

HERSHEY CO  
Form 10-Q  
November 07, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended **September 30, 2007**

OR

- 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 1-183

**THE HERSHEY COMPANY**

100 Crystal A Drive  
Hershey, PA 17033

Registrant's telephone number: **717-534-4200**

State of Incorporation  
**Delaware**

IRS Employer Identification No.  
**23-0691590**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, \$1 par value – 166,238,647 shares, as of October 19, 2007. Class B Common Stock, \$1 par value – 60,811,010 shares, as of October 19, 2007.

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**THE HERSHEY COMPANY****INDEX**

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**PART I - FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements (Unaudited)**

**THE HERSHEY COMPANY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(in thousands except per share amounts)

|  | <b>For the Three Months Ended</b> |                   |
|--|-----------------------------------|-------------------|
|  | <b>September 30,</b>              | <b>October 1,</b> |
|  | <b>2007</b>                       | <b>2006</b>       |
| <b>Net Sales</b>   | \$ 1,399,469                      | \$ 1,416,202      |
| <b>Costs and Expenses:</b>                                       |                                   |                   |
| Cost of sales  | 928,846                           | 870,733           |
| Selling, marketing and administrative                            | 229,809                           | 221,842           |
| Business realignment charge, net                                 | 112,043                           | 1,568             |
| <b>Total costs and expenses</b>                                  | <b>1,270,698</b>                  | <b>1,094,143</b>  |
| <b>Income before Interest and Income Taxes</b>                   | <b>128,771</b>                    | <b>322,059</b>    |
| Interest expense, net  | 33,055                            | 31,835            |
| <b>Income before Income Taxes</b>                                | <b>95,716</b>                     | <b>290,224</b>    |
| Provision for income taxes                                       | 32,932                            | 105,103           |
| <b>Net Income</b>  | <b>\$ 62,784</b>                  | <b>\$ 185,121</b> |
| <b>Earnings Per Share - Basic - Class B Common Stock</b>         | <b>\$ .26</b>                     | <b>\$ .73</b>     |
| <b>Earnings Per Share - Diluted - Class B Common Stock</b>       | <b>\$ .26</b>                     | <b>\$ .72</b>     |
| <b>Earnings Per Share - Basic - Common Stock</b>                 | <b>\$ .28</b>                     | <b>\$ .81</b>     |
| <b>Earnings Per Share - Diluted - Common Stock</b>               | <b>\$ .27</b>                     | <b>\$ .78</b>     |
| <b>Average Shares Outstanding - Basic - Common Stock</b>         | <b>167,165</b>                    | <b>173,232</b>    |
| <b>Average Shares Outstanding - Basic - Class B Common Stock</b> | <b>60,812</b>                     | <b>60,816</b>     |
| <b>Average Shares Outstanding - Diluted</b>                      | <b>230,388</b>                    | <b>237,681</b>    |
| <b>Cash Dividends Paid per Share:</b>                            |                                   |                   |
| Common Stock   | \$ .2975                          | \$ .2700          |
| Class B Common Stock   | \$ .2678                          | \$ .2425          |

The accompanying notes are an integral part of these consolidated financial statements.  
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**THE HERSHEY COMPANY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(in thousands except per share amounts)

|  | <b>For the Nine Months Ended</b> |                            |
|--|----------------------------------|----------------------------|
|  | <b>September 30,<br/>2007</b>    | <b>October 1,<br/>2006</b> |
| <b>Net Sales</b>   | \$ 3,604,494                     | \$ 3,607,621               |
| <b>Costs and Expenses:</b>                                       |                                  |                            |
| Cost of sales  | 2,390,402                        | 2,222,175                  |
| Selling, marketing and administrative                            | 663,112                          | 660,114                    |
| Business realignment charge, net                                 | 219,316                          | 9,139                      |
| Total costs and expenses   | 3,272,830                        | 2,891,428                  |
| <b>Income before Interest and Income Taxes</b>                   | 331,664                          | 716,193                    |
| Interest expense, net  | 90,523                           | 84,528                     |
| <b>Income before Income Taxes</b>                                | 241,141                          | 631,665                    |
| Provision for income taxes                                       | 81,330                           | 226,176                    |
| <b>Net Income</b>  | \$ 159,811                       | \$ 405,489                 |
| <b>Earnings Per Share - Basic - Class B Common Stock</b>         | \$ .65                           | \$ 1.58                    |
| <b>Earnings Per Share - Diluted - Class B Common Stock</b>       | \$ .65                           | \$ 1.57                    |
| <b>Earnings Per Share - Basic - Common Stock</b>                 | \$ .72                           | \$ 1.76                    |
| <b>Earnings Per Share - Diluted - Common Stock</b>               | \$ .69                           | \$ 1.69                    |
| <b>Average Shares Outstanding - Basic - Common Stock</b>         | 168,444                          | 175,977                    |
| <b>Average Shares Outstanding - Basic - Class B Common Stock</b> | 60,814                           | 60,817                     |
| <b>Average Shares Outstanding - Diluted</b>                      | 232,026                          | 240,326                    |
| <b>Cash Dividends Paid per Share:</b>                            |                                  |                            |
| Common Stock   | \$ .8375                         | \$ .7600                   |
| Class B Common Stock   | \$ .7528                         | \$ .6825                   |

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





**THE HERSHEY COMPANY**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands of dollars)

| ASSETS   | September 30,<br>2007 | December 31,<br>2006 |
|--|-----------------------|----------------------|
| <b>Current Assets:</b>   |                       |                      |
| Cash and cash equivalents  | \$ 41,573             | \$ 97,141            |
| Accounts receivable - trade  | 638,312               | 522,673              |
| Inventories  | 775,380               | 648,820              |
| Deferred income taxes  | 58,067                | 61,360               |
| Prepaid expenses and other   | 145,433               | 87,818               |
| Total current assets   | 1,658,765             | 1,417,812            |
| <b>Property, Plant and Equipment, at cost</b>  | <b>3,698,313</b>      | <b>3,597,756</b>     |
| Less-accumulated depreciation and amortization                                       | (2,147,961)           | (1,946,456)          |
| Net property, plant and equipment  | 1,550,352             | 1,651,300            |
| <b>Goodwill</b>  | <b>601,017</b>        | <b>501,955</b>       |
| <b>Other Intangibles</b>   | <b>150,136</b>        | <b>140,314</b>       |
| <b>Other Assets</b>  | <b>495,307</b>        | <b>446,184</b>       |
| Total assets   | \$ 4,455,577          | \$ 4,157,565         |
| <b>LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS' EQUITY</b>                       |                       |                      |
| <b>Current Liabilities:</b>  |                       |                      |
| Accounts payable   | \$ 252,276            | \$ 155,517           |
| Accrued liabilities  | 482,215               | 454,023              |
| Accrued income taxes   | 5,041                 | —                    |
| Short-term debt  | 1,086,098             | 655,233              |
| Current portion of long-term debt  | 15,008                | 188,765              |
| Total current liabilities  | 1,840,638             | 1,453,538            |
| <b>Long-term Debt</b>  | <b>1,271,658</b>      | <b>1,248,128</b>     |
| <b>Other Long-term Liabilities</b>   | <b>616,103</b>        | <b>486,473</b>       |
| <b>Deferred Income Taxes</b>   | <b>171,545</b>        | <b>286,003</b>       |
| Total liabilities  | 3,899,944             | 3,474,142            |
| <b>Minority Interest</b>   | <b>16,284</b>         | <b>—</b>             |
| <b>Stockholders' Equity:</b>   |                       |                      |
| Preferred Stock, shares issued:<br>none in 2007 and 2006                             | —                     | —                    |
| Common Stock, shares issued: 299,090,734 in 2007 and<br>299,085,666 in 2006          | 299,090               | 299,085              |
| Class B Common Stock, shares issued: 60,811,010 in 2007 and<br>60,816,078 in 2006    | 60,811                | 60,816               |
| Additional paid-in capital   | 330,887               | 298,243              |
| Retained earnings  | 3,938,695             | 3,965,415            |
| Treasury-Common Stock shares at cost:<br>132,875,127 in 2007 and 129,638,183 in 2006 | (4,000,719)           | (3,801,947)          |
| Accumulated other comprehensive loss   | (89,415)              | (138,189)            |

|  |    |           |    |           |
|--|----|-----------|----|-----------|
| Total stockholders' equity                                     |    | 539,349   |    | 683,423   |
| Total liabilities, minority interest, and stockholders' equity | \$ | 4,455,577 | \$ | 4,157,565 |

The accompanying notes are an integral part of these consolidated balance sheets.

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**THE HERSHEY COMPANY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands of dollars)

