

KROGER CO  
Form 10-Q  
December 19, 2007

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

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**FORM 10-Q**

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

For the quarterly period ended November 10, 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 1-303

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**THE KROGER CO.**  
(Exact name of registrant as specified in its charter)

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Ohio  
(State or other jurisdiction of  
incorporation or organization)

31-0345740  
(I.R.S. Employer  
Identification No.)

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

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

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

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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. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

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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).  
Yes ☐ No ☒.

There were 675,525,934 shares of Common Stock (\$1 par value) outstanding as of December 14, 2007.

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**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

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

|                                                                                                                      | Third Quarter Ended<br>November<br>10,<br>2007 | November<br>4,<br>2006 | Three O<br>November<br>10,<br>2007 |
|----------------------------------------------------------------------------------------------------------------------|------------------------------------------------|------------------------|------------------------------------|
| Sales                                                                                                                | \$ 16,135                                      | \$ 14,699              | \$ 53,000                          |
| Merchandise costs, including advertising, warehousing, and transportation,<br>excluding items shown separately below | 12,402                                         | 11,131                 | 40,500                             |
| Operating, general and administrative                                                                                | 2,823                                          | 2,685                  | 9,200                              |
| Rent                                                                                                                 | 150                                            | 139                    | 400                                |
| Depreciation and amortization                                                                                        | 315                                            | 295                    | 1,000                              |
| Operating profit                                                                                                     | 445                                            | 449                    | 1,600                              |
| Interest expense                                                                                                     | 110                                            | 107                    | 300                                |
| Earnings before income tax expense                                                                                   | 335                                            | 342                    | 1,300                              |
| Income tax expense                                                                                                   | 81                                             | 127                    | 400                                |
| Net earnings                                                                                                         | \$ 254                                         | \$ 215                 | \$ 800                             |
| Net earnings per basic common share                                                                                  | \$ 0.37                                        | \$ 0.30                | \$ 1.20                            |
| Average number of common shares used in basic calculation                                                            | 678                                            | 712                    | 600                                |
| Net earnings per diluted share                                                                                       | \$ 0.37                                        | \$ 0.30                | \$ 1.20                            |
| Average number of common shares used in diluted calculation                                                          | 685                                            | 720                    | 700                                |
| Dividends declared per common share                                                                                  | \$ .075                                        | \$ .065                | \$ .20                             |

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

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

November 10

2007

## ASSETS

## Current assets

|                                           |    |      |
|-------------------------------------------|----|------|
| Cash - In stores                          | \$ | 13   |
| Cash - Temporary cash investments         |    | 2    |
| Total cash and temporary cash investments |    | 16   |
| Deposits in-transit                       |    | 58   |
| Receivables                               |    | 73   |
| FIFO inventory                            |    | 5,73 |
| LIFO credit                               |    | (55) |
| Prefunded employee benefits               |    |      |
| Prepaid and other current assets          |    | 23   |
| Total current assets                      |    | 6,90 |

|                                    |  |       |
|------------------------------------|--|-------|
| Property, plant and equipment, net |  | 12,33 |
| Goodwill                           |  | 2,14  |
| Other assets                       |  | 52    |

|              |    |       |
|--------------|----|-------|
| Total Assets | \$ | 21,90 |
|--------------|----|-------|

## LIABILITIES

## Current liabilities

|                                                                                                        |    |      |
|--------------------------------------------------------------------------------------------------------|----|------|
| Current portion of long-term debt including obligations under capital leases and financing obligations | \$ | 1,71 |
| Accounts payable                                                                                       |    | 4,23 |
| Accrued salaries and wages                                                                             |    | 77   |
| Deferred income taxes                                                                                  |    | 22   |
| Other current liabilities                                                                              |    | 1,99 |
| Total current liabilities                                                                              |    | 8,93 |

|                                                                                                |  |      |
|------------------------------------------------------------------------------------------------|--|------|
| Long-term debt including obligations under capital leases and financing obligations            |  |      |
| Face-value long-term debt including obligations under capital leases and financing obligations |  | 5,74 |
| Adjustment to reflect fair-value interest rate hedges                                          |  | 2    |
| Long-term debt including obligations under capital leases and financing obligations            |  | 5,77 |

|                             |  |      |
|-----------------------------|--|------|
| Deferred income taxes       |  | 31   |
| Other long-term liabilities |  | 2,10 |

|                   |  |       |
|-------------------|--|-------|
| Total Liabilities |  | 17,13 |
|-------------------|--|-------|

Commitments and contingencies (see Note 11)

## SHAREOWNERS' EQUITY

|                                                                                                         |  |      |
|---------------------------------------------------------------------------------------------------------|--|------|
| Preferred stock, \$100 par, 5 shares authorized and unissued                                            |  |      |
| Common stock, \$1 par, 1,000 shares authorized; 946 shares issued in 2007 and 937 shares issued in 2006 |  | 94   |
| Additional paid-in capital                                                                              |  | 3,01 |
| Accumulated other comprehensive loss                                                                    |  | (24) |
| Accumulated earnings                                                                                    |  | 6,20 |

Common stock in treasury, at cost, 273 shares in 2007 and 232 shares in 2006

(5,15

|                                           |          |
|-------------------------------------------|----------|
| Total Shareowners' Equity                 | 4,76     |
| Total Liabilities and Shareowners' Equity | \$ 21,90 |

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

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

|                                                                                             | Three Quarters Ended<br>November<br>10,<br>2007 | November<br>10,<br>2006 |
|---------------------------------------------------------------------------------------------|-------------------------------------------------|-------------------------|
| <b>Cash Flows from Operating Activities:</b>                                                |                                                 |                         |
| Net earnings                                                                                | \$ 858                                          | \$                      |
| Adjustments to reconcile net earnings to net cash provided by operating activities:         |                                                 |                         |
| Depreciation and amortization                                                               | 1,030                                           |                         |
| LIFO charge                                                                                 | 100                                             |                         |
| Stock option expense                                                                        | 68                                              |                         |
| Expense for Company-sponsored pension plans                                                 | 47                                              |                         |
| Deferred income taxes                                                                       | (102)                                           |                         |
| Other                                                                                       | 33                                              |                         |
| Changes in operating assets and liabilities net of effects from acquisitions of businesses: |                                                 |                         |
| Store deposits in-transit                                                                   | 34                                              |                         |
| Receivables                                                                                 | 34                                              |                         |
| Inventories                                                                                 | (659)                                           |                         |
| Prepaid expenses                                                                            | 322                                             |                         |
| Accounts payable                                                                            | 349                                             |                         |
| Accrued expenses                                                                            | 88                                              |                         |
| Income taxes payable                                                                        | 121                                             |                         |
| Contribution to Company-sponsored pension plans                                             | (52)                                            |                         |
| Other                                                                                       | 6                                               |                         |
| <b>Net cash provided by operating activities</b>                                            | <b>2,277</b>                                    |                         |
| <b>Cash Flows from Investing Activities:</b>                                                |                                                 |                         |
| Payments for capital expenditures                                                           | (1,628)                                         |                         |
| Payments for acquisitions                                                                   | (86)                                            |                         |
| Proceeds from sale of assets                                                                | 46                                              |                         |
| Other                                                                                       | (46)                                            |                         |
| <b>Net cash used by investing activities</b>                                                | <b>(1,714)</b>                                  |                         |
| <b>Cash Flows from Financing Activities:</b>                                                |                                                 |                         |
| Dividends paid                                                                              | (151)                                           |                         |
| Proceeds from issuance of long-term debt                                                    | 625                                             |                         |

|                                                                  |              |    |
|------------------------------------------------------------------|--------------|----|
| Payments on long-term debt                                       | (545)        |    |
| Borrowings on bank revolver                                      | 341          |    |
| Proceeds from lease-financing transactions                       | 8            |    |
| Proceeds from issuance of capital stock                          | 215          |    |
| Treasury stock purchases                                         | (1,152)      |    |
| Increase (decrease) in bank overdrafts                           | 78           |    |
| Other                                                            | (5)          |    |
| <b>Net cash used by financing activities</b>                     | <b>(586)</b> |    |
| <b>Net decrease in total cash and temporary cash investments</b> | <b>(23)</b>  |    |
| <b>Total cash and temporary cash investments:</b>                |              |    |
| Beginning of year                                                | 189          |    |
| End of quarter                                                   | \$ 166       | \$ |
| <b>Reconciliation of capital expenditures:</b>                   |              |    |
| Payments for capital expenditures                                | \$ (1,628)   | \$ |
| Changes in construction-in-progress payables                     | 36           |    |
| Total capital expenditures                                       | \$ (1,592)   | \$ |
| <b>Supplemental cash flow information:</b>                       |              |    |
| Cash paid during the year for interest                           | \$ 387       | \$ |
| Cash paid during the year for income taxes                       | \$ 327       | \$ |

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

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## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

All amounts are in millions except per share amounts.

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

### **1. ACCOUNTING POLICIES**

#### *Basis of Presentation and Principles of Consolidation*

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

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

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

The unaudited information in the Consolidated Financial Statements for the third quarter and three quarters ended November 10, 2007 and November 4, 2006 includes the results of operations of the Company for the 12-week and 40-week periods then ended.

### *Store Closing and Other Expense Allowances*

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

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

The Company recorded asset impairments in the normal course of business totaling \$4 in the third quarter of 2007 and \$6 in the third quarter of 2006. During the first three quarters of 2007 and 2006, the Company recorded asset impairments in the normal course of business totaling \$15 and \$44, respectively.

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The following table summarizes accrual activity for future lease obligations of stores closed in the normal course of business and locations closed in California prior to the Fred Meyer merger in 1999.

|                                 | Future Lease Obligations |        |
|---------------------------------|--------------------------|--------|
|                                 | 2007                     | 2006   |
| Balance at beginning of year    | \$ 89                    | \$ 127 |
| Additions                       | 5                        | 7      |
| Payments                        | (12)                     | (12)   |
| Adjustments                     | (8)                      | (22)   |
| Balance at end of third quarter | \$ 74                    | \$ 100 |

## 2. GOODWILL AND BUSINESS ACQUISITIONS

The following table summarizes the changes in the Company's net goodwill balance through November 10, 2007.

|                                | Goodwill |
|--------------------------------|----------|
| Balance at February 3, 2007    | \$ 2,192 |
| FIN 48 adjustment (See Note 7) | (72)     |
| Additions                      | 24       |

|                              |    |       |
|------------------------------|----|-------|
| Balance at November 10, 2007 | \$ | 2,144 |
|------------------------------|----|-------|

In the second quarter of 2007, the Company completed acquisitions of 18 Scott's retail food stores in Northeast Indiana and 20 Farmer Jack retail food stores in Michigan for approximately \$86. The transactions were recorded using the purchase method of accounting. Assets and liabilities were recorded based on fair values with the purchase prices being primarily allocated to inventory, property, plant and equipment and goodwill. The results of operations are included in the Company's Consolidated Financial Statements since the date of acquisition.

