the straight-line attribution method applied to the fair value of each option grant, over the requisite service period associated with each award. The requisite service period is typically consistent with the vesting period, except as noted below. Because awards typically vest evenly over the requisite service period, compensation cost recognized through November 4, 2006 is at least equal to the grant-date fair value of the vested portion of all outstanding options. All of the Company's stock-based incentive plans are considered equity plans under SFAS No. 123(R).

The weighted-average fair value of stock options granted during the first three quarters ended November 4, 2006 and November 5, 2005, was $6.90 and $7.70, respectively. The