|   | <b>For the Nine Months Ended</b> |                            |
|---|----------------------------------|----------------------------|
|   | <b>September 30,<br/>2007</b>    | <b>October 1,<br/>2006</b> |
| <b>Cash Flows Provided from (Used by) Operating Activities</b>                      |                                  |                            |
| Net Income  | \$ 159,811                       | \$ 405,489                 |
| Adjustments to Reconcile Net Income to Net Cash                                     |                                  |                            |
| Provided from Operations:   |                                  |                            |
| Depreciation and amortization   | 227,776                          | 148,726                    |
| Stock-based compensation expense, net of tax of \$7,181 and \$14,596, respectively  | 12,822                           | 26,174                     |
| Excess tax benefits from exercise of stock options                                  | (9,804)                          | (5,315)                    |
| Deferred income taxes   | 65,234                           | 19,765                     |
| Business realignment initiatives, net of tax of \$118,786 and \$1,910, respectively | 197,876                          | 4,137                      |
| Contributions to pension plans  | (9,285)                          | (18,217)                   |
| Changes in assets and liabilities, net of effects from business acquisitions:       |                                  |                            |
| Accounts receivable - trade   | (110,415)                        | (173,436)                  |
| Inventories   | (128,561)                        | (154,013)                  |
| Accounts payable  | 91,221                           | (3,853)                    |
| Other assets and liabilities  | (181,391)                        | (23,104)                   |
| Net Cash Flows Provided from Operating Activities                                   | 315,284                          | 226,353                    |
| <b>Cash Flows Provided from (Used by) Investing Activities</b>                      |                                  |                            |
| Capital additions   | (118,204)                        | (119,357)                  |
| Capitalized software additions  | (9,526)                          | (10,580)                   |
| Business acquisitions   | (97,030)                         | —                          |
| Net Cash Flows (Used by) Investing Activities                                       | (224,760)                        | (129,937)                  |
| <b>Cash Flows Provided from (Used by) Financing Activities</b>                      |                                  |                            |
| Net increase in short-term debt   | 424,067                          | 20,970                     |
| Long-term borrowings  | —                                | 496,728                    |
| Repayment of long-term debt   | (188,852)                        | (176)                      |
| Cash dividends paid   | (186,531)                        | (174,446)                  |
| Exercise of stock options   | 43,878                           | 26,123                     |
| Excess tax benefits from exercise of stock options                                  | 9,804                            | 5,315                      |
| Repurchase of Common Stock  | (248,458)                        | (490,478)                  |
| Net Cash Flows (Used by) Financing Activities                                       | (146,092)                        | (115,964)                  |
| Decrease in Cash and Cash Equivalents   | (55,568)                         | (19,548)                   |
| Cash and Cash Equivalents, beginning of period                                      | 97,141                           | 67,183                     |
| Cash and Cash Equivalents, end of period  | \$ 41,573                        | \$ 47,635                  |
| Interest Paid   | \$ 115,974                       | \$ 96,676                  |

|                   |    |         |    |         |
|-------------------|----|---------|----|---------|
| Income Taxes Paid | \$ | 145,230 | \$ | 211,997 |
|-------------------|----|---------|----|---------|

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

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**THE HERSHEY COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. BASIS OF PRESENTATION**

Our unaudited consolidated financial statements provided in this report include the accounts of the Company and our majority-owned subsidiaries and entities in which we have a controlling financial interest after the elimination of intercompany accounts and transactions. We prepared these statements in accordance with the instructions to Form 10-Q. These statements do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements.

We included all adjustments (consisting only of normal recurring accruals) which we believe were considered necessary for a fair presentation. We reclassified certain prior year amounts to conform to the 2007 presentation. Operating results for the nine months ended September 30, 2007 may not be indicative of the results that may be expected for the year ending December 31, 2007, because of the seasonal effects of our business.

**Items Affecting Comparability**

Securities and Exchange Commission Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Misstatements When Quantifying Misstatements in Current Year Financial Statements* (“SAB No. 108”), required companies to change the accounting principle used for evaluating the effect of possible prior year misstatements when quantifying misstatements in current year financial statements. As a result, at December 31, 2006, we changed one of the five criteria of our revenue recognition policy, resulting in a delay in the recognition of revenue on goods in-transit until they are received by our customers. As permitted by SAB No. 108, we adjusted our financial statements for the three-month and nine-month periods ended October 1, 2006 to provide comparability. These adjustments were not material to our results of operations for those periods. For more information, refer to the consolidated financial statements and notes included in our 2006 Annual Report on Form 10-K.

**2. BUSINESS ACQUISITIONS**

In May 2007, we entered into an agreement with Godrej Beverages and Foods, Ltd., one of India’s largest consumer goods, confectionery and food companies, to manufacture and distribute confectionery products, snacks and beverages across India. Under the agreement, we invested \$58.7 million during the second quarter and own a 51% controlling interest. Total liabilities assumed were \$60.7 million. Effective in May 2007, this business acquisition was included in our consolidated results, including the related minority interest.

Also in May 2007, our Company and Lotte Confectionery Co., LTD., entered into a manufacturing agreement in China that will produce Hershey products and certain Lotte products for the market in China. We invested \$18.3 million in the second quarter and \$20.0 million in the third quarter of 2007 and own a 44% interest. We are accounting for this investment using the equity method.

### 3. STOCK COMPENSATION PLANS

At our annual meeting of stockholders, held April 17, 2007, stockholders approved The Hershey Company Equity and Incentive Compensation Plan (“EICP”). The EICP is an amendment and restatement of our former Key Employee Incentive Plan, a share-based employee incentive compensation plan, and is also a continuation of our Broad Based Stock Option Plan, Broad Based Annual Incentive Plan and Directors’ Compensation Plan. Following its adoption on April 17, 2007, the EICP became the single plan under which grants using shares for compensation and incentive purposes will be made. The following table summarizes our stock compensation costs:

|   | For the Three Months Ended |                    | For the Nine Months Ended |                    |
|---|----------------------------|--------------------|---------------------------|--------------------|
|   | September<br>30, 2007      | October<br>1, 2006 | September<br>30, 2007     | October<br>1, 2006 |
|   | (in millions of dollars)   |                    |                           |                    |
| Total compensation amount charged against income for stock compensation plans, including stock options, performance stock units (“PSUs”) and restricted stock units | \$ 7.6                     | \$12.3             | \$ 20.0                   | \$ 41.8            |
| Total income tax benefit recognized in Consolidated Statements of Income for share-based compensation   | \$ 2.8                     | \$ 4.5             | \$ 7.2                    | \$ 15.0            |

The decrease in share-based compensation expense from 2006 to 2007 was primarily associated with lower performance expectations for PSUs and the timing of stock option grants in 2007. Our annual grant of stock options to management level employees, which customarily has occurred in February of each year, was delayed in 2007 pending approval by our stockholders of the EICP at the annual meeting in April 2007. In 2008, we intend to resume our customary February grant schedule.

We estimated the fair value of each stock option grant on the date of the grant using a Black-Scholes option-pricing model and the weighted-average assumptions set forth in the following table:

|                          | For the Nine Months Ended |                    |
|--------------------------|---------------------------|--------------------|
|                          | September<br>30,<br>2007  | October 1,<br>2006 |
| Dividend yields          | 2.0%                      | 1.6%               |
| Expected volatility      | 19.5%                     | 23.7%              |
| Risk-free interest rates | 4.6%                      | 4.6%               |
| Expected lives in years  | 6.6                       | 6.6                |

#### Stock Options

A summary of the status of our stock options as of September 30, 2007, and the change during 2007 is presented below:

| Stock Options | For the Nine Months Ended September 30, 2007 |           |                  |
|---------------|--|-----------|------------------|
|               | Shares                                       | Weighted- | Weighted-Average |

|   |             | <b>Average<br/>Exercise Price</b> | <b>Remaining<br/>Contractual Term</b> |
|---|-------------|-----------------------------------|---------------------------------------|
| Outstanding at beginning of the period          | 13,855,113  | \$40.29                           | 6.3 years                             |
| Granted   | 2,115,225   | \$54.27                           |                                       |
| Exercised                                       | (1,473,627) | \$29.81                           |                                       |
| Forfeited                                       | (288,902)   | \$54.52                           |                                       |
| Outstanding as of September 30, 2007            | 14,207,809  | \$43.17                           | 6.4 years                             |
| Options exercisable as of September 30,<br>2007 | 8,487,112   | \$37.24                           | 5.1 years                             |

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|   | <b>For the Nine Months Ended</b> |                            |
|---|----------------------------------|----------------------------|
|   | <b>September 30,<br/>2007</b>    | <b>October 1,<br/>2006</b> |
| Weighted-average fair value of options granted (per share)    | \$ 12.94                         | \$ 15.07                   |
| Intrinsic value of options exercised (in millions of dollars) | \$ 32.2                          | \$ 20.9                    |

As of September 30, 2007, the aggregate intrinsic value of options outstanding was \$99.6 million and the aggregate intrinsic value of options exercisable was \$95.5 million.

As of September 30, 2007, there was \$45.0 million of total unrecognized compensation cost related to non-vested stock option compensation arrangements granted under our stock option plans. That cost is expected to be recognized over a weighted-average period of 2.6 years.

### Performance Stock Units and Restricted Stock Units

A summary of the status of our performance stock units and restricted stock units as of September 30, 2007, and the change during 2007 is presented below:

| <b>Performance Stock Units and Restricted Stock Units</b> | <b>For the Nine<br/>Months<br/>Ended<br/>September<br/>30, 2007</b> | <b>Weighted-average grant<br/>date<br/>fair value for equity<br/>awards or<br/>market value for liability<br/>awards</b> |
|---|---|--|
| Outstanding at beginning of year                          | 1,075,748   | \$44.89  |
| Granted   | 315,899   | \$51.04  |
| Performance assumption change                             | (235,108)   | \$51.16  |
| Vested  | (432,457)   | \$47.06  |
| Forfeited   | (54,358)  | \$50.21  |
| Outstanding as of September 30, 2007                      | 669,724   | \$39.99  |

As of September 30, 2007, there was \$10.5 million of unrecognized compensation cost relating to non-vested performance stock units and restricted stock units. We expect to recognize that cost over a weighted-average period of 2.6 years.

|   | <b>For the Nine Months Ended</b> |                            |
|---|----------------------------------|----------------------------|
|   | <b>September 30,<br/>2007</b>    | <b>October 1,<br/>2006</b> |
| Intrinsic value of share-based liabilities paid, combined with the fair value of shares vested (in millions of dollars) | \$ 21.8                          | \$ 4.2                     |

The lower amount in 2006 was primarily associated with the additional three-year vesting term for performance stock unit grants for the 2003-2005 performance cycle ("2003 grants") which reduced the number of shares that vested in 2006 compared with 2007. An additional three-year vesting term was imposed on the grant date for the 2003 grants with accelerated vesting for retirement, disability or death. The compensation cost based on grant date fair value for the 2003 grants is being recognized over a period from three to six years.

Deferred performance stock units, deferred restricted stock units, and directors' fees and accumulated dividend amounts representing deferred stock units totaled 728,776 units as of September 30, 2007. Each unit is equivalent to one share of the Company's Common Stock.



No stock appreciation rights were outstanding as of September 30, 2007.

For more information on our stock compensation plans, refer to the consolidated financial statements and notes included in our 2006 Annual Report on Form 10-K and our proxy statement for the 2007 annual meeting of stockholders.