The proforma effects of these acquisitions are not material to previously reported results.

### 3. STOCK OPTION PLANS

The Company recognized total stock based compensation of \$20 and \$16 in the third quarter ended November 10, 2007 and November 4, 2006, respectively. Total stock based compensation of \$68 and \$55 was recorded for the three quarters ended November 10, 2007 and November 4, 2006, respectively. These costs were recognized as operating, general and administrative costs in the Company's Consolidated Statements of Operations.

The Company grants options for common stock ("stock options") to employees, as well as to its non-employee directors, under various plans at an option price equal to the fair market value of the stock at the date of grant. In addition to stock options, the Company awards restricted stock to employees under various plans. Equity awards may be made once each quarter on a predetermined date. It has been the Company's practice to make a general annual grant, which occurred in the second quarter of 2007.

Stock options granted in the first three quarters of 2007 expire 10 years from the date of the grant and vest from one year to five years from the date of grant. Restricted stock awards in the first three quarters of 2007 have restrictions that lapse in one year to five years from the date of the awards. All awards become immediately exercisable upon certain changes of control of the Company.

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Changes in equity awards outstanding under the plans are summarized below.

#### *Stock Options*

|                                | Shares subject<br>to option | Weighted-average<br>exercise price |
|--------------------------------|-----------------------------|------------------------------------|
| Outstanding, February 3, 2007  | 51.9                        | \$ 20.09                           |
| Granted                        | 3.3                         | \$ 28.04                           |
| Exercised                      | (9.6)                       | \$ 19.02                           |
| Canceled or Expired            | (0.3)                       | \$ 20.70                           |
| Outstanding, November 10, 2007 | 45.3                        | \$ 20.91                           |

#### *Restricted Stock*

|                               | Restricted shares<br>outstanding | Weighted-average<br>grant-date fair<br>value |
|-------------------------------|----------------------------------|----------------------------------------------|
| Outstanding, February 3, 2007 | 2.4                              | \$ 20.02                                     |
| Granted                       | 2.4                              | \$ 28.26                                     |
| Lapsed                        | (1.3)                            | \$ 19.86                                     |

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|                                |       |    |       |
|--------------------------------|-------|----|-------|
| Canceled or Expired            | (0.1) | \$ | 21.85 |
| Outstanding, November 10, 2007 | 3.4   | \$ | 25.77 |

The weighted-average fair value of stock options granted during the first three quarters ended November 10, 2007 and November 4, 2006, was \$9.91 and \$6.90, respectively. The fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option-pricing model, based on the assumptions shown in the table below. The Black-Scholes model utilizes extensive accounting judgment and financial estimates, including the term employees are expected to retain their stock options before exercising them, the volatility of the Company's stock price over that expected term, the dividend yield over the term, and the number of awards expected to be forfeited before they vest. Using alternative assumptions in the calculation of fair value would produce fair values for stock option grants that could be different than those used to record stock-based compensation expense in the Consolidated Statements of Operations.

The following table reflects the weighted average assumptions used for grants awarded to option holders:

|                         | 2007       | 2006       |
|-------------------------|------------|------------|
| Risk-free interest rate | 5.06%      | 5.07%      |
| Expected dividend yield | 1.40%      | 1.50%      |
| Expected volatility     | 29.21%     | 27.60%     |
| Expected term           | 6.85 Years | 7.50 Years |

#### 4. DEBT OBLIGATIONS

Long-term debt consists of:

|                                                                          | November 10,<br>2007 | February 3,<br>2007 |
|--------------------------------------------------------------------------|----------------------|---------------------|
| Credit Facility and Commercial Paper borrowings                          | \$ 693               | \$ 352              |
| 4.95% to 9.20% Senior Notes and Debentures due through 2031              | 6,019                | 5,916               |
| 6.12% to 9.95% mortgages due in varying amounts through 2034             | 174                  | 169                 |
| Other                                                                    | 137                  | 144                 |
| Total debt, excluding capital leases and financing obligations           | 7,023                | 6,581               |
| Less current portion                                                     | (1,687)              | (878)               |
| Total long-term debt, excluding capital leases and financing obligations | \$ 5,336             | \$ 5,703            |

During each of the second and third quarters of 2007, the Company issued \$300, 6.4% senior notes due in 2017.

#### 5. COMPREHENSIVE INCOME

Comprehensive income is as follows:

| Third Quarter Ended<br>November 4, | Year-To-Date |
|------------------------------------|--------------|
|------------------------------------|--------------|

|                                                                     | November<br>10,<br>2007 | 2006   | November<br>10,<br>2007 |
|---------------------------------------------------------------------|-------------------------|--------|-------------------------|
| Net earnings                                                        | \$ 254                  | \$ 215 | \$ 858                  |
| Unrealized gain and (losses) on hedging activities, net of tax(1)   | (13)                    | (10)   | (4)                     |
| Amortization of amounts included in net periodic pension expense(2) | 3                       | -      | 15                      |
| Other                                                               | 1                       | -      | 2                       |
| Comprehensive income                                                | \$ 245                  | \$ 205 | \$ 871                  |

(1) Amount is net of tax of \$(7) for the third quarter of 2007 and \$(6) for the third quarter of 2006. Amount is net of tax of \$(2) for the first three quarters of 2007 and \$3 for the first three quarters of 2006.

(2) Amount is net of tax of \$1 for the third quarter of 2007 and \$9 for the first three quarters of 2007.

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

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## 6. BENEFIT PLANS

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

|                                          | Third Quarter    |       |                |      |
|------------------------------------------|------------------|-------|----------------|------|
|                                          | Pension Benefits |       | Other Benefits |      |
|                                          | 2007             | 2006  | 2007           | 2006 |
| Components of net periodic benefit cost: |                  |       |                |      |
| Service cost                             | \$ 10            | \$ 29 | \$ 3           | \$ 3 |
| Interest cost                            | 34               | 33    | 5              | 5    |
| Expected return on plan assets           | (38)             | (35)  | □              | □    |
| Amortization of:                         |                  |       |                |      |
| Prior service cost                       | 1                | 1     | (1)            | (2)  |
| Actuarial loss                           | 8                | 13    | □              | □    |
| Curtailment charge                       | □                | 5     | □              | □    |
| Net periodic benefit cost                | \$ 15            | \$ 46 | \$ 7           | \$ 6 |

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

|                                          | Year-To-Date     |        |                |       |
|------------------------------------------|------------------|--------|----------------|-------|
|                                          | Pension Benefits |        | Other Benefits |       |
|                                          | 2007             | 2006   | 2007           | 2006  |
| Components of net periodic benefit cost: |                  |        |                |       |
| Service cost                             | \$ 33            | \$ 101 | \$ 11          | \$ 10 |
| Interest cost                            | 114              | 104    | 16             | 16    |
| Expected return on plan assets           | (127)            | (117)  | □              | □     |
| Amortization of:                         |                  |        |                |       |
| Prior service cost                       | 2                | 4      | (5)            | (6)   |
| Actuarial loss                           | 27               | 34     | □              | □     |
| Curtailment charge                       | □                | 5      | □              | □     |

|                           |    |    |    |     |    |    |    |    |
|---------------------------|----|----|----|-----|----|----|----|----|
| Net periodic benefit cost | \$ | 49 | \$ | 131 | \$ | 22 | \$ | 20 |
|---------------------------|----|----|----|-----|----|----|----|----|

Net periodic benefit cost decreased in the first three quarters of 2007 compared to the first three quarters of 2006 due to participants in the cash balance formula of the consolidated retirement benefit plan being moved to a 401(k) retirement savings account plan effective January 1, 2007. The 401(k) retirement savings account plan will provide to eligible employees both Company matching contributions and automatic Company contributions based on participant contributions, plan compensation, and length of service. The Company contributed \$73 to employee 401(k) retirement savings accounts in the first three quarters of 2007.

The Company contributed \$52 and \$150 to Company-sponsored pension plans in the first three quarters of 2007 and 2006, respectively.

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

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## 7. INCOME TAXES

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

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

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

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

The Internal Revenue Service (IRS) concluded a field examination of our 2002 - 2004 U.S. tax returns during the third quarter of 2007. An examination of our 1999 - 2001 U.S. tax returns was completed in 2005. The Company contested two issues at the appellate level of the IRS. One of the issues was resolved in the third quarter of 2007 and we anticipate that the remaining issue may be resolved within the next 12 months. In the opinion of management, the ultimate disposition of the item noted above will not have a significant effect on our consolidated financial position, liquidity, or results of operations. Additionally, the Company has a case in the U.S. Tax Court. A decision on this case is not expected within the next 12 months. In connection with this case, the Company has extended the statute of limitations on its tax years after 1991.

As a result of settlements with taxing authorities during the quarter, unrecognized tax benefits of \$168 have been reclassified from other long-term liabilities to deferred income taxes and accrued taxes payable.

The effective income tax rate was 34.6% for the first three quarters of 2007 and 37.6% for the first three quarters of 2006. The 2007 effective income tax rate differed from the statutory rate primarily due to the effect of state taxes and the favorable resolution of certain tax issues during the third quarter totaling approximately \$40. The 2006 effective income tax rate differed from the federal statutory rate primarily due to the effect of state taxes.