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**4. INTEREST EXPENSE**

Net interest expense consisted of the following:

|                       | <b>For the Nine Months Ended</b> |                |
|-----------------------|----------------------------------|----------------|
|                       | <b>September</b>                 | <b>October</b> |
|                       | <b>30,</b>                       | <b>1,</b>      |
|                       | <b>2007</b>                      | <b>2006</b>    |
|                       | <b>(in thousands of dollars)</b> |                |
| Interest expense      | \$92,690                         | \$ 85,800      |
| Interest income       | (1,919)                          | (1,226)        |
| Capitalized interest  | (248)                            | (46)           |
| Interest expense, net | \$90,523                         | \$ 84,528      |

**5. BUSINESS REALIGNMENT INITIATIVES**

In February 2007, we announced a comprehensive, three-year supply chain transformation program (the “2007 business realignment initiatives”). When completed, this program will greatly enhance our manufacturing, sourcing and customer service capabilities, reduce inventories resulting in improvements in working capital and generate significant resources to invest in our growth initiatives. These initiatives include accelerated marketplace momentum within our core U.S. business, creation of innovative new product platforms to meet customer needs and disciplined global expansion. Under the program, which will be implemented in stages over three years, we will significantly increase manufacturing capacity utilization by reducing the number of production lines by more than one-third, outsource production of low value-added items and construct a flexible, cost-effective production facility in Monterrey, Mexico to meet current and emerging marketplace needs. The program will result in a total net reduction of 1,500 positions across our supply chain over the three-year implementation period.

The estimated pre-tax cost of the program is from \$525 million to \$575 million over the next three years. The total includes from \$475 million to \$525 million in business realignment costs and approximately \$50 million in project implementation costs. The costs will be incurred primarily in 2007 and 2008, with approximately \$380 million to \$400 million expected in 2007.

In July 2005, we announced initiatives intended to advance our value-enhancing strategy (the “2005 business realignment initiatives”). Charges for the 2005 business realignment initiatives were recorded during 2005 and 2006 and the 2005 business realignment initiatives were completed by December 31, 2006.

Charges (credits) associated with business realignment initiatives recorded during the three-month and nine-month periods ended September 30, 2007 and October 1, 2006 were as follows:

|   | For the Three Months Ended |                    | For the Nine Months Ended |                    |
|---|----------------------------|--------------------|---------------------------|--------------------|
|   | September<br>30,<br>2007   | October 1,<br>2006 | September<br>30,<br>2007  | October 1,<br>2006 |
|   | (in thousands of dollars)  |                    |                           |                    |
| Cost of sales   |                            |                    |                           |                    |
| 2007 business realignment initiatives                                 | \$ 37,452                  | \$ –               | \$ 88,618                 | \$ –               |
| 2005 business realignment initiatives                                 | –                          | –                  | –                         | (1,599)            |
| Previous business realignment initiatives                             | –                          | –                  | –                         | (1,600)            |
| Total cost of sales   | 37,452                     | –                  | 88,618                    | (3,199)            |
| Selling, marketing and administrative                                 |                            |                    |                           |                    |
| 2007 business realignment initiatives                                 | 2,395                      | –                  | 8,728                     | –                  |
| 2005 business realignment initiatives                                 | –                          | 108                | –                         | 108                |
| Total selling, marketing and administrative                           | 2,395                      | 108                | 8,728                     | 108                |
| Business realignment and<br>asset impairments, net                    |                            |                    |                           |                    |
| 2007 business realignment initiatives:                                |                            |                    |                           |                    |
| Fixed asset impairments and plant closure<br>expenses                 | 8,284                      | –                  | 48,382                    | –                  |
| Employee separation costs   | 103,759                    | –                  | 156,618                   | –                  |
| Contract termination costs  | –                          | –                  | 14,316                    | –                  |
| 2005 business realignment initiatives                                 | –                          | 1,568              | –                         | 8,626              |
| Previous business realignment initiatives                             | –                          | –                  | –                         | 513                |
| Total business realignment and asset<br>impairments, net              | 112,043                    | 1,568              | 219,316                   | 9,139              |
| Total net charges associated with business<br>realignment initiatives | \$ 151,890                 | \$ 1,676           | \$ 316,662                | \$ 6,048           |

The charge of \$37.5 million recorded in cost of sales during the third quarter of 2007 for the 2007 business realignment initiatives related to the accelerated depreciation of fixed assets over a reduced estimated remaining useful life and costs related to inventory reductions. The \$2.4 million recorded in selling, marketing and administrative expenses related primarily to project administration. In determining the costs related to fixed asset impairments, fair value was estimated based on the expected sales proceeds. Certain real estate with a carrying value of \$5.1 million was being held for sale as of September 30, 2007. The employee separation costs included \$35.7 million for involuntary terminations at six North American manufacturing facilities which are being closed. The facilities are located in Naugatuck, Connecticut; Reading, Pennsylvania; Oakdale, California; Smiths Falls, Ontario; Montreal, Quebec; and Dartmouth, Nova Scotia. The employee separation costs also included \$68.0 million for charges relating to pension and other post-retirement benefits curtailments and special termination benefits.

Charges (credits) associated with previous business realignment initiatives which began in 2003 and 2001 resulted from the finalization of the sale of certain properties, adjustments to liabilities which had previously been recorded, and the impact of the settlement as to several of the eight former employees who had filed a complaint alleging that the Company had discriminated against them on the basis of age in connection with the 2003 business realignment

initiatives. A settlement was reached with the remaining former employees in September 2007. The \$1.6 million charge associated with the 2005 business realignment initiatives was related primarily to the U.S. Voluntary Workforce Reduction Program (“VWRP”), in addition to costs for streamlining the Company’s international operations and facility rationalization relating to the closure of the Las Piedras, Puerto Rico plant. The business realignment charge included \$.7 million for involuntary terminations.

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The charge of \$88.6 million recorded in cost of sales during the first nine months of 2007 for the 2007 business realignment initiatives related to the accelerated depreciation of fixed assets over a reduced estimated remaining useful life and costs related to inventory reductions. The \$8.7 million recorded in selling, marketing and administrative expenses related primarily to project administration. In determining the costs related to fixed asset impairments, fair value was estimated based on the expected sales proceeds. The employee separation costs included \$59.3 million for involuntary terminations and \$97.2 million for charges relating to pension and other post-retirement benefits curtailments and special termination benefits.

A credit of \$1.6 million recorded in cost of sales for the 2005 business realignment initiatives related to higher than expected proceeds from the sale of equipment from the Las Piedras plant. The \$8.6 million charge associated with the 2005 business realignment initiatives related primarily to the U.S. VWRP, along with costs for streamlining the Company's international operations and facility rationalization relating to the closure of the Las Piedras plant. The business realignment charge included \$3.6 million for involuntary terminations. Charges (credits) associated with previous business realignment initiatives which began in 2003 and 2001 resulted from the finalization of the sale of certain properties, adjustments to liabilities which had previously been recorded, and the impact of the settlement as to several of the eight former employees who had filed a complaint alleging that the Company had discriminated against them on the basis of age in connection with the 2003 business realignment initiatives. A settlement was reached with the remaining former employees in September 2007.

The September 30, 2007 liability balance relating to the 2007 business realignment initiatives was \$57.3 million for employee separation costs. The September 30, 2007 liability balance relating to the 2005 business realignment initiatives was \$5.5 million. During the first nine months of 2007 we made payments against the liabilities recorded for the 2007 and 2005 business realignment initiatives of \$3.6 million and \$14.2 million, respectively. During the first nine months of 2006 we made total payments of \$24.7 million against the liabilities recorded for the 2005 business realignment initiatives.

## 6. EARNINGS PER SHARE

In accordance with Statement of Financial Accounting Standards No. 128, *Earnings Per Share*, we compute Basic and Diluted Earnings Per Share based on the weighted-average number of shares of the Common Stock and the Class B Common Stock outstanding as follows:

|  | For the Three Months Ended              |                    | For the Nine Months Ended |                    |
|--|---|--------------------|---------------------------|--------------------|
|  | September<br>30,<br>2007                | October 1,<br>2006 | September<br>30,<br>2007  | October 1,<br>2006 |
|  | (in thousands except per share amounts) |                    |                           |                    |
| Net income                               | \$ 62,784                               | \$ 185,121         | \$ 159,811                | \$ 405,489         |
| Weighted-average shares - Basic          |   |                    |                           |                    |
| Common Stock                             | 167,165                                 | 173,232            | 168,444                   | 175,977            |
| Class B Common Stock                     | 60,812                                  | 60,816             | 60,814                    | 60,817             |
| Total weighted-average shares -<br>Basic | 227,977                                 | 234,048            | 229,258                   | 236,794            |
| Effect of dilutive securities:           |   |                    |                           |                    |
| Employee stock options                   | 1,938                                   | 2,804              | 2,224                     | 2,833              |

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|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Performance and restricted stock units | 473     | 829     | 544     | 699     |
| Weighted-average shares - Diluted      | 230,388 | 237,681 | 232,026 | 240,326 |
| <b>Earnings Per Share - Basic</b>      |         |         |         |         |
| Class B Common Stock                   | \$ .26  | \$ .73  | \$ .65  | \$ 1.58 |
| Common Stock                           | \$ .28  | \$ .81  | \$ .72  | \$ 1.76 |
| <b>Earnings Per Share - Diluted</b>    |         |         |         |         |
| Class B Common Stock                   | \$ .26  | \$ .72  | \$ .65  | \$ 1.57 |
| Common Stock                           | \$ .27  | \$ .78  | \$ .69  | \$ 1.69 |

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The Class B Common Stock is convertible into Common Stock on a share for share basis at any time. In accordance with proposed Financial Accounting Standards Board (“FASB”) Staff Position No. FAS 128-a, *Computational Guidance for Computing Diluted EPS under the Two-Class Method*, the calculation of earnings per share-diluted for the Class B Common Stock was performed using the two-class method and the calculation of earnings per share-diluted for the Common Stock was performed using the if-converted method.

For the three-month and nine-month periods ended September 30, 2007, 6.8 million stock options were not included in the diluted earnings per share calculation because the effect would have been antidilutive. In the third quarter and first nine months of 2006, 3.7 million stock options were not included in the diluted earnings per share calculation because the effect would have been antidilutive.

## 7. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We account for derivative instruments in accordance with Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (“SFAS No. 133”). SFAS No. 133 requires us to recognize all derivative instruments at fair value. We classify the derivatives as assets or liabilities on the balance sheet. As of September 30, 2007 and October 1, 2006, all of our derivative instruments were classified as cash flow hedges.

### Summary of Activity

Our cash flow hedging derivative activity during the three months and nine months ended September 30, 2007 and October 1, 2006 was as follows:

|   | For the Three Months Ended |                    | For the Nine Months Ended |                    |
|---|----------------------------|--------------------|---------------------------|--------------------|
|   | September<br>30,<br>2007   | October 1,<br>2006 | September 30,<br>2007     | October 1,<br>2006 |
| (in millions of dollars)  |                            |                    |                           |                    |
| Net after-tax gains (losses) on cash flow hedging derivatives   | \$(2.5)                    | \$(25.3)           | \$2.3                     | \$(11.0)           |
| Reclassification adjustment of gains (losses) from accumulated other comprehensive income to income, net of tax | 0.6                        | (2.7)              | (.4)                      | (4.0)              |
| Hedge ineffectiveness gains (losses) recognized in cost of sales, before tax                                    | (.7)                       | .1                 | (.7)                      | 2.0                |

Net gains and losses on cash flow hedging derivatives were primarily associated with commodities futures contracts in 2007 and with commodities futures contracts and interest rate swap agreements in 2006.

Reclassification adjustments from accumulated other comprehensive income (loss) to income related to gains or losses on commodities futures contracts and were reflected in cost of sales. Reclassification adjustments for gains on interest rate swaps were reflected as an adjustment to interest expense.

We recognized no components of gains or losses on cash flow hedging derivatives in income due to excluding such components from the hedge effectiveness assessment.

The amount of net losses on cash flow hedging derivatives, including foreign exchange forward contracts, interest rate swap agreements and commodities futures contracts, expected to be reclassified into earnings in the next twelve months was approximately \$.5 million after tax as of September 30, 2007. This amount was primarily associated with foreign exchange forward contracts.

In February 2006, we terminated a forward swap agreement hedging the anticipated execution of \$250 million of term financing because the transaction was no longer expected to occur by the originally specified time period or within an additional two-month period of time thereafter. A gain of \$1.0 million was recorded in the first quarter of 2006 as a result of the discontinuance of this cash flow hedge. No other gains or losses on cash flow hedging derivatives were reclassified from accumulated other comprehensive income (loss) into income as a result of the discontinuance of a hedge because it became probable that a hedged forecasted transaction would not occur.

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For more information, refer to the consolidated financial statements and notes included in our 2006 Annual Report on Form 10-K.

## 8. COMPREHENSIVE INCOME

A summary of the components of comprehensive income (loss) is as follows:

|   | <b>For the Three Months Ended<br/>September 30, 2007</b> |                              |                             |
|---|--|------------------------------|-----------------------------|
|   | <b>Tax</b>   |                              |                             |
|   | <b>Pre-Tax<br/>Amount</b>                                | <b>(Expense)<br/>Benefit</b> | <b>After-Tax<br/>Amount</b> |
| <b>(in thousands of dollars)</b>          |  |                              |                             |
| Net income                                |  |                              | \$ 62,784                   |
| <b>Other comprehensive income (loss):</b> |  |                              |                             |
| Foreign currency translation adjustments  | \$ 16,738  | \$ —                         | 16,738                      |
| Pension and post-retirement benefit plans | (282)  | 111                          | (171)                       |
| <b>Cash flow hedges:</b>                  |  |                              |                             |
| Losses on cash flow hedging derivatives   | (3,970)  | 1,430                        | (2,540)                     |
| Reclassification adjustments              | (987)  | 353                          | (634)                       |
| Total other comprehensive income          | \$ 11,499  | \$ 1,894                     | 13,393                      |
| Comprehensive income                      |  |                              | \$ 76,177                   |

|   | <b>For the Three Months Ended<br/>October 1, 2006</b> |                              |                             |
|---|---|------------------------------|-----------------------------|
|   | <b>Tax</b>  |                              |                             |
|   | <b>Pre-Tax<br/>Amount</b>                             | <b>(Expense)<br/>Benefit</b> | <b>After-Tax<br/>Amount</b> |
| <b>(in thousands of dollars)</b>          |   |                              |                             |
| Net income                                |   |                              | \$ 185,121                  |
| <b>Other comprehensive income (loss):</b> |   |                              |                             |
| Foreign currency translation adjustments  | \$ 2,295  | \$ —                         | 2,295                       |
| <b>Cash flow hedges:</b>                  |   |                              |                             |
| Losses on cash flow hedging derivatives   | (39,603)  | 14,337                       | (25,266)                    |
| Reclassification adjustments              | 4,293   | (1,554)                      | 2,739                       |
| Total other comprehensive loss            | \$ (33,015)   | \$ 12,783                    | (20,232)                    |
| Comprehensive income                      |   |                              | \$ 164,889                  |

|   | <b>For the Nine Months Ended<br/>September 30, 2007</b> |                              |                             |
|---|---|------------------------------|-----------------------------|
|   | <b>Tax</b>  |                              |                             |
|   | <b>Pre-Tax<br/>Amount</b>                               | <b>(Expense)<br/>Benefit</b> | <b>After-Tax<br/>Amount</b> |
| <b>(in thousands of dollars)</b>          |   |                              |                             |
| Net income                                |   |                              | \$ 159,811                  |
| <b>Other comprehensive income (loss):</b> |   |                              |                             |
| Foreign currency translation adjustments  | \$ 44,056   | \$ —                         | 44,056                      |
| Pension and post-retirement benefit plans | 3,438   | (1,481)                      | 1,957                       |

## Cash flow hedges:

|  |           |            |            |
|--|-----------|------------|------------|
| Gains on cash flow hedging derivatives | 3,677     | (1,338)    | 2,339      |
| Reclassification adjustments           | 639       | (217)      | 422        |
| Total other comprehensive income       | \$ 51,810 | \$ (3,036) | 48,774     |
| Comprehensive income                   |           |            | \$ 208,585 |

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|   | <b>For the Nine Months Ended<br/>October 1, 2006</b> |                              |                             |
|---|--|------------------------------|-----------------------------|
|   | <b>Pre-Tax<br/>Amount</b>                            | <b>Tax</b>                   |                             |
|   |  | <b>(Expense)<br/>Benefit</b> | <b>After-Tax<br/>Amount</b> |
| <b>(in thousands of dollars)</b>          |  |                              |                             |
| Net income                                |  |                              | \$ 405,489                  |
| <b>Other comprehensive income (loss):</b> |  |                              |                             |
| Foreign currency translation adjustments  | \$ 10,497  | \$ —                         | 10,497                      |
| Minimum pension liability adjustments     | 118  | (42)                         | 76                          |
| <b>Cash flow hedges:</b>                  |  |                              |                             |
| Losses on cash flow hedging derivatives   | (17,201)   | 6,202                        | (10,999)                    |
| Reclassification adjustments              | 6,330  | (2,285)                      | 4,045                       |
| Total other comprehensive income          | \$ (256)   | \$ 3,875                     | 3,619                       |
| Comprehensive income                      |  |                              | \$ 409,108                  |

The components of accumulated other comprehensive income (loss) as shown on the Consolidated Balance Sheets are as follows:

|   | <b>September 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|-------------------------------|------------------------------|
| <b>(in thousands of dollars)</b>                      |                               |                              |
| Foreign currency translation adjustments              | \$ 44,021                     | \$ (35)                      |
| Pension and post-retirement benefit plans, net of tax | (136,015)                     | (137,972)                    |
| Cash flow hedges, net of tax                          | 2,579                         | (182)                        |
| Total accumulated other comprehensive loss            | \$ (89,415)                   | \$ (138,189)                 |

Effective December 31, 2006, we adopted Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106, and 132 (R) ("SFAS No. 158"). The provisions of SFAS No. 158 require that the funded status of our pension plans and the benefit obligations of our post-retirement benefit plans be recognized in our balance sheet. Appropriate adjustments were made to various assets and liabilities as of December 31, 2006, with an offsetting after-tax effect of \$138.0 million recorded as a component of other comprehensive income rather than as an adjustment to the ending balance of accumulated other comprehensive loss.

Excluding the impact of the adoption of SFAS No. 158, total other comprehensive income for the year ended December 31, 2006 was \$9.1 million after-tax, compared with the reported other comprehensive loss of \$128.9 million after-tax. The presentation of other comprehensive income for the year ended December 31, 2006 will be adjusted to exclude the impact of the adoption of SFAS No. 158 in our Annual Report on Form 10-K for the year ending December 31, 2007.

## 9. INVENTORIES

We value the majority of our inventories under the last-in, first-out ("LIFO") method and the remaining inventories at the lower of first-in, first-out ("FIFO") cost or market. Inventories were as follows:

| <b>September 30,<br/>2007</b>    | <b>December 31,<br/>2006</b> |
|----------------------------------|------------------------------|
| <b>(in thousands of dollars)</b> |                              |

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|                     |    |          |    |          |
|---------------------|----|----------|----|----------|
| Raw materials       | \$ | 240,607  | \$ | 214,335  |
| Goods in process    |    | 111,011  |    | 94,740   |
| Finished goods      |    | 503,909  |    | 418,250  |
| Inventories at FIFO |    | 855,527  |    | 727,325  |
| Adjustment to LIFO  |    | (80,147) |    | (78,505) |
| Total inventories   | \$ | 775,380  | \$ | 648,820  |

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The increase in raw material inventories as of September 30, 2007 resulted from the timing of deliveries to support manufacturing requirements, reflecting the seasonality of our business, and higher costs in 2007. The increase in finished goods inventories was primarily associated with seasonal sales patterns, preparation for production line transfers related to the 2007 business realignment initiatives and the introduction of new products.