## 8. EARNINGS PER COMMON SHARE

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

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

|                                                                 | Third Quarter Ended<br>November 10, 2007 |               |              | Third Quarter Ended<br>November 4, 2006 |               |              |
|-----------------------------------------------------------------|------------------------------------------|---------------|--------------|-----------------------------------------|---------------|--------------|
|                                                                 | Earnings                                 | Shares        | Per          | Earnings                                | Shares        | Per          |
|                                                                 | (Numerator)                              | (Denominator) | Share Amount | (Numerator)                             | (Denominator) | Share Amount |
| Earnings per basic common share                                 | \$ 254                                   | 678           | \$ 0.37      | \$ 215                                  | 712           | \$ 0.30      |
| Dilutive effect of stock options, restricted stock and warrants |                                          | 7             |              |                                         | 8             |              |
| Earnings per diluted common share                               | \$ 254                                   | 685           | \$ 0.37      | \$ 215                                  | 720           | \$ 0.30      |

|                                                                 | Year-To-Date<br>November 10, 2007 |               |              | Year-To-Date<br>November 4, 2006 |               |              |
|-----------------------------------------------------------------|-----------------------------------|---------------|--------------|----------------------------------|---------------|--------------|
|                                                                 | Earnings                          | Shares        | Per          | Earnings                         | Shares        | Per          |
|                                                                 | (Numerator)                       | (Denominator) | Share Amount | (Numerator)                      | (Denominator) | Share Amount |
| Earnings per basic common share                                 | \$ 858                            | 696           | \$ 1.23      | \$ 730                           | 718           | \$ 1.02      |
| Dilutive effect of stock options, restricted stock and warrants |                                   | 8             |              |                                  | 7             |              |
| Earnings per diluted common share                               | \$ 858                            | 704           | \$ 1.22      | \$ 730                           | 725           | \$ 1.01      |

The Company had options outstanding for approximately 3 shares and 21 shares during the third quarter of 2007 and 2006, respectively, that were excluded from the computations of earnings per diluted common share because their inclusion would have had an anti-dilutive effect on earnings per share. For the first three quarters of 2007 and 2006, the Company had options outstanding for approximately 2 and 29 shares, respectively, that were excluded from the computations of diluted earnings per share because their inclusion would have had an anti-dilutive effect on earnings per share.

## 9. RECENTLY ISSUED ACCOUNTING STANDARDS

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurement. SFAS No. 157 does not require any new fair value measurements. SFAS No. 157 will become effective for the Company's fiscal year beginning February 3, 2008. The Company is evaluating the effect the implementation of SFAS No. 157 will have on its Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to make an irrevocable election to measure certain financial instruments and other assets and liabilities at fair value on an instrument-by-instrument basis. Unrealized gains and losses on items for which the fair value option has been elected should be recognized into net earnings at each subsequent reporting date. SFAS No. 159 will become effective for the Company's fiscal year beginning February 3, 2008. The Company is currently evaluating the effect the adoption of SFAS No. 159 will have on its Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements-an amendment of ARB No. 51*. SFAS No. 160 will require the consolidation of noncontrolling interests as a component of equity. SFAS No. 160 will become effective for our fiscal year beginning February 1, 2009. We are currently evaluating the effect the adoption of SFAS No. 160 will have on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations (SFAS No. 141R)*, which replaces SFAS No. 141. SFAS No. 141R further expands the definitions of a business and the fair value measurement and reporting in a business combination. SFAS No. 141R will become effective for our fiscal year beginning February 1, 2009. We are currently evaluating the effect the adoption of SFAS No. 141R will have on our Consolidated Financial Statements.

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## 10. GUARANTOR SUBSIDIARIES

The Company's outstanding public debt (the "Guaranteed Notes") is jointly and severally, fully and unconditionally guaranteed by The Kroger Co. and certain of its subsidiaries (the "Guarantor Subsidiaries"). At November 10, 2007, a total of approximately \$6,019 of Guaranteed Notes were outstanding. The Guarantor Subsidiaries and non-guarantor subsidiaries are direct or indirect wholly-owned subsidiaries of The Kroger Co. Separate financial statements of The Kroger Co. and each of the Guarantor Subsidiaries are not presented because the guarantees are full and unconditional and the Guarantor Subsidiaries are jointly and severally liable. The Company believes that separate financial statements and other disclosures concerning the Guarantor Subsidiaries would not be material to investors.

The non-guaranteeing subsidiaries represent less than 3% on an individual and aggregate basis of consolidated assets, pre-tax earnings, cash flow and equity. Therefore, the non-guarantor subsidiaries' information is not separately presented in the tables below.

There are no current restrictions on the ability of the Guarantor Subsidiaries to make payments under the guarantees referred to above. The obligations of each guarantor under its guarantee are limited to the maximum amount permitted under Bankruptcy Law, the Uniform Fraudulent Conveyance Act, the Uniform Fraudulent Transfer Act, or any similar Federal or state law (e.g. laws requiring adequate capital to pay dividends) respecting fraudulent conveyance or fraudulent transfer.

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The following tables present summarized financial information as of November 10, 2007 and February 3, 2007, for the third quarter ended, and the three quarters ended November 10, 2007 and November 4, 2006:

### Condensed Consolidating Balance Sheets As of November 10, 2007

|                | The<br>Kroger<br>Co. | Guarantor<br>Subsidiaries | Eliminations | Co |
|----------------|----------------------|---------------------------|--------------|----|
| Current assets |                      |                           |              |    |

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|                                                                                                        |    |               |    |               |    |                 |    |
|--------------------------------------------------------------------------------------------------------|----|---------------|----|---------------|----|-----------------|----|
| Cash and temporary cash investments                                                                    | \$ | 21            | \$ | 145           | \$ | 0               | \$ |
| Deposits in-transit                                                                                    |    | 64            |    | 516           |    | 0               |    |
| Receivables                                                                                            |    | 142           |    | 1,965         |    | (1,372)         |    |
| Net inventories                                                                                        |    | 487           |    | 4,699         |    | 0               |    |
| Prepaid and other current assets                                                                       |    | 57            |    | 179           |    | 0               |    |
| <b>Total current assets</b>                                                                            |    | <b>771</b>    |    | <b>7,504</b>  |    | <b>(1,372)</b>  |    |
| Property, plant and equipment, net                                                                     |    | 1,619         |    | 10,712        |    | 0               |    |
| Goodwill                                                                                               |    | 56            |    | 2,088         |    | 0               |    |
| Other assets                                                                                           |    | 1,145         |    | 860           |    | (1,480)         |    |
| Investment in and advances to subsidiaries                                                             |    | 11,887        |    | 0             |    | (11,887)        |    |
| <b>Total assets</b>                                                                                    | \$ | <b>15,478</b> | \$ | <b>21,164</b> | \$ | <b>(14,739)</b> | \$ |
| <b>Current liabilities</b>                                                                             |    |               |    |               |    |                 |    |
| Current portion of long-term debt including obligations under capital leases and financing obligations | \$ | 1,715         | \$ | 0             | \$ | 0               | \$ |
| Accounts payable                                                                                       |    | 1,725         |    | 5,358         |    | (2,852)         |    |
| Other current liabilities                                                                              |    | 0             |    | 2,993         |    | 0               |    |
| <b>Total current liabilities</b>                                                                       |    | <b>3,440</b>  |    | <b>8,351</b>  |    | <b>(2,852)</b>  |    |
| <b>Long-term debt including obligations under capital leases and financing obligations</b>             |    |               |    |               |    |                 |    |
| Face value long-term debt including obligations under capital leases and financing obligations         |    | 5,747         |    | 0             |    | 0               |    |
| Adjustment to reflect fair value interest rate hedges                                                  |    | 28            |    | 0             |    | 0               |    |
| <b>Long-term debt including obligations under capital leases and financing obligations</b>             |    | <b>5,775</b>  |    | <b>0</b>      |    | <b>0</b>        |    |
| Other long-term liabilities                                                                            |    | 1,494         |    | 926           |    | 0               |    |
| <b>Total liabilities</b>                                                                               |    | <b>10,709</b> |    | <b>9,277</b>  |    | <b>(2,852)</b>  |    |
| Shareowners' Equity                                                                                    |    | 4,769         |    | 11,887        |    | (11,887)        |    |
| <b>Total liabilities and shareowners' equity</b>                                                       | \$ | <b>15,478</b> | \$ | <b>21,164</b> | \$ | <b>(14,739)</b> | \$ |

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**Condensed Consolidating  
Balance Sheets  
As of February 3, 2007**

|                                     | The Kroger Co. | Guarantor    |              |
|-------------------------------------|----------------|--------------|--------------|
|                                     |                | Subsidiaries | Eliminations |
| Current assets                      |                |              |              |
| Cash and temporary cash investments | \$ 25          | \$ 164       | \$ 0         |
| Store deposits in-transit           | 69             | 545          | 0            |
| Receivables                         | 168            | 1,982        | (1,372)      |

|                                                                                                        |                  |                  |                    |
|--------------------------------------------------------------------------------------------------------|------------------|------------------|--------------------|
| Net inventories                                                                                        | 406              | 4,203            | □                  |
| Prepaid and other current assets                                                                       | 371              | 194              | □                  |
| <b>Total current assets</b>                                                                            | <b>1,039</b>     | <b>7,088</b>     | <b>(1,372)</b>     |
| Property, plant and equipment, net                                                                     | 1,429            | 10,350           | □                  |
| Goodwill                                                                                               | 56               | 2,136            | □                  |
| Other assets                                                                                           | 647              | 1,149            | (1,307)            |
| Investment in and advances to subsidiaries                                                             | 11,510           | □                | (11,510)           |
| <b>Total assets</b>                                                                                    | <b>\$ 14,681</b> | <b>\$ 20,723</b> | <b>\$ (14,189)</b> |
| <b>Current liabilities</b>                                                                             |                  |                  |                    |
| Current portion of long-term debt including obligations under capital leases and financing obligations | \$ 906           | \$ □             | \$ □               |
| Accounts payable                                                                                       | 1,614            | 4,869            | (2,679)            |
| Other current liabilities                                                                              | (537)            | 3,408            | □                  |
| <b>Total current liabilities</b>                                                                       | <b>1,983</b>     | <b>8,277</b>     | <b>(2,679)</b>     |
| <b>Long-term debt including obligations under capital leases and financing obligations</b>             |                  |                  |                    |
| Face value long-term debt including obligations under capital leases and financing obligations         | 6,136            | □                | □                  |
| Adjustment to reflect fair value interest rate hedges                                                  | 18               | □                | □                  |
| <b>Long-term debt including obligations under capital leases and financing obligations</b>             | <b>6,154</b>     | <b>□</b>         | <b>□</b>           |
| Other long-term liabilities                                                                            | 1,621            | 936              | □                  |
| <b>Total liabilities</b>                                                                               | <b>9,758</b>     | <b>9,213</b>     | <b>(2,679)</b>     |
| Shareowners' Equity                                                                                    | 4,923            | 11,510           | (11,510)           |
| <b>Total liabilities and shareowners' equity</b>                                                       | <b>\$ 14,681</b> | <b>\$ 20,723</b> | <b>\$ (14,189)</b> |