## 10. SHORT-TERM DEBT

As a source of short-term financing, we utilize commercial paper or bank loans with an original maturity of three months or less. In December 2006, we entered into a five-year unsecured revolving credit agreement. The credit limit is \$1.1 billion with an option to borrow an additional \$400 million with the concurrence of the lenders. These funds may be used for general corporate purposes. Due to seasonal working capital needs, share repurchases and other business activities, we currently expect borrowings to exceed \$1.1 billion from time to time during the next twelve months. In lieu of increasing the borrowing limit under the five-year credit agreement, in August 2007, we entered into a new unsecured revolving short-term credit agreement to borrow up to \$300 million. Funds borrowed under the new short-term credit agreement may be used for general corporate purposes, including commercial paper backstop. The agreement will expire in August 2008. These unsecured revolving credit agreements contain certain financial and other covenants, customary representations, warranties, and events of default. As of September 30, 2007, we complied with all covenants pertaining to our credit agreements. There were no significant compensating balance agreements that legally restricted these funds. For more information, refer to the consolidated financial statements and notes included in our 2006 Annual Report on Form 10-K.

## 11. LONG-TERM DEBT

In May 2006, we filed a shelf registration statement on Form S-3 that registered an indeterminate amount of debt securities. This registration statement was effective immediately upon filing under Securities and Exchange Commission regulations governing "well-known seasoned issuers" (the "WKSI Registration Statement"). In August 2006, we issued \$500 million of Notes under the WKSI Registration Statement. Proceeds from the debt issuances and any other offerings under the WKSI Registration Statement may be used for general corporate requirements. These may include reducing existing borrowings, financing capital additions, funding contributions to our pension plans, future business acquisitions and working capital requirements.

## 12. FINANCIAL INSTRUMENTS

The carrying amounts of financial instruments including cash and cash equivalents, accounts receivable, accounts payable and short-term debt approximated fair value as of September 30, 2007 and December 31, 2006, because of the relatively short maturity of these instruments.

The carrying value of long-term debt, including the current portion, was \$1,286.7 million as of September 30, 2007, compared with a fair value of \$1,319.6 million, an increase of \$32.9 million over the carrying value, based on quoted market prices for the same or similar debt issues.

### Foreign Exchange Forward Contracts

The following table summarizes our foreign exchange activity:

| September 30, 2007       |                       |
|--------------------------|-----------------------|
| Contract<br>Amount       | Primary<br>Currencies |
| (in millions of dollars) |                       |

|   |    |      |  |
|---|----|------|--|
| Foreign exchange forward contracts to purchase foreign currencies | \$ | 24.2 | British pounds<br>Australian dollars<br>Mexican pesos<br>Euros |
| Foreign exchange forward contracts to sell foreign currencies     | \$ | 85.7 | Canadian dollars<br>Brazilian reais<br>Mexican pesos           |

Our foreign exchange forward contracts mature in 2007 and 2008.

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We define the fair value of foreign exchange forward contracts as the amount of the difference between contracted and current market foreign currency exchange rates at the end of the period. On a quarterly basis, we estimate the fair value of foreign exchange forward contracts by obtaining market quotes for future contracts with similar terms, adjusted where necessary for maturity differences. We do not hold or issue financial instruments for trading purposes.

The total fair value of our foreign exchange forward contracts included in prepaid expenses and other current assets, accrued liabilities and non-current assets (liabilities), as appropriate, on the Consolidated Balance Sheets were as follows:

|  | <b>September 30,<br/>2007</b>   | <b>December 31,<br/>2006</b> |
|--|---------------------------------|------------------------------|
|  | <b>(in millions of dollars)</b> |                              |
| Fair value of foreign exchange forward contracts – (liability) asset | \$ (2.3)                        | \$ 1.5                       |

### **13. INCOME TAXES**

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (“FIN No. 48”). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. FIN No. 48 describes 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 and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

We adopted the provisions of FIN No. 48 as of January 1, 2007. The adoption of FIN No. 48 did not result in a significant change to the liability for unrecognized tax benefits. Upon adoption, we had unrecognized tax benefits of \$79.0 million of which \$45.5 million would impact the effective income tax rate if recognized. The entire amount of unrecognized tax benefits was classified as other long-term liabilities on the balance sheet since we do not expect to make any significant payments to taxing authorities related to such tax positions in the next twelve months. We report accrued interest and penalties related to unrecognized tax benefits in income tax expense. Upon adoption, we had accruals of approximately \$17.4 million for the payment of interest and penalties.

We file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. A number of years may elapse before an uncertain tax position, for which we have unrecognized tax benefits, is audited and finally resolved. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, we believe that our unrecognized tax benefits reflect the most likely outcome. We adjust these unrecognized tax benefits, as well as the related interest, in light of changing facts and circumstances. Settlement of any particular position could require the use of cash. Favorable resolution would be recognized as a reduction to our effective income tax rate in the period of resolution.

The number of years with open tax audits varies depending on the tax jurisdiction. Our major taxing jurisdictions include the United States (federal and state) and Canada. We are no longer subject to U.S. federal examinations by the Internal Revenue Service (“IRS”) for years before 2004 and various tax examinations by state taxing authorities could be conducted for years beginning in 2000. We are no longer subject to Canadian federal income tax examinations by the Canada Revenue Agency (“CRA”) for years before 1999. U.S. and Canadian federal audit issues typically involve the timing of deductions and transfer pricing adjustments. We work with the IRS and the CRA to resolve proposed audit adjustments and to minimize the amount of adjustments. We do not anticipate that any potential tax adjustments will have a significant impact on our financial position or results of operations.





**14. PENSION AND OTHER POST-RETIREMENT BENEFIT PLANS**

Components of net periodic benefits (income) cost consisted of the following:

|   | <b>Pension Benefits</b>           |                            | <b>Other Benefits</b>             |                            |
|---|-----------------------------------|----------------------------|-----------------------------------|----------------------------|
|   | <b>For the Three Months Ended</b> |                            |                                   |                            |
|   | <b>September<br/>30,<br/>2007</b> | <b>October 1,<br/>2006</b> | <b>September<br/>30,<br/>2007</b> | <b>October 1,<br/>2006</b> |
|   | <b>(in thousands of dollars)</b>  |                            |                                   |                            |
| Service cost                                    | \$ 10,384                         | \$ 14,168                  | \$ 816                            | \$ 1,434                   |
| Interest cost                                   | 15,618                            | 14,710                     | 5,482                             | 4,774                      |
| Expected return on plan assets                  | (29,659)                          | (26,212)                   | —                                 | —                          |
| Amortization of prior service cost              | 262                               | 1,145                      | (42)                              | 49                         |
| Amortization of unrecognized transition balance | —                                 | 4                          | —                                 | —                          |
| Recognized net actuarial gain/loss              | (104)                             | 3,435                      | 33                                | 928                        |
| Administrative expenses                         | 74                                | 176                        | —                                 | —                          |
| Net periodic benefits (income) cost             | (3,425)                           | 7,426                      | 6,289                             | 7,185                      |
| Special termination benefits                    | 40,690                            | —                          | 652                               | —                          |
| Settlement                                      | —                                 | —                          | —                                 | —                          |
| Curtailment                                     | 4,106                             | —                          | 22,733                            | —                          |
| Total amount reflected in earnings              | \$ 41,371                         | \$ 7,426                   | \$ 29,674                         | \$ 7,185                   |

We made contributions of \$1.4 million and \$5.3 million to the pension plans and other benefits plans, respectively, during the third quarter of 2007. The Special termination benefits and Curtailment losses recorded in the third quarter of 2007 related to the 2007 business realignment initiatives. The Settlement and Curtailment losses recorded during the third quarter of 2006 related to the termination of a small non-qualified plan. In the third quarter of 2006, we made contributions of \$9.6 million and \$5.0 million to our pension and other benefits plans, respectively. The contributions in 2007 and 2006 also included benefit payments from our non-qualified pension plans and post-retirement benefit plans.

In the third quarter of 2007, there was net periodic pension benefits income of \$3.4 million, compared with net periodic benefits cost of \$7.4 million in the third quarter of 2006. The net periodic pension benefits income resulted from the changes to the U.S. pension plans announced in October 2006, the higher actual return on pension assets during 2006 and a higher discount rate.

|  | <b>Pension Benefits</b>           |                            | <b>Other Benefits</b>             |                            |
|--|-----------------------------------|----------------------------|-----------------------------------|----------------------------|
|  | <b>For the Nine Months Ended</b>  |                            |                                   |                            |
|  | <b>September<br/>30,<br/>2006</b> | <b>October 1,<br/>2006</b> | <b>September<br/>30,<br/>2006</b> | <b>October 1,<br/>2006</b> |

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|   | 2007                      |           | 2007      |           |
|---|---------------------------|-----------|-----------|-----------|
|   | (in thousands of dollars) |           |           |           |
| Service cost                                    | \$ 32,350                 | \$ 42,532 | \$ 3,165  | \$ 4,290  |
| Interest cost                                   | 44,837                    | 43,964    | 14,943    | 14,313    |
| Expected return on plan assets                  | (86,801)                  | (78,847)  | —         | —         |
| Amortization of prior service cost              | 1,389                     | 3,432     | (116)     | 144       |
| Amortization of unrecognized transition balance | —                         | 13        | —         | —         |
| Recognized net actuarial loss                   | 806                       | 10,193    | 1,008     | 2,780     |
| Administrative expenses                         | 375                       | 579       | —         | —         |
| Net periodic benefits (income) cost             | (7,044)                   | 21,866    | 19,000    | 21,527    |
| Special termination benefits                    | 46,856                    | —         | 652       | —         |
| Settlement                                      | —                         | 28        | —         | —         |
| Curtailment                                     | 8,321                     | 31        | 41,595    | —         |
| Total amount reflected in earnings              | \$ 48,133                 | \$ 21,925 | \$ 61,247 | \$ 21,527 |

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We made contributions of \$9.3 million and \$15.7 million to the pension plans and other benefits plans, respectively, during the first nine months of 2007. In the first nine months of 2006, we made contributions of \$18.2 million and \$18.2 million to our pension and other benefits plans, respectively. The contributions in 2007 and 2006 also included benefit payments from our non-qualified pension plans and post-retirement benefit plans.

In the first nine months of 2007, there was net periodic pension benefits income of \$7.0 million, compared with net periodic benefits cost of \$21.9 million in the first nine months of 2006. The net periodic pension benefits income resulted from the changes to the U.S. pension plans announced in October 2006, the higher actual return on pension assets during 2006 and a higher discount rate.

For 2007, there are no minimum funding requirements for the domestic plans and minimum funding requirements for the non-domestic plans are not material. We do not anticipate any significant contributions during the remainder of 2007.

For more information, refer to the consolidated financial statements and notes included in our 2006 Annual Report on Form 10-K.

## 15. SHARE REPURCHASES

### Repurchases and Issuances of Common Stock

A summary of cumulative share repurchases and issuances is as follows:

|  | <b>For the nine months<br/>ended<br/>September 30, 2007</b> |                |
|--|---|----------------|
|  | <b>Shares</b>   | <b>Dollars</b> |
|  | <b>(in thousands)</b>                                       |                |
| Shares repurchased in the open market under pre-approved share repurchase programs               | 2,916   | \$ 149,983     |
| Shares repurchased to replace Treasury Stock issued for stock options and incentive compensation | 1,855   | 98,475         |
| Total share repurchases  | 4,771   | 248,458        |
| Shares issued for stock options and incentive compensation                                       | (1,534)   | (49,686)       |
| Net change   | 3,237   | \$ 198,772     |

We intend to continue to repurchase shares of Common Stock in order to replace Treasury Stock shares issued for exercised stock options. The value of shares purchased in a given period will vary based on stock options exercised over time and market conditions.

In December 2006, our Board of Directors approved an additional \$250 million share repurchase program. As of September 30, 2007, \$100.0 million remained available for repurchases of Common Stock under this program.

## 16. PENDING ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("SFAS No. 157"). SFAS No. 157 establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for our Company beginning January 1, 2008. Pending additional guidance from the FASB, we have not yet determined the impact of the adoption

of the new accounting standard.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS No. 159”). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for our Company beginning January 1, 2008. We do not expect any significant changes to our financial accounting and reporting as a result of this new accounting standard.

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**17. SUBSEQUENT EVENTS**

In October 2007, Richard H. Lenny, Chairman, President and Chief Executive Officer informed our Board of Directors of his intention to retire at the end of 2007. Mr. Lenny will continue as Chairman of the Board and as a Director of the Company until December 31, 2007, and as Chief Executive Officer until December 1, 2007.

Also in October 2007, David J. West was named President and a Director of the Company. Mr. West will assume the role of Chief Executive Officer on December 1, 2007. Prior to his appointment, Mr. West was Executive Vice President, Chief Operating Officer.

Our Board of Directors also appointed Robert H. Campbell non-executive Chairman of the Board, effective January 1, 2008. Mr. Campbell is currently a member of The Hershey Company's Board of Directors, Chairman of the Compensation and Executive Organization Committee, and a member of the Audit Committee and Executive Committee.

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**Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition****SUMMARY OF OPERATING RESULTS****Analysis of Selected Items from Our Income Statement**

|   | For the Three Months Ended |                       |   | For the Nine Months Ended |                       |   |
|---|----------------------------|-----------------------|---|---------------------------|-----------------------|---|
|   | September<br>30,<br>2007   | October<br>1,<br>2006 | Percent<br>Change<br>Increase<br>(Decrease) | September<br>30,<br>2007  | October<br>1,<br>2006 | Percent<br>Change<br>Increase<br>(Decrease) |
| (in thousands except per share amounts) |                            |                       |   |                           |                       |   |
| Net Sales                               | \$ 1,399.5                 | \$1,416.2             | (1.2)%                                      | \$ 3,604.5                | \$ 3,607.6            | (0.1)%                                      |
| Cost of Sales                           | 928.9                      | 870.7                 | 6.7%  | 2,390.4                   | 2,222.2               | 7.6%  |
| Gross Profit                            | 470.6                      | 545.5                 | (13.7)%                                     | 1,214.1                   | 1,385.4               | (12.4)%                                     |
| Gross Margin                            | 33.6%                      | 38.5%                 |   | 33.7%                     | 38.4%                 |   |
| SM&A Expense                            | 229.8                      | 221.8                 | 3.6%  | 663.1                     | 660.1                 | 0.5%  |
| SM&A Expense as a<br>percent of sales   | 16.4%                      | 15.7%                 |   | 18.4%                     | 18.3%                 |   |
| Business<br>Realignment Charge,<br>net  | 112.0                      | 1.6                   | N/A   | 219.3                     | 9.1                   | N/A   |
| EBIT                                    | 128.8                      | 322.1                 | (60.0)%                                     | 331.7                     | 716.2                 | (53.7)%                                     |
| EBIT Margin                             | 9.2%                       | 22.7%                 |   | 9.2%                      | 19.9%                 |   |
| Interest Expense, net                   | 33.1                       | 31.9                  | 3.8%  | 90.5                      | 84.5                  | 7.1%  |
| Provision for Income<br>Taxes           | 32.9                       | 105.1                 | (68.7)%                                     | 81.4                      | 226.2                 | (64.0)%                                     |
| Effective Income Tax<br>Rate            | 34.4%                      | 36.2%                 |   | 33.7%                     | 35.8%                 |   |
| Net Income                              | \$ 62.8                    | \$ 185.1              | (66.1)%                                     | \$ 159.8                  | \$ 405.5              | (60.6)%                                     |
| Net Income Per<br>Share-Diluted         | \$ .27                     | \$ .78                | (65.4)%                                     | \$ .69                    | \$ 1.69               | (59.2)%                                     |

**Results of Operations - Third Quarter 2007 vs. Third Quarter 2006****U.S. Price Increases**

In April 2007, we announced an increase of approximately 4% to 5% in the wholesale prices of our domestic confectionery line, effective immediately. The increase applies to our standard bar, king-size bar, 6-pack and vending lines. These products represent approximately one-third of our portfolio. This action was implemented to help offset increases in input costs, including raw and packaging materials, fuel, utilities and transportation. We expect minimal financial impact from the pricing changes for the full year 2007.

**Net Sales**

Net sales for the third quarter of 2007 were slightly lower compared with the third quarter of 2006 as a sales volume decline in the U.S. was only partially offset by sales volume increases for our international businesses, primarily

exports to Asia and Latin America and higher sales for our business in Mexico. The sales decrease in the U.S. reflected sluggish retail sales particularly in the convenience store and vending classes of trade which led to reduced inventory levels at select distributors. Lower levels of new product introductions and the timing of seasonal sales also contributed to lower sales in the U.S. Reduced price realization from higher rates of promotional spending, including increases from trial-driving consumer coupons, and higher returns, discounts and allowances were only partially offset by higher list prices. Favorable foreign currency exchange rates also contributed modestly to net sales. The acquisition of the Godrej Hershey Foods and Beverages Company increased net sales by \$19.0 million, or 1.3%.

*Key Marketplace Metrics*

Consumer takeaway increased 3.5% during the third quarter of 2007 compared with the same period of 2006. Consumer takeaway is provided for channels of distribution accounting for approximately 80% of our U.S.

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confectionery retail business. These channels of distribution include food, drug, mass merchandisers, including Wal-Mart Stores, Inc., and convenience stores.

Market share in measured channels declined by 1.1 share points during the third quarter of 2007. The change in market share is provided for measured channels which include sales in the food, drug, convenience store and mass merchandiser classes of trade, excluding sales of Wal-Mart Stores, Inc.

### **Cost of Sales and Gross Margin**

Business realignment charges of \$37.5 million were included in cost of sales in the third quarter of 2007. The remainder of the cost of sales increase was primarily associated with higher input costs, particularly for dairy products, and business acquisitions, offset partially by reduced product obsolescence costs, the sales volume decrease in the U.S. and improved supply chain productivity.

Over half of the gross margin decline was attributable to the impact of business realignment initiatives recorded in 2007. The rest of the decline resulted from higher input costs and reduced price realization which were only partially offset by favorable supply chain productivity and reduced product obsolescence costs.

### **Selling, Marketing and Administrative**

Selling, marketing and administrative expenses increased primarily as a result of higher selling and advertising expenses which were only partially offset by reduced incentive compensation and consumer promotion expenses. Expenses of \$2.4 million for project implementation related to our 2007 business realignment initiatives were included in selling, marketing and administrative expense for the third quarter of 2007.

### **Business Realignment Initiatives**

Business realignment charges of \$112.0 million were recorded in the third quarter of 2007 associated with the 2007 business realignment initiatives. The charges were primarily associated with employee separation costs.

During the third quarter of 2006, we recorded charges related to previous business realignment initiatives. The \$1.6 million business realignment charge was related primarily to a U.S. VWRP, in addition to costs for streamlining our international operations and facility rationalization related to the closure of the Las Piedras plant.

### **Income Before Interest and Income Taxes and EBIT Margin**

EBIT decreased in the third quarter of 2007 compared with the third quarter of 2006 principally as a result of higher net business realignment charges associated with our business realignment initiatives. Net pre-tax business realignment charges of \$151.9 million were recorded in the third quarter of 2007 compared with \$1.7 million recorded in the third quarter of 2006, an increase of \$150.2 million. The remainder of the decrease in EBIT was attributable to lower gross profit resulting primarily from higher input costs, and higher selling, marketing and administrative expenses.

EBIT margin decreased from 22.7% for the third quarter of 2006 to 9.2% for the third quarter of 2007. The impact of net business realignment charges reduced EBIT margin by 10.7 percentage points. The remainder of the decrease resulted from the lower gross margin and higher selling, marketing and administrative expense as a percentage of sales.

### **Interest Expense, Net**



Net interest expense was higher in the third quarter of 2007 than the comparable period of 2006 primarily reflecting increased short-term borrowings.

**Income Taxes and Effective Tax Rate**

Our effective income tax rate was 34.4% for the third quarter of 2007 and benefited by 2.1 percentage points as a result of the higher effective tax rate associated with business realignment charges recorded during the quarter.