**Condensed Consolidating  
Statements of Operations  
For the Quarter Ended November 10, 2007**

|                                                             | <b>The Kroger<br/>Co.</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|-------------------------------------------------------------|---------------------------|-----------------------------------|---------------------|---------------------|
| Sales                                                       | \$ 2,122                  | \$ 14,322                         | \$ (309)            | \$ 16,135           |
| Merchandise costs, including warehousing and transportation | 1,714                     | 10,997                            | (309)               | 12,402              |
| Operating, general and administrative                       | 406                       | 2,417                             | □                   | 2,823               |
| Rent                                                        | 30                        | 120                               | □                   | 150                 |
| Depreciation and amortization                               | 34                        | 281                               | □                   | 315                 |

|                                    |        |        |          |        |
|------------------------------------|--------|--------|----------|--------|
| Operating profit (loss)            | (62)   | 507    | □        | 445    |
| Interest expense                   | 108    | 2      | □        | 110    |
| Equity in earnings of subsidiaries | 545    | □      | (545)    | □      |
| Earnings before income tax expense | 375    | 505    | (545)    | 335    |
| Income tax expense (benefit)       | 121    | (40)   | □        | 81     |
| Net earnings                       | \$ 254 | \$ 545 | \$ (545) | \$ 254 |

**Condensed Consolidating  
Statements of Operations  
For the Quarter Ended November 4, 2006**

|                                                             | <b>The Kroger<br/>Co.</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|-------------------------------------------------------------|---------------------------|-----------------------------------|---------------------|---------------------|
| Sales                                                       | \$ 2,094                  | \$ 12,834                         | \$ (229)            | \$ 14,699           |
| Merchandise costs, including warehousing and transportation | 1,608                     | 9,752                             | (229)               | 11,131              |
| Operating, general and administrative                       | 406                       | 2,279                             | □                   | 2,685               |
| Rent                                                        | 35                        | 104                               | □                   | 139                 |
| Depreciation and amortization                               | 29                        | 266                               | □                   | 295                 |
| Operating profit (loss)                                     | 16                        | 433                               | □                   | 449                 |
| Interest expense                                            | 106                       | 1                                 | □                   | 107                 |
| Equity in earnings of subsidiaries                          | 283                       | □                                 | (283)               | □                   |
| Earnings before income tax expense                          | 193                       | 432                               | (283)               | 342                 |
| Income tax expense (benefit)                                | (22)                      | 149                               | □                   | 127                 |
| Net earnings                                                | \$ 215                    | \$ 283                            | \$ (283)            | \$ 215              |

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**Condensed Consolidating  
Statements of Operations  
For the Three Quarters Ended November 10, 2007**

|                                                             | <b>The Kroger<br/>Co.</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|-------------------------------------------------------------|---------------------------|-----------------------------------|---------------------|---------------------|
| Sales                                                       | \$ 6,934                  | \$ 47,018                         | \$ (952)            | \$ 53,000           |
| Merchandise costs, including warehousing and transportation | 5,639                     | 35,864                            | (952)               | 40,551              |
| Operating, general and administrative                       | 1,320                     | 7,939                             | □                   | 9,259               |
| Rent                                                        | 97                        | 391                               | □                   | 488                 |
| Depreciation and amortization                               | 112                       | 918                               | □                   | 1,030               |
| Operating profit (loss)                                     | (234)                     | 1,906                             | □                   | 1,672               |
| Interest expense                                            | 355                       | 5                                 | □                   | 360                 |
| Equity in earnings of subsidiaries                          | 1,572                     | □                                 | (1,572)             | □                   |
| Earnings before income tax expense                          | 983                       | 1,901                             | (1,572)             | 1,312               |
| Income tax expense                                          | 125                       | 329                               | □                   | 454                 |

|              |    |     |    |       |    |         |    |     |
|--------------|----|-----|----|-------|----|---------|----|-----|
| Net earnings | \$ | 858 | \$ | 1,572 | \$ | (1,572) | \$ | 858 |
|--------------|----|-----|----|-------|----|---------|----|-----|

**Condensed Consolidating  
Statements of Operations  
For the Three Quarters Ended November 4, 2006**

|                                                             | The Kroger<br>Co. | Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|-------------------------------------------------------------|-------------------|---------------------------|--------------|--------------|
| Sales                                                       | \$ 7,045          | \$ 42,952                 | \$ (745)     | \$ 49,252    |
| Merchandise costs, including warehousing and transportation | 5,669             | 32,463                    | (745)        | 37,387       |
| Operating, general and administrative                       | 1,357             | 7,505                     | □            | 8,862        |
| Rent                                                        | 111               | 377                       | □            | 488          |
| Depreciation and amortization                               | 110               | 863                       | □            | 973          |
| Operating profit (loss)                                     | (202)             | 1,744                     | □            | 1,542        |
| Interest expense                                            | 367               | 5                         | □            | 372          |
| Equity in earnings of subsidiaries                          | 1,233             | □                         | (1,233)      | □            |
| Earnings before income tax expense                          | 664               | 1,739                     | (1,233)      | 1,170        |
| Income tax expense (benefit)                                | (66)              | 506                       | □            | 440          |
| Net earnings                                                | \$ 730            | \$ 1,233                  | \$ (1,233)   | \$ 730       |

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**Condensed Consolidating  
Statements of Cash Flows  
For the Three Quarters Ended November 10, 2007**

|                                                           | The Kroger<br>Co. | Guarantor<br>Subsidiaries | Consolidated |
|-----------------------------------------------------------|-------------------|---------------------------|--------------|
| Net cash provided by operating activities                 | \$ 1,200          | \$ 1,077                  | \$ 2,277     |
| Cash flows from investing activities:                     |                   |                           |              |
| Payments for capital expenditures, excluding acquisitions | (141)             | (1,487)                   | (1,628)      |
| Other                                                     | (27)              | (59)                      | (86)         |
| Net cash used by investing activities                     | (168)             | (1,546)                   | (1,714)      |
| Cash flows from financing activities:                     |                   |                           |              |
| Dividends paid                                            | (151)             | □                         | (151)        |
| Proceeds from issuance of long-term debt                  | 974               | □                         | 974          |
| Payments on long-term debt                                | (545)             | □                         | (545)        |
| Proceeds from issuance of capital stock                   | 215               | □                         | 215          |
| Treasury stock purchases                                  | (1,152)           | □                         | (1,152)      |
| Other                                                     | □                 | 73                        | 73           |
| Net change in advances to subsidiaries                    | (377)             | 377                       | □            |
| Net cash used by financing activities                     | (1,036)           | 450                       | (586)        |
| Net decrease in cash and temporary cash investments       | (4)               | (19)                      | (23)         |

## Cash and temporary cash investments:

|                   |       |        |        |
|-------------------|-------|--------|--------|
| Beginning of year | 25    | 164    | 189    |
| End of quarter    | \$ 21 | \$ 145 | \$ 166 |

**Condensed Consolidating  
Statements of Cash Flows  
For the Three Quarters Ended November 4, 2006**

|                                                                | The Kroger<br>Co. | Guarantor<br>Subsidiaries | Consolidated |
|----------------------------------------------------------------|-------------------|---------------------------|--------------|
| Net cash provided by operating activities                      | \$ (75)           | \$ 1,906                  | \$ 1,831     |
| Cash flows from investing activities:                          |                   |                           |              |
| Payments for capital expenditures, excluding acquisitions      | (100)             | (1,078)                   | (1,178)      |
| Other                                                          | 60                | 26                        | 86           |
| Net cash used by investing activities                          | (40)              | (1,052)                   | (1,092)      |
| Cash flows from financing activities:                          |                   |                           |              |
| Dividends paid                                                 | (94)              | □                         | (94)         |
| Proceeds from issuance of long-term debt                       | 280               | □                         | 280          |
| Payments on long-term debt                                     | (543)             | □                         | (543)        |
| Proceeds from issuance of capital stock                        | 89                | □                         | 89           |
| Treasury stock purchases                                       | (527)             | □                         | (527)        |
| Other                                                          | (1)               | (12)                      | (13)         |
| Net change in advances to subsidiaries                         | 871               | (871)                     | □            |
| Net cash used by financing activities                          | 75                | (883)                     | (808)        |
| Net increase (decrease) in cash and temporary cash investments | (40)              | (29)                      | (69)         |
| Cash and temporary cash investments:                           |                   |                           |              |
| Beginning of year                                              | 39                | 171                       | 210          |
| End of quarter                                                 | \$ (1)            | \$ 142                    | \$ 141       |

**11. COMMITMENTS AND CONTINGENCIES**

The Company continuously evaluates contingencies based upon the best available evidence.

The Company believes that allowances for loss have been provided to the extent necessary and that its assessment of contingencies is reasonable. To the extent that resolution of contingencies results in amounts that vary from the Company's estimates, future earnings will be charged or credited.

The principal contingencies are described below:

*Insurance* □ The Company's workers' compensation risks are self-insured in certain states. In addition, other workers' compensation risks and certain levels of insured general liability risks are based on retrospective premium plans, deductible plans, and self-insured retention plans. The liability for workers' compensation risks is

accounted for on a present value basis. Actual claim settlements and expenses incident thereto may differ from the provisions for loss. Property risks have been underwritten by a subsidiary and are reinsured with unrelated insurance companies. Operating divisions and subsidiaries have paid premiums, and the insurance subsidiary has provided loss allowances, based upon actuarially determined estimates.

**Litigation** ¶ On October 6, 2006, the Company petitioned the Tax Court (*In Re: Ralphs Grocery Company and Subsidiaries, formerly known as Ralphs Supermarkets, Inc.*, Docket No. 20364-06) for a redetermination of deficiencies set by the Commissioner of Internal Revenue. The dispute at issue involves a 1992 transaction in which Ralphs Holding Company acquired the stock of Ralphs Grocery Company and made an election under Section 338(h)(10) of the Internal Revenue Code. The Commissioner has determined that the acquisition of the stock was not a purchase as defined by Section 338(h)(3) of the Internal Revenue Code and that the acquisition does not qualify as a purchase. The Company has strong arguments in favor of its position and believes it is more likely than not that its position will be sustained. However, due to the inherent uncertainty involved in the litigation process, there can be no assurances that the Tax Court will rule in favor of the Company. As of November 10, 2007, an adverse decision would require a cash payment of approximately \$406, including interest.

On February 2, 2004, the Attorney General for the State of California filed an action in Los Angeles federal court (*California, ex rel Lockyer v. Safeway, Inc. dba Vons, a Safeway Company; Albertson's, Inc. and Ralphs Grocery Company, a division of The Kroger Co.*, United States District Court Central District of California, Case No. CV04-0687) alleging that the Mutual Strike Assistance Agreement (the "Agreement") between the Company, Albertson's, Inc. and Safeway Inc. (collectively, the "Retailers"), which was designed to prevent the union from placing disproportionate pressure on one or more of the Retailers by picketing such Retailer(s) but not the other Retailer(s) during the labor dispute in Southern California, violated Section 1 of the Sherman Act. The lawsuit seeks declarative and injunctive relief. On May 25, 2005, the Court denied a motion for a summary judgment filed by the defendants. Ralphs and the other defendants filed a notice of an interlocutory appeal to the United States Court of Appeals for the Ninth Circuit. On November 29, 2005, the appellate court dismissed the appeal. On December 7, 2006, the Court denied a motion for summary judgment filed by the State of California. The Company continues to believe it has strong defenses against this lawsuit and is vigorously defending it. Although this lawsuit is subject to uncertainties inherent to the litigation process, based on the information presently available to the Company, management does not expect that the ultimate resolution of this action will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

Various claims and lawsuits arising in the normal course of business, including suits charging violations of certain antitrust, wage and hour, or civil rights laws, are pending against the Company. Some of these suits purport or have been determined to be class actions and/or seek substantial damages. Any damages that may be awarded in antitrust cases will be automatically trebled. Although it is not possible at this time to evaluate the merits of all of these claims and lawsuits, nor their likelihood of success, the Company is of the belief that any resulting liability will not have a material adverse effect on the Company's financial position.

The Company continually evaluates its exposure to loss contingencies arising from pending or threatened litigation and believes it has made adequate provisions for these contingencies. Nonetheless, assessing and predicting the outcomes of these matters involve substantial uncertainties. It remains possible that despite management's current belief, material differences in actual outcomes or changes in management's evaluations or predictions could arise that could have a material adverse impact on the Company's financial condition or results of operation.

**Guarantees** ¶ The Company periodically enters into real estate joint ventures in connection with the development of certain properties. The Company usually sells its interests in such partnerships upon completion of the projects. As of November 10, 2007, the Company was a partner with 50% ownership in two real estate joint ventures for which it has guaranteed approximately \$7 of debt incurred by the ventures. Based on the covenants underlying this indebtedness as of November 10, 2007, it is unlikely that the Company will be responsible for repayment of these obligations.

**Assignments** ¶ The Company is contingently liable for leases that have been assigned to various third parties in connection with facility closings and dispositions. The Company could be required to satisfy the obligations under the leases if any of the assignees are unable to fulfill their lease obligations. Due to the wide distribution of the Company's assignments among third parties, and various other remedies available, the Company believes the likelihood that it will be required to assume a material amount of these obligations is remote.

**Benefit Plans** □ The Company administers certain non-contributory defined benefit retirement plans and contributory defined contribution retirement plans for substantially all non-union employees and some union-represented employees as determined by the terms and conditions of collective bargaining agreements. Funding for the defined benefit pension plans is based on a review of the specific requirements and an evaluation of the assets and liabilities of each plan. Funding for the Company's matching and automatic contributions under the defined contribution plans is based on years of service, plan compensation, and amount of contributions by participants.

In addition to providing pension benefits, the Company provides certain health care benefits for retired employees. Funding for the retiree health care benefits occurs as claims or premiums are paid.

The determination of the obligation and expense for the Company's defined benefit retirement pension plan and other post-retirement benefits is dependent on the Company's selection of assumptions used by actuaries in calculating those amounts. Those assumptions are described in the Company's 2006 Annual Report on Form 10-K and include, among others, the discount rate, the expected long-term rate of return on plan assets, and the rates of increase in compensation and health care costs. Actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally affect the recognized expense and recorded obligation in such future periods. While the Company believes that the assumptions are appropriate, significant differences in actual experience or significant changes in assumptions may materially affect the pension and other post-retirement obligations and future expense.

The Company contributed \$52 and \$150 to its Company-sponsored defined benefit pension plans in the first three quarters of 2007 and 2006, respectively. The Company expects these contributions will reduce its minimum required contributions in future years. Among other things, investment performance of plan assets, the interest rates required to be used to calculate pension obligations and future changes in legislation will determine the amounts of any additional contributions. In addition, we expect matching cash contributions to our 401(k) Retirement Savings Account Plan, a defined contribution plan, to total approximately \$93 in 2007.

The Company also contributes to various multi-employer pension plans based on obligations arising from most of its collective bargaining agreements. These plans provide retirement benefits to participants based on their service to contributing employers. The benefits are paid from assets held in trust for that purpose. Trustees are appointed in equal number by employers and unions. The trustees typically are responsible for determining the level of benefits to be provided to participants as well as for such matters as the investment of the assets and the administration of the plans.

Based on the most recent information available to it, the Company believes that the present value of actuarial accrued liabilities in most or all of these multi-employer plans substantially exceeds the value of the assets held in trust to pay benefits. Because the Company is only one of a number of employers contributing to these plans, it is difficult to ascertain what the Company's □share□ of the underfunding would be, although we anticipate the Company's contributions to these plans will increase each year. Although underfunding can result in the imposition of excise taxes on contributing employers, other factors such as increased contributions, changes in benefits, and improved investment performance can reduce underfunding so that excise taxes are not triggered. Moreover, if the Company were to exit certain markets or otherwise cease making contributions to these funds, the Company could trigger a substantial withdrawal liability. Any adjustment for withdrawal liability will be recorded when it is probable that a liability exists and can be reasonably determined, in accordance with SFAS No. 87, *Employers' Accounting for Pensions*.

## **12. INTEREST RATE HEDGES**

The Company has unamortized proceeds from six interest rate swaps once classified as fair value hedges totaling approximately \$36. The unamortized proceeds are recorded as adjustments to the carrying values of the underlying debt and are being amortized over the remaining lives of the debt.

During the second quarter of 2007, the Company terminated a forward-starting interest rate swap in a notional amount of \$250 classified as a cash flow hedge in the amount of \$11. The unamortized proceeds have been recorded net of tax in other comprehensive income and will be amortized to earnings as the payments of

interest to which the hedge relates are made.

At the end of the third quarter of 2007, the Company maintained six interest rate swap agreements that are being accounted for as fair value hedges. As of November 10, 2007, liabilities totaling \$11 have been recorded to reflect the fair value of these agreements, offset by reductions in the fair value of the underlying debt. In addition, the Company maintained two forward-starting interest rate swap agreements, with an aggregate notional amount totaling \$500. As of November 10, 2007, liabilities totaling \$4 million have been recorded to reflect the fair value of these agreements, offset by decreases in Other Comprehensive Income.

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## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following analysis should be read in conjunction with the Consolidated Financial Statements.

### OVERVIEW

Third quarter total sales increased 9.8% to \$16.1 billion compared to \$14.7 billion in the third quarter of 2006. Identical supermarket sales increased 7.7% with fuel and 5.7% without fuel compared to the third quarter of 2006. Strong identical sales growth continues to be a key driver of our objective to increase earnings and create value for shareholders. This is the tenth consecutive quarter Kroger has reported identical supermarket sales growth, excluding fuel, in excess of 3%. This growth continues to be broad-based across our geographic regions and merchandise departments with all supermarket divisions and departments experiencing positive identical sales growth.

For the third quarter of 2007, net earnings totaled \$254 million, or \$0.37 per diluted share. These results include a tax benefit of approximately \$40 million or, \$.06 per diluted share from the resolution of certain tax issues during the quarter, offset by unfavorable fuel margins and an increased LIFO charge. We have experienced and expect fuel margin variations from quarter to quarter. In the third quarter, our fuel margins were weaker than the prior year. On a year-to-date basis they were more consistent with historical results. Net earnings for the first three quarters of 2007 totaled \$858 million, which include expenses of \$0.02 per diluted share for charges related to labor unrest at one of our distribution centers in the first quarter of 2007 and a benefit of \$.06 per diluted share from the resolution of certain tax issues during the third quarter of 2007.

Operating margin on a year-to-date basis increased 3 basis points compared to the same period in 2006. Excluding the effect of retail fuel operations, charges related to labor unrest at one of our distribution centers in the first quarter of 2007, and certain legal expenses in 2006 our operating margin increased 7 basis points on a year-to-date basis. For fiscal year 2007, we continue to anticipate a slight increase in our operating margin excluding fuel.

### RESULTS OF OPERATIONS

#### *Net Earnings*

Net earnings totaled \$254 million for the third quarter of 2007, an increase of 18.1% from net earnings of \$215 million for the third quarter of 2006. This was the result of identical sales leverage, OG&A savings, and a tax benefit of approximately \$40 million from the resolution of certain tax issues, offset by weaker fuel margins and a higher LIFO charge in the third quarter of 2007, compared to the same period of 2006. Net earnings totaled \$858 million for the first three quarters of 2007, an increase of 17.5% from net earnings of \$730 for the first three quarters of 2006. The increase in our year-to-date net earnings was the result of strong identical sales growth, decreases in net interest, and a tax benefit of approximately \$40 million from the resolution of certain tax issues during the third quarter, offset by an \$18 million expense related to labor unrest at one of our distribution centers in the first quarter, and a LIFO charge of \$100 million for the first three quarters, compared to \$53 million in the first three quarters of 2006. The increase in the LIFO charge for the first three quarters was caused by general product cost increases across most core grocery and perishable categories. The first quarter results for 2006 included a non-recurring legal expense charge of \$45 million, or \$.03 cents per diluted share.

Net earnings of \$0.37 per diluted share for the third quarter of 2007 represented an increase of 23.3% over net earnings of \$0.30 per diluted share for the third quarter of 2006. Earnings of \$1.22 per diluted share for the first three quarters of 2007 represented an increase of 20.8% over net earnings of \$1.01 for the first three quarters of 2006. Earnings per share growth resulted from increased net earnings and the repurchase of our stock under stock buyback plans announced in May 2006 and June 2007.

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## Sales

### Total Sales (in millions)

|                                      | Third Quarter |                     |           |                     | Year-To-Date |                     |           |                     |
|--------------------------------------|---------------|---------------------|-----------|---------------------|--------------|---------------------|-----------|---------------------|
|                                      | 2007          |                     | 2006      |                     | 2007         |                     | 2006      |                     |
|                                      | 2007          | Percentage Increase | 2006      | Percentage Increase | 2007         | Percentage Increase | 2006      | Percentage Increase |
| Total supermarket sales without fuel | \$ 13,787     | 7.6%                | \$ 12,816 | 5.4%                | \$ 45,388    | 6.1%                | \$ 42,796 | 5.9%                |
| Total supermarket fuel sales         | 1,362         | 34.6%               | 1,012     | 2.5%                | 4,307        | 24.3%               | 3,465     | 26.7%               |
| Total supermarket sales              | 15,149        | 9.6%                | 13,828    | 5.2%                | 49,695       | 7.4%                | 46,261    | 7.2%                |
| Other sales(1)                       | 986           | 13.3%               | 871       | (0.6)%              | 3,305        | 10.5%               | 2,991     | 11.4%               |
| Total sales                          | \$ 16,135     | 9.8%                | \$ 14,699 | 4.8%                | \$ 53,000    | 7.6%                | \$ 49,252 | 7.5%                |

(1) Other sales primarily relate to sales at convenience and jewelry stores and sales by our manufacturing plants to outside firms.

The change in our total sales for the third quarter and the first three quarters of 2007 was primarily the result of identical store sales increases and increased fuel gallons, as well as inflation in almost all grocery and perishable categories as well as fuel. Identical store sales growth for the third quarter of 2007 was 7.7% including supermarket fuel operations and 5.7% excluding supermarket fuel operations. Increases in the number of customer transactions and average transaction size in the third quarter of 2007 were responsible for our increases in identical supermarket sales and total sales, excluding fuel.

We define a supermarket as identical when it has been in operation without expansion or relocation for five full quarters. Differences between total supermarket sales and identical supermarket sales primarily relate to changes in supermarket square footage. Our identical supermarket sales results are summarized in the table below. The identical supermarket dollar figures presented were used to calculate third quarter 2007 percent changes.

### Identical Supermarket Sales (in millions)

|                        | Third Quarter |             |
|------------------------|---------------|-------------|
|                        | 2007          | 2006        |
| Including fuel centers | \$ 14,283.6   | \$ 13,261.9 |
| Excluding fuel centers | \$ 13,012.9   | \$ 12,312.1 |
| Including fuel centers | 7.7%          | 4.9%        |
| Excluding fuel centers | 5.7%          | 5.3%        |

We define a supermarket as comparable when it has been in operation for five full quarters, including expansions and relocations. Our comparable supermarket sales results are summarized in the table below. The comparable supermarket dollar figures presented were used to calculate the third quarter 2007 percent changes.

**Comparable Supermarket Sales**  
(in millions)

|                        | <b>Third Quarter</b> |             |
|------------------------|----------------------|-------------|
|                        | <b>2007</b>          | <b>2006</b> |
| Including fuel centers | \$ 14,768.2          | \$ 13,676.9 |
| Excluding fuel centers | \$ 13,439.7          | \$ 12,694.6 |
| Including fuel centers | 8.0%                 | 5.2%        |
| Excluding fuel centers | 5.9%                 | 5.5%        |

*FIFO Gross Margin*

We calculate First-In, First-Out (□FIFO□) Gross Margin as follows: Sales minus merchandise costs plus Last-In, First-Out (□LIFO□) charge. Merchandise costs include advertising, warehousing and transportation, but exclude depreciation expenses and rent expense. FIFO gross margin is an important measure used by management to evaluate merchandising and operational effectiveness.

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Our FIFO gross margin rate decreased 110 basis points to 23.38% for the third quarter of 2007 from 24.48% for the third quarter of 2006, primarily due to the lower margins associated with fuel sales. Our retail fuel sales lower our FIFO gross margin rate due to the very low FIFO gross margin on retail fuel sales as compared to non-fuel sales. Excluding the effect of retail fuel operations, our FIFO gross margin rate decreased 34 basis points for the third quarter of 2007 compared to the third quarter of 2006, as we continue to reinvest operating cost savings into our customer 1<sup>st</sup> strategy.

Our FIFO gross margin rate declined 52 basis points to 23.68% for the first three quarters of 2007 from 24.20% for the first three quarters of 2006. Excluding the effect of retail fuel operations, FIFO gross margin, as a percent of sales, declined 18 basis points versus the first three quarters of last year. This decline results from our reinvesting operating cost savings into our Customer 1<sup>st</sup> strategy.

*Operating, General and Administrative Expenses*

Operating, general and administrative (□OG&A□) expenses consist primarily of employee-related costs such as wages, health care benefit costs and retirement plan costs. We do not include rent expense, depreciation and amortization expense, and interest expense, among other items, in OG&A. OG&A expenses, as a percent of sales, decreased 78 basis points to 17.49% for the third quarter of 2007 from 18.27% for the third quarter of 2006. Our retail fuel sales lower our OG&A rate due to very low OG&A rates on retail fuel sales as compared to non-fuel sales. OG&A expenses, as a percent of sales excluding fuel, decreased 49 basis points for the third quarter of 2007 compared to the third quarter of 2006. This decline resulted from identical sales growth, increased productivity, progress made in controlling our utility expenses, and health care and pension cost savings recently negotiated in completed labor agreements. These gains were partially offset by higher credit card fees.

OG&A expenses, as a percent of sales, decreased 52 basis points to 17.47% for the first three quarters of 2007 from 17.99% for the first three quarters of 2006. Excluding the effect of retail fuel operations and the non-recurring legal expense in 2006, OG&A, as a percent of sales, declined 24 basis points versus the first three quarters of last year. This decline was primarily the result of identical sales growth and the same cost controls noted in the preceding paragraph.

*Rent Expense*

Rent expense was \$150 million, or .93% of sales, for the third quarter of 2007, compared to \$139 million, or .95% of sales, for the third quarter of 2006. For the first three quarters, rent expense was \$488 million, or .92% of total sales in 2007, compared to \$488 million, or .99% of sales, in 2006. The decrease in rent expense, as a percent of sales, in both the third quarter and the first three quarters of 2007, compared to the same periods of 2006, results from strong sales growth and also implementation of our strategy to own rather than lease whenever possible. Excluding the effect of retail fuel operations, rent as a percent of sales, declined 1 and 7 basis points in the third quarter and the first three quarters of 2007, respectively, compared to the same periods of 2006.

#### *Depreciation Expense*

Depreciation expense was \$315 million, or 1.96% of total sales, for the third quarter of 2007 compared to \$295 million, or 2.01% of total sales, for the third quarter of 2006. Depreciation expense was \$1,030 million, or 1.94% of total sales, for the first three quarters of 2007 compared to \$973 million, or 1.97% of total sales, for the first three quarters of 2006. The increase in depreciation expense, in total dollars, was the result of higher capital expenditures during the last rolling four quarters of 2007 compared to the comparable period in 2006. Excluding the effect of retail fuel operations, depreciation as a percent of sales, remained constant in both the third quarter and the first three quarters of 2007 compared to the same periods of 2006.

#### *Interest Expense*

Net interest expense was \$110 million, or 0.68% of total sales, and \$107 million, or 0.73% of total sales, in the third quarters of 2007 and 2006, respectively. For the first three quarters, interest expense was \$360 million, or 0.68% of total sales, in 2007 and \$372 million, or 0.75% of total sales, in 2006. The increase in net interest expense for the third quarter, when compared to the same period of 2006, resulted primarily from a \$528 million increase in total debt at November 10, 2007 compared to November 4, 2006. This increase in total debt reflects additional borrowings to fund a higher level of capital expenditures, as well as additional share repurchases in 2007, compared to the same period of 2006. The reduction in net interest expense year-to-date, when compared to the prior year, resulted primarily from a reduction in the average daily total debt balance during the first three quarters of the year.

#### *Income Taxes*

Our effective income tax rate was 24.2% for the third quarter of 2007 and 37.1% for the third quarter of 2006. For the first three quarters, our effective income tax rate was 34.6% in 2007 and 37.6% in 2006. The 2007 effective income tax rate differed from the federal statutory rate primarily due to the effect of state taxes and the resolution of certain tax issues during the third quarter of 2007 that affected tax expense by approximately \$40 million. The 2006 effective income tax rate differed from the federal statutory rate primarily due to the effect of state taxes.

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## **LIQUIDITY AND CAPITAL RESOURCES**

### *Cash Flow Information*

#### Net cash provided by operating activities

We generated \$2.3 billion of cash from operating activities during the first three quarters of 2007, compared to \$1.8 billion in 2006. The cash generated from operating activities was primarily due to strong operating results adjusted for non-cash expenses. In addition, cash used to purchase additional inventory and to make cash contributions to Company-sponsored pension plans was offset by increases in accounts payable and income taxes payable and a decrease in prepaid expenses. We contributed \$52 million to company sponsored pension plans during the first three quarters of 2007 compared to \$150 million during the first three quarters of 2006.

#### Net cash used by investing activities

Investing activities used \$1.7 billion of cash during the first three quarters of 2007 compared to \$1.1 billion during the first three quarters of 2006. The amount of cash used by investing activities increased in 2007 versus 2006 due primarily to higher capital spending and payments for two acquisitions.

Net cash used by financing activities

Financing activities used \$586 million of cash in the first three quarters of 2007 compared to \$808 million in the first three quarters of 2006. The decrease in the amount of cash used was a result of proceeds received from the issuance of long term-term debt and capital stock, offset by greater stock repurchases and dividends paid. We received proceeds from the issuance of common stock in connection with exercises of employee stock options.

*Debt Management*

As of November 10, 2007, we maintained a \$2.5 billion, five-year revolving credit facility that terminates in 2011. Outstanding borrowings under the credit agreement and commercial paper borrowings, and some outstanding letters of credit, reduce funds available under the credit agreement. In addition to the credit agreement, we maintained three money market lines totaling \$75 million in the aggregate. The money market lines allow us to borrow from banks at mutually agreed upon rates, usually at rates below the rates offered under the credit agreement. As of November 10, 2007, we had outstanding commercial paper and borrowings under our credit agreement totaling \$552 and \$166 million, respectively, that reduced amounts available under our credit agreement and had no borrowings under the money market line. The outstanding letters of credit that reduced the funds available under our credit agreement totaled \$342 million as of November 10, 2007.

Our bank credit facility and the indentures underlying our publicly issued debt contain various restrictive covenants. As of November 10, 2007, we were in compliance with these financial covenants. Furthermore, management believes it is not reasonably likely that Kroger will fail to comply with these financial covenants in the foreseeable future.

Total debt, including both the current and long-term portions of capital leases and lease-financing obligations, increased \$528 million to \$7.5 billion as of the end of the third quarter of 2007, from \$7.0 billion as of the end of the third quarter of 2006. Total debt increased \$430 million as of the end of the third quarter of 2007 from \$7.1 billion as of year-end 2006. The increases in 2007 resulted from the issuance of \$300 million, 6.4% senior notes in the second and third quarters of 2007, respectively, and borrowings under the bank revolver, offset by the repayment of \$200 million, 7.65% senior notes and \$300 million, 7.80% senior notes which came due during the first half of 2007.

*Common Stock Repurchase Program*

During the third quarter of 2007, we invested \$442 million to repurchase 16.5 million shares of Kroger stock at an average price of \$26.77 per share. For the first three quarters of 2007, we invested \$1,152 million to repurchase 42.4 million shares of Kroger stock at an average price of \$27.15 per share. These shares were reacquired under three separate stock repurchase programs. The first is a \$500 million repurchase program that was authorized by Kroger's Board of Directors on May 4, 2006. The second is a \$1 billion repurchase program that was authorized by Kroger's Board of Directors on June 26, 2007, which replaced the prior \$500 million authorization above. The third is a program that purchases shares using the cash proceeds from the exercises of stock options by participants in Kroger's stock option and long-term incentive plans as well as the associated tax benefits. As of November 10, 2007, we had approximately \$202 million remaining under the June 2007 repurchase program.

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**CAPITAL EXPENDITURES**

Capital expenditures totaled \$555 million for the third quarter of 2007 compared to \$415 million for the third quarter of 2006. Year-to-date, capital expenditures, excluding acquisitions, totaled \$1.6 billion in 2007 and \$1.2 billion in 2006. During the third quarter of 2007, we opened, acquired, expanded or relocated 13 food stores and also completed 54 within-the-wall remodels. During the first three quarters of 2007, we opened, acquired,

expanded or relocated 82 food stores and also completed 155 within-the-wall remodels. Total food store square footage increased 2.0% from the third quarter of 2006. Excluding acquisitions and operational closings, total food store square footage increased 1.8% over the third quarter of 2006.

## CRITICAL ACCOUNTING POLICIES

We have chosen accounting policies that we believe are appropriate to report accurately and fairly our operating results and financial position, and we apply those accounting policies in a consistent manner. Except as noted below, our critical accounting policies are summarized in our 2006 Annual Report on Form 10-K filed with the SEC on April 4, 2007.

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. We base our estimates on historical experience and other factors we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could vary from those estimates.

### *Accounting for Uncertainty in Income Taxes*

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

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

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

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

The IRS concluded a field examination of our 2002 — 2004 U.S. tax returns during the third quarter of 2007. An examination of our 1999 — 2001 U.S. tax returns was completed in 2005. We contested two issues at the appellate level of the IRS. One of the issues was resolved in the third quarter of 2007 and we anticipate that the remaining issue may be resolved within the next 12 months. In the opinion of management, the ultimate disposition of the item noted above will not have a significant effect on our consolidated financial position, liquidity, or results of operations. Additionally, we have a case in the U.S. Tax Court. A decision on this case is not expected within the next 12 months. In connection with this case, we have extended the statute of limitations on our tax years after 1991.

As a result of settlements with taxing authorities during the quarter, we have reclassified unrecognized tax benefits of \$168 million from other long-term liabilities to deferred income taxes and accrued taxes payable.

## RECENTLY ISSUED ACCOUNTING STANDARDS

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurement.

SFAS No. 157 does not require any new fair value measurements. SFAS No. 157 will become effective for our fiscal year beginning February 3, 2008. We are evaluating the effect the implementation of SFAS No. 157 will have on our Consolidated Financial Statements.

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In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to make an irrevocable election to measure certain financial instruments and other assets and liabilities at fair value on an instrument-by-instrument basis. Unrealized gains and losses on items for which the fair value option has been elected should be recognized into net earnings at each subsequent reporting date. SFAS No. 159 will become effective for our fiscal year beginning February 3, 2008. We are currently evaluating the effect the adoption of SFAS No. 159 will have on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements-an amendment of ARB No. 51*. SFAS No. 160 will require the consolidation of noncontrolling interests as a component of equity. SFAS No. 160 will become effective for our fiscal year beginning February 1, 2009. We are currently evaluating the effect the adoption of SFAS No. 160 will have on our Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations (SFAS No. 141R)*, which replaces SFAS No. 141. SFAS No. 141R further expands the definitions of a business and the fair value measurement and reporting in a business combination. SFAS No. 141R will become effective for our fiscal year beginning February 1, 2009. We are currently evaluating the effect the adoption of SFAS No. 141R will have on our Consolidated Financial Statements.

## OUTLOOK

This discussion and analysis contains certain forward-looking statements about Kroger's future performance. These statements are based on management's assumptions and beliefs in light of the information currently available. Such statements relate to, among other things: projected changes in net earnings; identical sales growth; expected pension plan contributions; our ability to generate operating cash flow; projected capital expenditures; square footage growth; opportunities to reduce costs; cash flow requirements; and our operating plan for the future; and are indicated by words such as "comfortable," "committed," "will," "expect," "goal," "should," "target," "believe," "anticipate," "plan," "striving," and similar words or phrases. These forward-looking statements are subject to uncertainties and other factors that could cause actual results to differ materially.

Statements elsewhere in this report and below regarding our expectations, projections, beliefs, intentions or strategies are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. While we believe that the statements are accurate, uncertainties about the general economy, our labor relations, our ability to execute our plans on a timely basis and other uncertainties described below could cause actual results to differ materially.

- We expect earnings per diluted share to slightly exceed our previous guidance of \$1.64 - \$1.67 for 2007. This represents earnings per share growth of 14% or greater in 2007 from adjusted 2006 earnings of \$1.47, which excludes the estimated effect of a 53<sup>rd</sup> week in 2006 of approximately \$0.07 per diluted share.
- We expect identical food store sales growth, excluding fuel sales, of approximately 5% in 2007.
- In 2007, we will continue to focus on increasing sales growth and balancing investments in gross margin and improved customer service with operating cost reductions to provide a better shopping experience for our customers. We expect operating margins, excluding fuel, to improve slightly in 2007.
- We plan to use free cash flow to repurchase stock and pay cash dividends.
- Capital expenditures reflect our strategy of growth through expansion and acquisition, as well as focusing on increasing productivity from our existing store base through remodels. In addition, we will continue

our emphasis on self-development and ownership of real estate, logistics and technology improvements. The continued capital spending in technology is focused on improving store operations, logistics, manufacturing procurement, category management, merchandising and buying practices, and should reduce merchandising costs. We intend to continue using cash flow from operations to finance capital expenditure requirements. We expect capital investment for 2007 to be in the range of \$1.9-\$2.1 billion, excluding acquisitions. We expect total food store square footage to grow approximately 2% before acquisitions and operational closings.

- Based on current operating trends, we believe that cash flow from operations and other sources of liquidity, including borrowings under our commercial paper program and bank credit facility, will be adequate to meet anticipated requirements for working capital, capital expenditures, and interest payments for the foreseeable future. We also believe we have adequate coverage of our debt covenants to continue to respond effectively to competitive conditions.
- We expect that our OG&A results will be affected by increased costs, such as higher energy costs and credit card fees, as well as any future labor disputes, offset by improved productivity from process changes, cost savings negotiated in recently completed labor agreements and leverage gained through sales increases.

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- We expect that our effective tax rate for the fourth quarter of 2007 will be approximately 38%. The total fiscal year 2007 tax rate will be approximately 35.6% due to the tax benefit realized in the third quarter of 2007 related to settlements with taxing authorities.
- We expect rent expense, as a percent of total sales and excluding closed-store activity, will decrease due to the emphasis our current strategy places on ownership of real estate.
- We believe that in 2007 there will be opportunities to reduce our operating costs in such areas as administration, labor, shrink, warehousing and transportation. These savings will be invested in our core business to drive profitable sales growth and offer improved value and enhanced shopping experiences for our customers.
- Although we are not required to make cash contributions to Company-sponsored pension plans during 2007, we contributed \$52 million to these plans during the first three quarters of 2007. Additional voluntary contributions may be made if our cash flows from operations exceed our expectations. We expect any additional elective contributions made during 2007 will reduce our contributions in future years. Among other things, investment performance of plan assets, the interest rates required to be used to calculate pension obligations and future changes in legislation will determine the amounts of any additional contributions. In addition, we expect to make automatic and matching cash contributions to our 401(k) Retirement Savings Account Plan totaling \$93 million in 2007.
- We expect our contributions to multi-employer pension plans to increase approximately 1.0% - 2.0% during 2007 over the \$204 million we contributed during 2006.

Various uncertainties and other factors could cause us to fail to achieve our goals. These include:

- We have various labor agreements expiring in 2007 and 2008, including agreements covering associates in Memphis, which has been extended, Columbus, Indianapolis, Las Vegas, Louisville, Nashville, Phoenix and Portland. In all of these contracts, rising health care and pension costs will continue to be an important issue in negotiations.
- Our ability to achieve sales and earnings goals may be affected by: labor disputes; industry consolidation; pricing and promotional activities of existing and new competitors, including non-traditional competitors; our response to these actions; the state of the economy, including the inflationary and deflationary trends in certain commodities; stock repurchases; and the success of our future growth plans.

- In addition to the factors identified above, our identical store sales growth could be affected by increases in Kroger private label sales, the effect of our [sister stores] (new stores opened in close proximity to an existing store) and reductions in retail pricing.
- Our operating margins, without fuel, could fail to improve as expected or if we are unsuccessful at containing our operating costs.
- We have estimated our exposure to the claims and litigation arising in the normal course of business, as well as in material litigation facing Kroger, and believe we have made adequate provisions for them where it is reasonably possible to estimate our exposure and where we believe an adverse outcome is probable. Unexpected outcomes in these matters, however, could result in an adverse effect on our earnings.
- Consolidation in the food industry is likely to continue and the effects on our business, either favorable or unfavorable, cannot be foreseen.
- Rent expense, which includes subtenant rental income, could be adversely affected by the state of the economy, increased store closure activity and future consolidation.
- Depreciation expense, which includes the amortization of assets recorded under capital leases, is computed principally using the straight-line method over the estimated useful lives of individual assets, or the remaining terms of leases. Use of the straight-line method of depreciation creates a risk that future asset write-offs or potential impairment charges related to store closings would be larger than if an accelerated method of depreciation was followed.
- Our effective tax rate may differ from the expected rate due to changes in laws, the status of pending items with various taxing authorities and the deductibility of certain expenses.

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- The grocery retail industry continues to experience fierce competition from other traditional food retailers, supercenters, mass merchandisers, club or warehouse stores, drug stores and restaurants. Our continued success is dependent upon our ability to compete in this industry and to reduce operating expenses, including managing health care and pension costs contained in our collective bargaining agreements. The competitive environment may cause us to reduce our prices in order to gain or maintain share of sales, thus reducing margins. While we believe our opportunities for sustained profitable growth are considerable, unanticipated actions of competitors could adversely affect our sales.
- Changes in laws or regulations, including changes in accounting standards, taxation requirements and environmental laws may have a material effect on our financial statements.
- Changes in the general business and economic conditions in our operating regions, including the rate of inflation, population growth and employment and job growth in the markets in which we operate, may affect our ability to hire and train qualified employees to operate our stores. This would negatively affect earnings and sales growth. General economic changes may also affect the shopping habits of our customers, which could affect sales and earnings.
- Changes in our product mix may negatively affect certain financial indicators. For example, we continue to add supermarket fuel centers to our store base. Since gasoline generates low profit margins, including generating decreased margins as the market price increases, we expect to see our FIFO gross profit margins decline as gasoline sales increase. Although this negatively affects our FIFO gross margin, gasoline sales provide a positive effect on OG&A as a percent of sales.
- Our ability to integrate any companies we acquire or have acquired, and achieve operating improvements at those companies, will affect our operations.
- Our capital expenditures, expected square footage growth, and number of store projects completed during the year could differ from our estimates if we are unsuccessful in acquiring suitable sites for new stores, if development costs vary from those budgeted or if our logistics and technology projects are not

completed in the time frame expected or on budget.

- Interest expense could be adversely affected by the interest rate environment, changes in the Company's credit ratings, fluctuations in the amount of outstanding debt, decisions to incur prepayment penalties on the early redemption of debt and any factor that adversely affects our operations that results in an increase in debt.
- Adverse weather conditions could increase the cost our suppliers charge for their products, or may decrease the customer demand for certain products. Additionally, increases in some costs, such as utility costs or raw material costs, could negatively affect financial ratios and earnings.
- Although we presently operate only in the United States, civil unrest in foreign countries in which our suppliers do business may affect the prices we are charged for imported goods. If we are unable to pass on these increases to our customers, our FIFO gross margin and net earnings will suffer.
- The actual amount of automatic and matching cash contributions to our 401(k) Retirement Savings Account Plan will depend on the savings rate, plan compensation, and length of service of participants.

We cannot fully foresee the effects of changes in economic conditions on Kroger's business. We have assumed economic and competitive situations will not change significantly for 2007.

Other factors and assumptions not identified above could also cause actual results to differ materially from those set forth in our forward-looking statements. Accordingly, actual events and results may vary significantly from those included in, contemplated or implied by forward-looking statements made by us or our representatives.

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

There have been no significant changes in our exposure to market risk from the information provided in Item 7A. Quantitative and Qualitative Disclosures About Market Risk in our Form 10-K filed with the SEC on April 4, 2007.

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

The Chief Executive Officer and the Chief Financial Officer, together with a disclosure review committee appointed by the Chief Executive Officer, evaluated Kroger's disclosure controls and procedures as of the quarter ended November 10, 2007. Based on that evaluation, Kroger's Chief Executive Officer and Chief Financial Officer concluded that Kroger's disclosure controls and procedures were effective as of the end of the period covered by this report.

In connection with the evaluation described above, there was no change in Kroger's internal control over financial reporting during the quarter ended November 10, 2007, that has materially affected, or is reasonably likely to materially affect, Kroger's internal control over financial reporting.

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## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

Various claims and lawsuits arising in the normal course of business, including suits charging violations of certain antitrust, wage and hour, or civil rights laws, are pending against the Company. Some of these suits purport or have been determined to be class actions and/or seek substantial damages. Any damages that may be awarded in antitrust cases will be automatically trebled. Although it is not possible at this time to evaluate the merits of all of these claims and lawsuits, nor their likelihood of success, the Company is of the belief that any resulting liability will not have a material adverse effect on the Company's financial position.

The Company continually evaluates its exposure to loss contingencies arising from pending or threatened litigation and believes it has made adequate provisions therefor. Nonetheless, assessing and predicting the outcomes of these matters involve substantial uncertainties. It remains possible that despite management's current belief, material differences in actual outcomes or changes in management's evaluations or predictions could arise that could have a material adverse impact on the Company's financial condition or results of operation.

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## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

(c)

### ISSUER PURCHASES OF EQUITY SECURITIES

| Period <sup>(1)</sup>                  | Total Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid<br>Per<br>Share | Total Number of<br>Shares Purchased<br>as Part of Publicly<br>Announced Plans<br>or Programs <sup>(2)</sup> | Maximum<br>Dollar<br>Value<br>of<br>Shares<br>that<br>May<br>Yet Be<br>Purchased<br>Under<br>the<br>Plans<br>or<br>Programs <sup>(3)</sup><br>(in<br>millions) |
|----------------------------------------|----------------------------------------|------------------------------------------|-------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                        |                                        |                                          |                                                                                                             |                                                                                                                                                                |
| First four weeks                       |                                        |                                          |                                                                                                             |                                                                                                                                                                |
| August 19, 2007 to September 15, 2007  | 10,370,886                             | \$ 25.85                                 | 10,359,123                                                                                                  | \$ 347                                                                                                                                                         |
| Second four weeks                      |                                        |                                          |                                                                                                             |                                                                                                                                                                |
| September 16, 2007 to October 13, 2007 | 3,709,137                              | \$ 28.02                                 | 3,688,993                                                                                                   | \$ 259                                                                                                                                                         |
| Third four weeks                       |                                        |                                          |                                                                                                             |                                                                                                                                                                |
| October 14, 2007 to November 10, 2007  | 2,468,054                              | \$ 28.73                                 | 2,468,021                                                                                                   | \$ 202                                                                                                                                                         |
| Total                                  | 16,548,077                             | \$ 26.77                                 | 16,516,137                                                                                                  | \$ 202                                                                                                                                                         |

- (1) The reported periods conform to the Company's fiscal calendar composed of thirteen 28-day periods. The third quarter of 2007 contained three 28-day periods.
- (2) Shares were repurchased under (i) a \$1 billion stock repurchase program, authorized by the Board of Directors on June 26, 2007, and (ii) a program announced on December 6, 1999, to repurchase common stock to reduce dilution resulting from our employee stock option plans which program is limited to proceeds received from exercises of stock options and the tax benefits associated therewith. The programs have no expiration date but may be terminated by the Board of Directors at any time. Total shares purchased include shares that were surrendered to the Company by participants in the Company's long-term incentive plans to pay for taxes on restricted stock awards.
- (3) Amounts shown in this column reflect amounts remaining under the \$1 billion stock repurchase program referenced in clause (i) of Note 2 above. Amounts to be invested under the program utilizing option exercise proceeds are dependent upon option exercise activity.

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## Item 6. Exhibits.

- EXHIBIT 3.1 - Amended Articles of Incorporation are hereby incorporated by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended May 20, 2006, filed with the SEC on June 29, 2006.

- EXHIBIT 3.2 - Regulations are hereby incorporated by reference to Exhibit 3.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended May 26, 2007, filed with the SEC on July 3, 2007.
- EXHIBIT 4.1 - Instruments defining the rights of holders of long-term debt of the Company and its subsidiaries are not filed as Exhibits because the amount of debt under each instrument is less than 10% of the consolidated assets of the Company. The Company undertakes to file these instruments with the Commission upon request.
- EXHIBIT 31.1 - Rule 13a-14(a) / 15d-14(a) Certifications of Chief Executive Officer.
- EXHIBIT 31.2 - Rule 13a-14(a) / 15d-14(a) Certifications of Chief Financial Officer.
- EXHIBIT 32.1 - Section 1350 Certifications.
- EXHIBIT 99.1 - Additional Exhibits - Statement of Computation of Ratio of Earnings to Fixed Charges.

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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 KROGER CO.**

|        |                   |     |                                                                                                       |
|--------|-------------------|-----|-------------------------------------------------------------------------------------------------------|
| Dated: | December 19, 2007 | By: | /s/ David B. Dillon<br>David B. Dillon<br>Chairman of the Board and Chief Executive Officer           |
| Dated: | December 19, 2007 | By: | /s/ J. Michael Schlotman<br>J. Michael Schlotman<br>Senior Vice President and Chief Financial Officer |

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### **Exhibit Index**

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Exhibit 32.1 - Section 1350 Certifications.

Exhibit 99.1 - Additional Exhibits - Statement of Computation of Ratio of Earnings to Fixed Charges.

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