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## **Net Income and Net Income Per Share**

Net Income in the third quarter of 2007 was reduced by \$94.4 million, or \$0.41 per share-diluted, and was reduced by \$1.1 million, in the third quarter of 2006 as a result of net charges associated with our business realignment initiatives. After considering the impact of business realignment charges in each period, earnings per share-diluted in the third quarter of 2007 decreased \$0.10 as compared to the third quarter of 2006.

## **Results of Operations – First Nine Months 2007 vs. First Nine Months 2006**

### **Net Sales**

Net sales for the first nine months of 2007 were slightly lower than the comparable period of 2006 as lower sales volume for existing products in the U.S. was substantially offset by volume increases from the introduction of new products, primarily in the U.S., and higher sales for our international businesses, primarily Canada, Mexico and exports to Asia. The acquisition of the Godrej Hershey Foods and Beverages Company increased net sales by \$26.4 million, or 0.7%, in the first nine months of 2007. These increases were substantially offset by decreased price realization from higher rates of promotional spending and higher returns, discounts and allowances for products at retail which more than offset increases in list prices.

### *Key Marketplace Metrics*

Consumer takeaway increased 1.3% during the first nine months of 2007. Consumer takeaway is provided for channels of distribution accounting for approximately 80% of our U.S. confectionery retail business. These channels of distribution include food, drug, mass merchandisers, including Wal-Mart Stores, Inc., and convenience stores.

Market Share in measured channels declined by 1.3 share points during the first nine months of 2007. The change in market share is provided for measured channels which include sales in the food, drug, convenience store and mass merchandiser classes of trade, excluding sales of Wal-Mart Stores, Inc.

### **Cost of Sales and Gross Margin**

Business realignment charges of \$88.6 million were included in cost of sales in the first nine months of 2007, compared with a credit of \$3.2 million in the prior year. The remainder of the cost of sales increase was primarily associated with significantly higher input costs, particularly for dairy products, and the Godrej Hershey Foods and Beverages acquisition, offset somewhat by favorable supply chain productivity.

Over half of the gross margin decline was attributable to the impact of business realignment initiatives recorded in 2007 compared with 2006. The rest of the decline reflected substantially higher costs for raw materials somewhat offset by improved supply chain productivity. Also contributing to the decrease was lower net price realization due to higher promotional costs.

### **Selling, Marketing and Administrative**

Selling, marketing and administrative expenses increased as a result of project implementation costs related to our 2007 business realignment initiatives of \$8.7 million. These costs and increased selling expenses were mostly offset by lower administrative costs associated with incentive compensation. Higher advertising expense was substantially offset by lower consumer promotional expenses.



### **Business Realignment Initiatives**

Business realignment charges of \$219.3 million were recorded in the first nine months of 2007 associated with our 2007 business realignment initiatives. The charges were primarily related to employee separation costs, fixed asset impairments and the closure of certain manufacturing facilities, along with the termination of certain contracts.

During the first nine months of 2006, we recorded charges related to previous business realignment initiatives. The \$9.1 million charge for these business realignment initiatives related primarily to a U.S. VWRP, along with facility rationalization relating to the closure of the Las Piedras plant and streamlining our international operations.

### **Income Before Interest and Income Taxes and EBIT Margin**

EBIT decreased in the first nine months of 2007 compared with the first nine months of 2006 principally as a result of higher net business realignment charges associated with our 2007 business realignment initiatives. Net pre-tax business realignment charges of \$316.7 million were recorded in the first nine months of 2007 compared with \$6.0 million recorded in the first nine months of 2006, an increase of \$310.7 million. The remainder of the decrease in EBIT was due to lower gross profit, resulting primarily from higher input costs, slightly offset by lower selling, marketing and administrative expenses.

EBIT margin decreased from 19.9% for the first nine months of 2006 to 9.2% for the first nine months of 2007. The impact of net business realignment charges reduced EBIT margin by 8.7 percentage points. The remainder of the decrease primarily resulted from the lower gross margin.

### **Interest Expense, Net**

Net interest expense was higher in the first nine months of 2007 than the comparable period of 2006 primarily reflecting increased borrowings in addition to higher average interest rates in 2007.

### **Income Taxes and Effective Tax Rate**

Our effective income tax rate was 33.7% for the first nine months of 2007 and benefited by 2.2 percentage points as a result of the higher effective tax rate associated with business realignment charges recorded during the first nine months. We expect our effective income tax rate for the full year 2007 to be 36.0%, excluding the impact of tax benefits associated with business realignment charges during the year.

### **Net Income and Net Income Per Share**

Net Income in the first nine months 2007 was reduced by \$197.9 million, or \$0.85 per share-diluted, and was reduced by \$4.1 million, or \$0.01 per share-diluted, in the first nine months of 2006 as a result of net charges associated with our business realignment initiatives. After considering the impact of business realignment charges in each period, earnings per share-diluted for the first nine months of 2007 was lower by \$.16 per share-diluted as compared with the first nine months of 2006.

### **Liquidity and Capital Resources**

Historically, our major source of financing has been cash generated from operations. Domestic seasonal working capital needs, which typically peak during the summer months, generally have been met by issuing commercial paper. Commercial paper may also be issued from time to time to finance ongoing business transactions such as the refinancing of obligations associated with certain lease arrangements, the repayment of long-term debt and for other

general corporate purposes. During the first nine months of 2007, cash and cash equivalents decreased by \$55.6 million. Cash provided from operations for the first nine months of 2007 increased from the comparable period of 2006 primarily as a result of improved cash flows related to working capital.

Cash provided from operations, short-term borrowings, cash provided from stock options exercises and cash on hand at the beginning of the period was sufficient to fund the repayment of long-term debt of \$188.9 million, the repurchase of Common Stock for \$248.5 million, business acquisitions of \$97.0 million, dividend payments of \$186.5 million and capital additions and capitalized software expenditures of \$127.7 million.

Cash used by changes in other assets and liabilities was \$181.4 million for the first nine months of 2007 compared with cash used of \$23.1 million for the same period of 2006. The increase in the amount of cash used by

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other assets and liabilities from 2006 to 2007 primarily reflected the impact of business realignment initiatives, incentive compensation and interest payments.

During the second quarter of 2007, we acquired a 51% controlling interest in Godrej Hershey Foods and Beverages Company in India for \$58.7 million. During the second and third quarters of 2007, we invested a total of \$38.3 million to acquire a 44% equity interest under an agreement with Lotte Confectionery Co., LTD in China.

A receivable of approximately \$17.9 million was included in prepaid expenses and other current assets as of September 30, 2007 and \$14.0 million as of December 31, 2006 related to the recovery of damages from a product recall and temporary plant closure in Canada. The increase resulted from currency exchange rate fluctuations and additional costs. The product recall during the fourth quarter of 2006 was caused by a contaminated ingredient purchased from an outside supplier with whom we have filed a claim for damages and are currently in litigation.

Interest paid was \$116.0 million during the first nine months of 2007 versus \$96.7 million for the comparable period of 2006. The increase in interest paid reflects additional borrowings and the higher interest rate environment. Income taxes paid were \$145.2 million during the first nine months of 2007 versus \$212.0 million for the comparable period of 2006. The decrease in taxes paid in 2007 was primarily related to a lower federal extension payment for 2006 income taxes and the impact of lower annualized taxable income in 2007.

The ratio of current assets to current liabilities decreased slightly to 0.9:1.0 as of September 30, 2007 from 1.0:1.0 as of December 31, 2006. The capitalization ratio (total short-term and long-term debt as a percent of stockholders' equity, short-term and long-term debt) increased to 81% as of September 30, 2007 from 75% as of December 31, 2006.

Generally, our short-term borrowings are in the form of commercial paper or bank loans with an original maturity of three months or less. In December 2006, we entered into a five-year credit agreement establishing an unsecured revolving credit facility to borrow up to \$1.1 billion with the option to increase borrowings by an additional \$400 million with the concurrence of the lenders. In October 2007, we exercised our option under the agreement to extend the term by one year. The extension is expected to become effective in the fourth quarter of 2007. We may use these funds for general corporate purposes. Due to seasonal working capital needs, share repurchases and other business activities, we currently expect borrowings to exceed \$1.1 billion from time to time during the next twelve months. In lieu of increasing the borrowing limit under the five-year credit agreement, in August 2007, we entered into a new unsecured revolving short-term credit agreement to borrow up to \$300 million. Funds borrowed under the new short-term credit agreement may be used for general corporate purposes, including commercial paper backstop. The agreement will expire in August 2008.

### **Capital Structure**

Hershey Trust Company, as trustee for the benefit of Milton Hershey School (the "Milton Hershey School Trust") maintains voting control over The Hershey Company. Historically, the Milton Hershey School Trust has not taken an active role in setting our policy, nor has it exercised influence with regard to the ongoing business decisions of our Board of Directors or management. However, in October 2007, the Milton Hershey School Trust issued a statement that, in its role as controlling stockholder of the Company, it intends to retain its controlling interest in The Hershey Company and that the long-term prosperity of the Company requires the Board of Directors of the Company and its management to build on its strong U.S position by aggressively pursuing strategies for domestic and international growth. The Milton Hershey School Trust also stated that it has communicated to the Company's Board of Directors that it is not satisfied with the Company's results which have been underperforming both the market and its own stated expectations. As a result, the Milton Hershey School Trust has stated that, as controlling stockholder, it is actively engaged in an ongoing process, the goal of which has been to ensure vigorous focus by the Company's Board of

Directors on resolving the Company's current business challenges and on implementing new growth strategies.

For more information on the Company's capital structure, refer to the consolidated financial statements and notes included in our 2006 Annual Report on Form 10-K.

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## **Outlook**

The outlook section contains a number of forward-looking statements, all of which are based on current expectations. Actual results may differ materially. Refer to the Safe Harbor Statement below as well as Risk Factors and other information contained in our 2006 Annual Report on Form 10-K for information concerning the key risks to achieving future performance goals.

We have revised our operating performance expectations for the full year 2007 as a result of slower than expected improvement in U.S. sales and increased investment in consumer and customer programs. Our latest expectations with regard to key operating performance measures are presented below.

We expect net sales for the full year 2007 to be essentially even with 2006. Excluding incremental sales from the Godrej Hershey Beverages and Foods acquisition, net sales are expected to decline approximately 1%. The decline in net sales, primarily in the United States, reflects increased competitive activity, reduced retail velocity, a decrease in sales from the introduction of new products and lower shipments to select distributors. The sales decrease in the U.S. is expected to be partially offset by incremental sales from the Godrej acquisition and increased sales for our international businesses.

We expect that our 2007 business realignment initiatives designed to execute a comprehensive, three-year supply chain transformation plan will result in total pre-tax charges and non-recurring project implementation costs of \$525 million to \$575 million. Total charges include project management and start-up costs of approximately \$50 million. In 2007, we now expect to record charges of approximately \$380 million to \$400 million, or \$1.03 to \$1.08 per share-diluted. Total charges to be recorded in 2007 are expected to be higher than our original estimates due to the earlier timing of charges related to early retirement and voluntary severance programs. Charges related to these programs were originally expected to be recorded in 2008, however, they were recorded in the third quarter of 2007 upon acceptance by the employees.

As a result of the program, we estimate on-going savings of approximately \$170 million to \$190 million to be generated by 2010. A portion of the savings will be invested in our strategic growth initiatives, in such areas as core brand growth, new product innovation, selling and go-to-market capabilities and disciplined global expansion. The amount and timing of this investment will be contingent upon market conditions and the pace of our innovation and global expansion.

Excluding the impact of business realignment charges, we now expect our gross margin to be down nearly 200 basis points for the full year 2007. We expect significantly higher input costs in 2007 compared with 2006, particularly as a result of a significant increase in dairy input costs. The dairy markets are not as developed as many of the other commodities markets and, therefore, it is not possible to hedge our costs by taking forward positions to extend coverage for longer periods of time. An unfavorable sales mix resulting primarily from reduced shipments of higher-margin, single-serve items will also contribute to the lower gross margin.

Excluding the impact of business realignment charges, we now expect EBIT margin to decline approximately 250 basis points for the full year 2007. This decline will result from the decision to maintain our increased levels of brand investment, despite the increase in expected dairy costs and an unfavorable sales mix. In addition to the lower gross margin, increased investment spending for trade promotions, advertising and improved selling capabilities is expected to contribute to the decline in EBIT, EBIT margin and earnings per share-diluted in 2007.

Excluding the impact of business realignment charges, earnings per share-diluted is now expected to be in the \$2.08 - \$2.12 range for the full year 2007.





In this section, we have provided diluted earnings per share measures excluding certain items. These non-GAAP financial measures are used in evaluating results of operations for internal purposes. These non-GAAP measures are not intended to replace the presentation of financial results in accordance with GAAP. Rather, we believe exclusion of such items provides additional information to investors to facilitate the comparison of past and present operations. Below is a reconciliation of GAAP and non-GAAP items to our earnings per share outlook:

|                                 | 2006    | 2007             |
|---------------------------------|---------|------------------|
| Reported / Expected EPS-Diluted | \$ 2.34 | \$ 1.00 - \$1.09 |
| Total Realignment Charges       | \$ 0.03 | \$ 1.03 - \$1.08 |
| EPS-Diluted from Operations*    | \$ 2.37 | \$ 2.08 - \$2.12 |

\*From operations, excluding business realignment and one-time costs.

### **Subsequent Events**

In October 2007, Richard H. Lenny, Chairman, President and Chief Executive Officer informed our Board of Directors of his intention to retire at the end of 2007. Mr. Lenny will continue as Chairman of the Board and as a Director of the Company until December 31, 2007, and as Chief Executive Officer until December 1, 2007.

Also in October 2007, David J. West was named President and a Director of the Company. Mr. West will assume the role of Chief Executive Officer on December 1, 2007. Prior to his appointment, Mr. West was Executive Vice President, Chief Operating Officer.

Our Board of Directors also appointed Robert H. Campbell non-executive Chairman of the Board, effective January 1, 2008. Mr. Campbell is currently a member of The Hershey Company's Board of Directors, Chairman of the Compensation and Executive Organization Committee, and a member of the Audit Committee and Executive Committee.

### **Safe Harbor Statement**

We are subject to changing economic, competitive, regulatory and technological conditions, risks and uncertainties because of the nature of our operations. In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, we note the following factors that, among others, could cause future results to differ materially from the forward-looking statements, expectations and assumptions that we have discussed directly or implied in this report. Many of the forward-looking statements contained in this report may be identified by the use of words such as "intend," "believe," "expect," "anticipate," "should," "planned," "projected," "estimated," and "potential," among

Our results could differ materially because of the following factors, which include, but are not limited to:

Our ability to implement and generate expected ongoing annual savings from the initiatives to transform our supply chain and advance our value-enhancing strategy;

Changes in raw material and other costs and selling price increases;

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Our ability to execute our supply chain transformation within the anticipated timeframe in accordance with our cost estimates;

The impact of future developments related to the product recall and temporary plant closure in Canada during the fourth quarter of 2006, including our ability to recover costs we incurred for the recall and plant closure from responsible third parties;

Pension cost factors, such as actuarial assumptions, market performance and employee retirement decisions;

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Changes in our stock price, and resulting impacts on our expenses for incentive compensation, stock options and certain employee benefits;

Market demand for our new and existing products;

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Changes in our business environment, including actions of competitors and changes in consumer preferences;

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Changes in governmental laws and regulations, including taxes;

•

Risks and uncertainties related to our international operations; and

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Such other matters as discussed in our Annual Report on Form 10-K for 2006.

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### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The potential net loss in fair value of foreign exchange forward contracts of ten percent resulting from a hypothetical near-term adverse change in market rates was \$.2 million as of September 30, 2007 and December 31, 2006. The market risk resulting from a hypothetical adverse market price movement of ten percent associated with the estimated average fair value of net commodity positions increased from \$3.7 million as of December 31, 2006, to \$28.6 million as of September 30, 2007. Market risk represents 10% of the estimated average fair value of net commodity positions at four dates prior to the end of each period.

### **Item 4. Controls and Procedures**

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 (the "Exchange Act") is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

As of the end of the period covered by this quarterly report, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as required by Rule 13a-15 under the Exchange Act. This evaluation was carried out under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. There has been no change during the most recent fiscal quarter in our internal control over financial reporting identified in connection with the evaluation that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II - OTHER INFORMATION**

Items 1, 1A, 3, 4 and 5 have been omitted as not applicable.

**Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Purchases of Equity Securities**

| <b>Period</b>                           | <b>(a) Total<br/>Number of<br/>Shares<br/>Purchased</b> | <b>(b) Average<br/>Price Paid<br/>per Share</b> | <b>(c) Total Number<br/>of Shares<br/>Purchased as<br/>Part of Publicly<br/>Announced Plans<br/>or Programs</b> | <b>(d) Approximate<br/>Dollar Value of<br/>Shares that May<br/>Yet Be<br/>Purchased Under<br/>the Plans or<br/>Programs<br/>(in thousands of<br/>dollars)</b> |
|---|---|---|---|---|
| July 2 through<br>July 29, 2007         | 366,000   | \$ 47.73  | 366,000   | \$132,534   |
| July 30 through<br>August 26, 2007      | 718,400   | \$ 47.29  | 687,400   | \$100,017   |
| August 27 through<br>September 30, 2007 | —   | —   | —   | \$100,017   |
| <b>Total</b>                            | <b>1,084,400</b>  |   | <b>1,053,400</b>  |   |

**Item 6 - Exhibits**

The following items are attached or incorporated herein by reference:

| <b><u>Exhibit<br/>Number</u></b> | <b><u>Description</u></b>  |
|----------------------------------|--|
| 10.1                             | The Hershey Company Compensation Limit Replacement Plan is attached hereto and filed as Exhibit 10.1.  |
| 10.2                             | Master Innovation and Supply Agreement between the Company and Barry Callebaut, AG, dated July 13, 2007, is incorporated by reference from Exhibit 10.1 to the Company's Current Report on Form 8-K, Filed on July 19, 2007. |
| 10.3                             | Supply Agreement for Monterrey, Mexico, between the Company and Barry Callebaut, AG, dated July 13, 2007, is incorporated by reference from Exhibit 10.2 to the Company's Current Report on Form 8-K, filed July 19, 2007.   |

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- 10.4 The Company's Short-Term Credit Agreement is incorporated by reference from Exhibit 10.1 to the Company's Current Report on Form 8-K, filed August 30, 2007.
- 12.1 Statement showing computation of ratio of earnings to fixed charges for the nine months ended September 30, 2007 and October 1, 2006.
- 31.1 Certification of Richard H. Lenny, Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Humberto P. Alfonso, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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Certification of Richard H. Lenny, Chief Executive Officer, and Humberto P. Alfonso, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\*Pursuant to Securities and Exchange Commission Release No. 33-8212, this certification will be treated as “accompanying” this Quarterly Report on Form 10-Q and not “filed” as part of such report for purposes of Section 18 of the Exchange Act or otherwise subject to the liability of Section 18 of the Exchange Act, and this certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**THE HERSHEY COMPANY**  
**(Registrant)**

Date: November 7, 2007      /s/Bert Alfonso  
Humberto (Bert) P. Alfonso  
Chief Financial Officer

Date: November 7, 2007      /s/David W. Tacka  
David W. Tacka  
Chief Accounting Officer



**EXHIBIT INDEX**

|              |   |
|--------------|---|
| Exhibit 10.1 | The Hershey Company Compensation Limit Replacement Plan   |
| Exhibit 12.1 | Computation of Ratio of Earnings to Fixed Charges   |
| Exhibit 31.1 | Certification of Richard H. Lenny, Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| Exhibit 31.2 | Certification of Humberto P. Alfonso, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| Exhibit 32.1 | Certification of Richard H. Lenny, Chief Executive Officer, and Humberto P. Alfonso, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |