SILECK MICHAEL
Form 3
June 01, 2009

# FORM 3

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

| OMB APPROVAL | |
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## INITIAL STATEMENT OF BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
Â SILECK MICHAEL
(Last) (First) (Middle)

C/O UNIFI, INC.,Â 7201 W. FRIENDLY AVENUE
(Street)

GREENSBORO,Â NCÂ 27410
(City) (State) (Zip)

2. Date of Event Requiring Statement (Month/Day/Year)
05/28/2009

3. Issuer Name **and** Ticker or Trading Symbol
UNIFI INC [UFI]

4. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
_____ Officer (give title below) _____ Other (specify below)

5. If Amendment, Date Original Filed(Month/Day/Year)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

### Table I - Non-Derivative Securities Beneficially Owned

| 1.Title of Security (Instr. 4) | 2. Amount of Securities Beneficially Owned (Instr. 4) | 3. Ownership Form: Direct (D) or Indirect (I) (Instr. 5) | 4. Nature of Indirect Beneficial Ownership (Instr. 5) |
|---|---|---|---|
| Common Stock | 0 | D | Â |

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

SEC 1473 (7-02)

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### Table II - Derivative Securities Beneficially Owned (*e.g.*, puts, calls, warrants, options, convertible securities)

| 1. Title of Derivative Security (Instr. 4) | 2. Date Exercisable and Expiration Date (Month/Day/Year) | 3. Title and Amount of Securities Underlying Derivative Security (Instr. 4) | 4. Conversion or Exercise Price of Derivative Security | 5. Ownership Form of Derivative Security: Direct (D) | 6. Nature of Indirect Beneficial Ownership (Instr. 5) |
|---|---|---|---|---|---|
| | | Title | | | |

| Date Exercisable | Expiration Date | Amount or Number of Shares | or Indirect (I) (Instr. 5) |
|---|---|---|---|

# Reporting Owners

| Reporting Owner Name / Address | Relationships | | | |
|---|---|---|---|---|
| | Director | 10% Owner | Officer | Other |
| SILECK MICHAEL<br>C/O UNIFI, INC.<br>7201 W. FRIENDLY AVENUE<br>GREENSBORO,Â NCÂ 27410 | Â X | Â | Â | Â |

# Signatures

| /s/Michael Sileck | 05/29/2009 |
|---|---|
| **Signature of Reporting Person | Date |

# Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 5(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *See* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. ily:times;"> Cash and temporary cash investments **$242** $189 Deposits in-transit **676** 614 Receivables **786** 778 FIFO Inventory **5,459** 5,059 LIFO credit **(604)** (450) Prefunded employee benefits **300** 300 Prepaid and other current assets **255** 265 Total current assets **7,114** 6,755 Property, plant and equipment, net **12,498** 11,779 Goodwill **2,144** 2,192 Other assets **543** 489

Total Assets **$22,299** $21,215

**LIABILITIES** Current liabilities Current portion of long-term debt including obligations under capital leases and financing obligations **$1,592** $906 Accounts payable **4,050** 3,804 Accrued salaries and wages **815** 796 Deferred income taxes **239** 268 Other current liabilities **1,993** 1,807

Total current liabilities **8,689** 7,581 Long-term debt including obligations under capital leases and financing obligations Face value long-term debt including obligations under capital leases and financing obligations **6,485** 6,136 Adjustment to reflect fair value interest rate hedges **44** 18

Long-term debt including obligations under capital leases and financing obligations **6,529** 6,154 Deferred income taxes **367** 722 Other long-term liabilities **1,800** 1,835

Total Liabilities **17,385** 16,292

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: 947 shares issued in 2007 and 937 shares issued in 2006 **947** 937 Additional paid-in capital **3,031** 2,755 Accumulated other comprehensive loss **(122)** (259)Accumulated earnings **6,480** 5,501 Common stock in treasury, at cost, 284 shares in 2007 and 232 shares in 2006 **(5,422)** (4,011)

Total Shareowners' Equity **4,914** 4,923

Total Liabilities and Shareowners' Equity **$22,299** $21,215

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

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Explanation of Responses:

**THE KROGER CO.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

Years Ended February 2, 2008, February 3, 2007, and January 28, 2006

| (In millions, except per share amounts) | 2007 (52 weeks) | 2006 (53 weeks) | 2005 (52 weeks) |
|---|---|---|---|
| Sales | **$ 70,235** | $ 66,111 | $ 60,553 |
| Merchandise costs, including advertising, warehousing, and transportation, excluding items shown separately below | **53,779** | 50,115 | 45,565 |
| Operating, general and administrative | **12,155** | 11,839 | 11,027 |
| Rent | **644** | 649 | 661 |
| Depreciation and amortization | **1,356** | 1,272 | 1,265 |
| Operating Profit | **2,301** | 2,236 | 2,035 |
| Interest expense | **474** | 488 | 510 |
| Earnings before income tax expense | **1,827** | 1,748 | 1,525 |
| Income tax expense | **646** | 633 | 567 |
| Net earnings | **$ 1,181** | $ 1,115 | $ 958 |
| Net earnings per basic common share | **$ 1.71** | $ 1.56 | $ 1.32 |
| Average number of common shares used in basic calculation | **690** | 715 | 724 |
| Net earnings per diluted common share | **$ 1.69** | $ 1.54 | $ 1.31 |
| Average number of common shares used in diluted calculation | **698** | 723 | 731 |

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

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**THE KROGER CO.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

Years Ended February 2, 2008, February 3, 2007 and January 28, 2006

| (In millions) | 2007 (52 weeks) | 2006 (53 weeks) | 2005 (52 weeks) |
|---|---|---|---|
| Cash Flows From Operating Activities: | | | |
| Net earnings | **$ 1,181** | $ 1,115 | $ 958 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Depreciation and amortization | **1,356** | 1,272 | 1,265 |
| LIFO charge | **154** | 50 | 27 |
| Stock-based employee compensation | **87** | 72 | 7 |
| Expense for Company-sponsored pension plans | **67** | 161 | 138 |
| Deferred income taxes | **(86)** | (60) | (63) |
| Other | **37** | 20 | 39 |
| Changes in operating assets and liabilities net of effects from acquisitions of businesses: | | | |
| Store deposits in-transit | **(62)** | (125) | 18 |
| Inventories | **(383)** | (173) | (157) |
| Receivables | **(17)** | (90) | (19) |
| Prepaid expenses | **3** | (43) | 31 |
| Accounts payable | **185** | 256 | (80) |
| Accrued expenses | **156** | 98 | 155 |
| Income taxes receivable (payable) | **43** | (4) | 200 |
| Contribution to Company-sponsored pension plans | **(52)** | (150) | (300) |
| Other | **(88)** | (48) | (27) |
| Net cash provided by operating activities | **2,581** | 2,351 | 2,192 |
| Cash Flows From Investing Activities: | | | |
| Payments for capital expenditures | **(2,126)** | (1,683) | (1,306) |
| Proceeds from sale of assets | **49** | 143 | 69 |
| Payments for acquisitions | **(90)** | | |
| Other | **(51)** | (47) | (42) |
| Net cash used by investing activities | **(2,218)** | (1,587) | (1,279) |
| Cash Flows From Financing Activities: | | | |
| Proceeds from issuance of long-term debt | **1,372** | 10 | 14 |
| Proceeds from lease-financing transactions | **8** | 15 | 76 |
| Payments on long-term debt | **(560)** | (556) | (103) |
| Borrowings (payments) on bank revolver | **218** | 352 | (694) |
| Excess tax benefits on stock-based awards | **36** | 38 | |
| Proceeds from issuance of capital stock | **188** | 168 | 78 |
| Treasury stock purchases | **(1,421)** | (633) | (252) |
| Dividends paid | **(202)** | (140) | |
| Increase in book overdrafts | **61** | 1 | 35 |
| Other | **(10)** | (40) | (1) |
| Net cash used by financing activities | **(310)** | (785) | (847) |
| Net increase (decrease) in cash and temporary cash investments | **53** | (21) | 66 |
| Cash and temporary cash investments: | | | |
| Beginning of year | **189** | 210 | 144 |
| End of year | **$ 242** | $ 189 | $ 210 |
| Reconciliation of capital expenditures: | | | |

| (In millions) | 2007 (52 weeks) | 2006 (53 weeks) | 2005 (52 weeks) |
|---|---|---|---|
| Payments for capital expenditures | **$ (2,126)** | $ (1,683) | $ (1,306) |
| Changes in construction-in-progress payables | **66** | (94) | |
| Total capital expenditures | **$ (2,060)** | $ (1,777) | $ (1,306) |
| Disclosure of cash flow information: | | | |
| Cash paid during the year for interest | **$ 477** | $ 514 | $ 511 |
| Cash paid during the year for income taxes | **$ 640** | $ 615 | $ 431 |

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

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**THE KROGER CO.**

**CONSOLIDATED STATEMENT OF CHANGES IN SHAREOWNERS' EQUITY**

Years Ended February 2, 2008, February 3, 2007 and January 28, 2006

| | Common Stock | | | Treasury Stock | | | | |
|---|---|---|---|---|---|---|---|---|
| **(In millions)** | **Shares** | **Amount** | **Additional Paid-In Capital** | **Shares** | **Amount** | **Accumulated Other Comprehensive Gain (Loss)** | **Accumulated Earnings** | **Total** |
| Balances at January 29, 2005 | 918 | $ 918 | $ 2,432 | 190 | $ (3,149) | $ (202) | $ 3,620 | $ 3,619 |
| Issuance of common stock: | | | | | | | | |
| Stock options and warrants exercised | 8 | 8 | 57 | | | | | 65 |
| Restricted stock issued | 1 | 1 | 13 | | | | | 14 |
| Treasury stock activity: | | | | | | | | |
| Treasury stock purchases, at cost | | | | 14 | (239) | | | (239) |
| Stock options and restricted stock exchanged | | | | | (15) | | | (15) |
| Tax benefits from exercise of stock options and warrants | | | 34 | | | | | 34 |
| Other comprehensive loss, net of income tax of $26 | | | | | | (41) | | (41) |
| Other | | | | | | | (5) | (5) |
| Net earnings | | | | | | | 958 | 958 |
| Balances at January 28, 2006 | 927 | 927 | 2,536 | 204 | (3,403) | (243) | 4,573 | 4,390 |
| Issuance of common stock: | | | | | | | | |
| Stock options and warrants exercised | 9 | 9 | 95 | (1) | 30 | | | 134 |
| Restricted stock issued | 1 | 1 | 13 | | (5) | | | 9 |
| Treasury stock activity: | | | | | | | | |
| Treasury stock purchases, at cost | | | | 18 | (374) | | | (374) |
| Stock options and restricted stock exchanged | | | | 11 | (259) | | | (259) |
| Tax benefits from exercise of stock options and warrants | | | 39 | | | | | 39 |
| Share-based employee compensation | | | 72 | | | | | 72 |
| Other comprehensive gain net of income tax of $(63) | | | | | | 102 | | 102 |
| SFAS No. 158 adjustment net of income tax of $71 | | | | | | (120) | | (120) |
| Other | | | | | | 2 | | 2 |
| Cash dividends declared ($0.26 per common share) | | | | | | | (187) | (187) |
| Net earnings | | | | | | | 1,115 | 1,115 |
| Balances at February 3, 2007 | 937 | 937 | 2,755 | 232 | (4,011) | (259) | 5,501 | 4,923 |
| Issuance of common stock: | | | | | | | | |
| Stock options and warrants exercised | 10 | 10 | 175 | | 3 | | | 188 |
| Restricted stock issued | | | (25) | (1) | 11 | | | (14) |
| Treasury stock activity: | | | | | | | | |
| Treasury stock purchases, at cost | | | | 43 | (1,151) | | | (1,151) |

| | Common Stock | | | Treasury Stock | | Accumulated Other Comprehensive Gain (Loss) | | |
|---|---|---|---|---|---|---|---|---|
| Stock options and restricted stock exchanged | | | | 10 | (270) | | | (270) |
| Tax benefits from exercise of stock options | | | 35 | | | | | 35 |
| Share-based employee compensation | | | 87 | | | | | 87 |
| Other comprehensive gain net of income tax of $(82) | | | | | | 137 | | 137 |
| Other | | | 4 | | (4) | | 4 | 4 |
| Cash dividends declared ($0.30 per common share) | | | | | | | (206) | (206) |
| Net earnings | | | | | | | 1,181 | 1,181 |
| Balances at February 2, 2008 | 947 | $ 947 | $ 3,031 | 284 | $ (5,422) | $ (122) | $ 6,480 | $ 4,914 |

Comprehensive income:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Net earnings | $ 1,181 | $ 1,115 | $ 958 |
| Realized loss on hedging activities, net of income tax of $1 | (2) | | |
| Unrealized gain (loss) on hedging activities, net of income tax of $12 in 2007, $(5) in 2006 and $(1) in 2005 | (19) | 7 | 1 |
| Additional minimum pension liability adjustment, net of income tax of $(58) in 2006 and $26 in 2005 | | 95 | (42) |
| Change in pensions and other postretirement defined benefit plans, net of income tax of $(95) | 158 | | |
| Comprehensive income | $ 1,318 | $ 1,217 | $ 917 |

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

All dollar amounts are in millions except share and per share amounts.

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

### 1. ACCOUNTING POLICIES

The following is a summary of the significant accounting policies followed in preparing these financial statements.

*Description of Business, Basis of Presentation and Principles of Consolidation*

The Kroger Co. (the "Company") was founded in 1883 and incorporated in 1902. As of February 2, 2008, the Company was one of the largest retailers in the United States based on annual sales. The Company also manufactures and processes food for sale by its supermarkets. The accompanying financial statements include the consolidated accounts of the Company and its subsidiaries. Significant intercompany transactions and balances have been eliminated.

*Fiscal Year*

The Company's fiscal year ends on the Saturday nearest January 31. The last three fiscal years consist of the 52-week period ended February 2, 2008, the 53-week period ended February 3, 2007, and the 52-week period ended January 28, 2006.

*Pervasiveness of Estimates*

The preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities. Disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of consolidated revenues and expenses during the reporting period also is required. Actual results could differ from those estimates.

*Cash and temporary cash investments*

Cash and temporary cash investments represent store cash, escrow deposits and Euros held to settle Euro-denominated contracts. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 52, *Foreign Currency Translation,* the Company valued its carrying amount of Euros at the spot rate as of February 2, 2008.

*Inventories*

Inventories are stated at the lower of cost (principally on a last-in, first-out "LIFO" basis) or market. In total, approximately 97% and 98% of inventories for 2007 and 2006, respectively, were valued using the LIFO method. Cost for the balance of the inventories, including substantially all fuel inventories, was determined using the first-in, first-out ("FIFO") method. Replacement cost was higher than the carrying amount by $604 at February 2, 2008 and $450 at February 3, 2007. The Company follows the Link-Chain, Dollar-Value LIFO method for purposes of calculating its LIFO charge or credit.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

The item-cost method of accounting to determine inventory cost before the LIFO adjustment is followed for substantially all store inventories at the Company's supermarket divisions. This method involves counting each item in inventory, assigning costs to each of these items based on the actual purchase costs (net of vendor allowances and cash discounts) of each item and recording the cost of items sold. The item-cost method of accounting allows for more accurate reporting of periodic inventory balances and enables management to more precisely manage inventory when compared to the retail method of accounting.

The Company evaluates inventory shortages throughout the year based on actual physical counts in its facilities. Allowances for inventory shortages are recorded based on the results of these counts to provide for estimated shortages as of the financial statement date.

*Property, Plant and Equipment*

Property, plant and equipment are recorded at cost. 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. Buildings and land improvements are depreciated based on lives varying from 10 to 40 years. All new purchases of store equipment are assigned lives varying from three to nine years. Some store equipment acquired as a result of the Fred Meyer merger was assigned a 15-year life. The life of this equipment was not changed. Leasehold improvements are amortized over the shorter of the lease term to which they relate, which varies from four to 25 years, or the useful life of the asset. Manufacturing plant and distribution center equipment is depreciated over lives varying from three to 15 years. Information technology assets are generally depreciated over five years. Depreciation and amortization expense was $1,356 in 2007, $1,272 in 2006 and $1,265 in 2005.

Interest costs on significant projects constructed for the Company's own use are capitalized as part of the costs of the newly constructed facilities. Upon retirement or disposal of assets, the cost and related accumulated depreciation are removed from the balance sheet and any gain or loss is reflected in net earnings.

*Deferred Rent*

The Company recognizes rent holidays, including the time period during which the Company has access to the property for construction of buildings or improvements and escalating rent provisions on a straight-line basis over the term of the lease. The deferred amount is included in Other Current Liabilities and Other Long-Term Liabilities on the Company's Consolidated Balance Sheets.

*Goodwill*

The Company reviews goodwill for impairment during the fourth quarter of each year, and also upon the occurrence of trigger events. The reviews are performed at the operating division level. Generally, fair value is determined using a multiple of earnings, or discounted projected future cash flows, and is compared to the carrying value of a division for purposes of identifying potential impairment. Projected future cash flows are based on management's knowledge of the current operating environment and expectations for the future. If potential for impairment is identified, the fair value of a division is measured against the fair value of its underlying assets and liabilities, excluding goodwill, to estimate an implied fair value of the division's goodwill. Goodwill impairment is recognized for any excess of the carrying value of

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

the division's goodwill over the implied fair value. Results of the goodwill impairment reviews performed during 2007, 2006 and 2005 are summarized in Note 2 to the Consolidated Financial Statements.

*Intangible Assets*

In addition to goodwill, the Company has recorded intangible assets totaling $32, $24 and $34 for leasehold equities, liquor licenses and pharmacy prescription file purchases, respectively at February 2, 2008. Balances at February 3, 2007 were $26, $22 and $28 for leasehold equities, liquor licenses and pharmacy prescription files, respectively. Leasehold equities are amortized over the remaining life of the lease. Owned liquor licenses are not amortized, while liquor licenses that must be renewed are amortized over their useful lives. Pharmacy prescription file purchases are amortized over seven years. These assets are considered annually during the Company's testing for impairment.

*Impairment of Long-Lived Assets*

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company monitors the carrying value of long-lived assets for potential impairment each quarter based on whether certain trigger events have occurred. These events include current period losses combined with a history of losses or a projection of continuing losses or a significant decrease in the market value of an asset. When a trigger event occurs, an impairment calculation is performed, comparing projected undiscounted future cash flows, utilizing current cash flow information and expected growth rates related to specific stores, to the carrying value for those stores. If impairment is identified for long-lived assets to be held and used, discounted future cash flows are compared to the asset's current carrying value. Impairment is recorded when the carrying value exceeds the discounted cash flows. With respect to owned property and equipment held for sale, the value of the property and equipment is adjusted to reflect recoverable values based on previous efforts to dispose of similar assets and current economic conditions. Impairment is recognized for the excess of the carrying value over the estimated fair market value, reduced by estimated direct costs of disposal. The Company recorded asset impairments in the normal course of business totaling $24, $61 and $48 in 2007, 2006 and 2005, respectively. Costs to reduce the carrying value of long-lived assets for each of the years presented have been included in the Consolidated Statements of Operations as "Operating, general and administrative" expense.

*Store Closing Costs*

All closed store liabilities related to exit or disposal activities initiated after December 31, 2002, are accounted for in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The Company provides for closed store liabilities relating to the present value of the estimated remaining noncancellable lease payments after the closing date, net of estimated subtenant income. The Company estimates the net lease liabilities using a discount rate to calculate the present value of the remaining net rent payments on closed stores. The closed store lease liabilities usually are paid over the lease terms associated with the closed stores, which generally have remaining terms ranging from one to 20 years. Adjustments to closed store liabilities primarily relate to changes in subtenant income and actual exit costs differing from original estimates. 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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

accrued amount that is not a sufficient estimate of future costs, or that no longer is needed for its originally intended purpose, is adjusted to income in the proper period.

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

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

| | Future Lease Obligations |
|---|---|
| Balance at January 28, 2006 | $ 127 |
| Additions | 9 |
| Payments | (20) |
| Adjustments | (27) |
| Balance at February 3, 2007 | 89 |
| Additions | 8 |
| Payments | (16) |
| Adjustments | (7) |
| Balance at February 2, 2008 | $ 74 |

*Interest Rate Risk Management*

The Company uses derivative instruments primarily to manage its exposure to changes in interest rates. The Company's current program relative to interest rate protection and the methods by which the Company accounts for its derivative instruments are described in Note 6.

*Commodity Price Protection*

The Company enters into purchase commitments for various resources, including raw materials utilized in its manufacturing facilities and energy to be used in its stores, manufacturing facilities and administrative offices. The Company enters into commitments expecting to take delivery of and to utilize those resources in the conduct of the normal course of business. The Company's current program relative to commodity price protection and the methods by which the Company accounts for its purchase commitments are described in Note 6.

*Benefit Plans*

Effective February 3, 2007, the Company adopted the recognition and disclosure provisions of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans-an*

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

*amendment of FASB Statements No. 87, 99, 106 and 132(R)*, which required the recognition of the funded status of its retirement plans on the Consolidated Balance Sheet. Actuarial gains or losses, prior service costs or credits and transition obligations that have not yet been recognized are now required to be recorded as a component of Accumulated Other Comprehensive Income ("AOCI"). The Company currently uses a December 31 measurement date. Effective for 2008, the statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. The Company will adopt the measurement date change in fiscal 2008.

The determination of the obligation and expense for Company-sponsored pension plans and other post-retirement benefits is dependent on the selection of assumptions used by actuaries and the Company in calculating those amounts. Those assumptions are described in Note 14 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 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 also participates in various multi-employer plans for substantially all union employees. Pension expense for these plans is recognized as contributions are funded. Refer to Note 14 for additional information regarding the Company's benefit plans.

*Stock Option Plans*

Effective January 29, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment,* using the modified prospective transition method, and therefore, has not restated results for prior periods. Under this method, the Company recognizes compensation expense for all share-based payments granted after January 29, 2006, as well as all share-based payments granted prior to, but not yet vested as of, January 29, 2006, in accordance with SFAS No. 123(R). Under the fair value recognition provisions of SFAS No. 123(R), the Company recognizes share-based compensation expense, net of an estimated forfeiture rate, over the requisite service period of the award. Prior to the adoption of SFAS No. 123(R), the Company accounted for share-based payments under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* ("APB No. 25") and the disclosure provisions of SFAS No. 123. The Company elected the alternative transition method for calculating windfall tax benefits available as of the adoption of SFAS No. 123(R). For further information regarding the adoption of SFAS No. 123(R), see Note 10 to the Consolidated Financial Statements.

*Deferred Income Taxes*

Deferred income taxes are recorded to reflect the tax consequences of differences between the tax basis of assets and liabilities and their financial reporting basis. Refer to Note 4 for the types of differences that give rise to significant portions of deferred income tax assets and liabilities. Deferred income taxes are classified as a net current or noncurrent asset or liability based on the classification of the related asset or liability for financial reporting purposes. A deferred tax asset or liability that is not related to an asset or liability for financial reporting is classified according to the expected reversal date.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

*Uncertain Tax Positions*

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.

Various taxing authorities periodically audit the Company's income tax returns. These audits include questions regarding the Company's tax filing positions, including the timing and amount of deductions and the allocation of income to various tax jurisdictions. In evaluating the exposures connected with these various tax filing positions, including state and local taxes, the Company records allowances for probable exposures. A number of years may elapse before a particular matter, for which an allowance has been established, is audited and fully resolved. As of February 2, 2008, the Internal Revenue Service has concluded an examination for tax years 2002 through 2004.

The assessment of the Company's tax position relies on the judgment of management to estimate the exposures associated with the Company's various filing positions.

*Self-Insurance Costs*

The Company primarily is self-insured for costs related to workers' compensation and general liability claims. Liabilities are actuarially determined and are recognized based on claims filed and an estimate of claims incurred but not reported. The liabilities for workers' compensation claims are accounted for on a present value basis. The Company has purchased stop-loss coverage to limit its exposure to any significant exposure on a per claim basis. The Company is insured for covered costs in excess of these per claim limits.

The following table summarizes the changes in the Company's self-insurance liability through February 2, 2008.

| | **2007** | 2006 | 2005 |
|---|---|---|---|
| Beginning balance | **$ 440** | $ 445 | $ 440 |
| Expense | **215** | 196 | 198 |
| Claim payments | **(185)** | (201) | (193) |
| Ending balance | **470** | 440 | 445 |
| Less current portion | **(183)** | (165) | (179) |
| Long-term portion | **$ 287** | $ 275 | $ 266 |

The current portion of the self-insured liability is included in "Other accrued liabilities", and the long-term portion is included in "Other long-term liabilities" in the Consolidated Balance Sheets.

The Company is also similarly self-insured for property-related losses. The Company has purchased stop-loss coverage to limit its exposure to losses in excess of $25 on a per claim basis, except in the case of

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

an earthquake, for which stop-loss coverage is in excess of $50 per claim, up to $200 per claim in California and $300 outside of California.

*Revenue Recognition*

Revenues from the sale of products are recognized at the point of sale of the Company's products. Discounts provided to customers by the Company at the time of sale, including those provided in connection with loyalty cards, are recognized as a reduction in sales as the products are sold. Discounts provided by vendors, usually in the form of paper coupons, are not recognized as a reduction in sales provided the coupons are redeemable at any retailer that accepts coupons. Pharmacy sales are recorded when provided to the customer. Sales taxes are not recorded as a component of sales. The Company does not recognize a sale when it sells gift cards and gift certificates. Rather, a sale is recognized when the gift card or gift certificate is redeemed to purchase the Company's products.

*Merchandise Costs*

The "Merchandise costs" line item of the Consolidated Statements of Operations includes product costs, net of discounts and allowances; advertising costs (see separate discussion below); inbound freight charges; warehousing costs, including receiving and inspection costs; transportation costs; and manufacturing production and operational costs. Warehousing, transportation and manufacturing management salaries are also included in the "Merchandise costs" line item; however, purchasing management salaries and administration costs are included in the "Operating, general, and administrative" line item along with most of the Company's other managerial and administrative costs. Rent expense and depreciation expense are shown separately in the Consolidated Statements of Operations.

Warehousing and transportation costs include distribution center direct wages, repairs and maintenance, utilities, inbound freight and, where applicable, third party warehouse management fees, as well as transportation direct wages and repairs and maintenance. These costs are recognized in the periods the related expenses are incurred.

The Company believes the classification of costs included in merchandise costs could vary widely throughout the industry. The Company's approach is to include in the "Merchandise costs" line item the direct, net costs of acquiring products and making them available to customers in its stores. The Company believes this approach most accurately presents the actual costs of products sold.

The Company recognizes all vendor allowances as a reduction in merchandise costs when the related product is sold. When possible, vendor allowances are applied to the related product by item and, therefore, reduce the carrying value of inventory by item. When the items are sold, the vendor allowance is recognized. When it is not possible, due to systems constraints, to allocate vendor allowances to the product by item, vendor allowances are recognized as a reduction in merchandise costs based on inventory turns and, therefore, recognized as the product is sold.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

*Advertising Costs*

The Company's advertising costs are recognized in the periods the related expenses are incurred and are included in the "Merchandise costs" line item of the Consolidated Statements of Operations. The Company's pre-tax advertising costs totaled $506 in 2007, $508 in 2006 and $498 in 2005. The Company does not record vendor allowances for co-operative advertising as a reduction of advertising expense.

*Deposits In-Transit*

Deposits in-transit generally represent funds deposited to the Company's bank accounts at the end of the year related to sales, a majority of which were paid for with credit cards and checks, to which the Company does not have immediate access.

*Consolidated Statements of Cash Flows*

For purposes of the Consolidated Statements of Cash Flows, the Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be temporary cash investments. Book overdrafts, which are included in accounts payable, represent disbursements that are funded as the item is presented for payment. Book overdrafts totaled $661, $600 and $596 as of February 2, 2008, February 3, 2007, and January 28, 2006, respectively, and are reflected as a financing activity in the Consolidated Statements of Cash Flows.

*Segments*

The Company operates retail food and drug stores, multi-department stores, jewelry stores, and convenience stores throughout the United States. The Company's retail operations, which represent substantially all of the Company's consolidated sales, are its only reportable segment. All of the Company's operations are domestic.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

## 2. GOODWILL

The annual evaluation of goodwill performed during the fourth quarter of 2007, 2006 and 2005 did not result in impairment.

The following table summarizes the changes in the Company's net goodwill balance through February 2, 2008.

| | Goodwill |
|---|---|
| Balance at January 29, 2005 | $ 2,191 |
| Goodwill recorded | |
| Purchase accounting adjustments | 1 |
| Balance at January 28, 2006 | 2,192 |
| Goodwill recorded | |
| Purchase accounting adjustments | |
| Balance at February 3, 2007 | 2,192 |
| Goodwill recorded | 23 |
| Effect of FIN 48 adoption | (71) |
| Balance at February 2, 2008 | $ 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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

## 3. PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment, net consists of:

| | 2007 | 2006 |
|---|---|---|
| Land | **$ 1,779** | $ 1,690 |
| Buildings and land improvements | **5,875** | 5,402 |
| Equipment | **8,620** | 8,255 |
| Leasehold improvements | **4,626** | 4,221 |
| Construction-in-progress | **965** | 822 |
| Leased property under capital leases and financing obligations | **571** | 592 |
| Total property, plant and equipment | **22,436** | 20,982 |
| Accumulated depreciation and amortization | **(9,938)** | (9,203) |
| Property, plant and equipment, net | **$ 12,498** | $ 11,779 |

Accumulated depreciation for leased property under capital leases was $286 at February 2, 2008, and $288 at February 3, 2007.

Approximately $540 and $566, original cost, of Property, Plant and Equipment collateralized certain mortgages at February 2, 2008, and February 3, 2007, respectively.

## 4. TAXES BASED ON INCOME

The provision for taxes based on income consists of:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Federal | | | |
| Current | **$ 661** | $ 652 | $ 609 |
| Deferred | **(62)** | (52) | (79) |
| | **599** | 600 | 530 |
| State and local | | | |
| Current | **71** | 55 | 42 |
| Deferred | **(24)** | (22) | (5) |
| | **47** | 33 | 37 |
| Total | **$ 646** | $ 633 | $ 567 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

A reconciliation of the statutory federal rate and the effective rate follows:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Statutory rate | **35.0%** | 35.0% | 35.0% |
| State income taxes, net of federal tax benefit | **1.7%** | 1.9% | 1.6% |
| Favorable resolution of issues | **(1.9)%** | | |
| Deferred tax adjustment | | (1.2)% | |
| Other changes, net | **0.6%** | 0.5% | 0.6% |
| | **35.4%** | 36.2% | 37.2% |

During the third quarter of 2007, the Company resolved favorably certain tax issues. This resulted in a 2007 tax benefit of approximately $40.

In 2006, during the reconciliation of the Company's deferred tax balances, after the filing of annual federal and state tax returns, the Company identified adjustments to be made in the prior years' deferred tax reconciliation. These deferred tax balances were corrected in the Company's Consolidated Financial Statements for the year ended February 3, 2007, which resulted in a reduction of the Company's 2006 provision for income tax expense of approximately $21. The Company does not believe these adjustments are material to its Consolidated Financial Statements for the year ended February 3, 2007, or to any prior years' Consolidated Financial Statements. As a result, the Company has not restated any prior year amounts.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

The tax effects of significant temporary differences that comprise tax balances were as follows:

| | 2007 | 2006 |
|---|---|---|
| Current deferred tax assets: | | |
| Net operating loss carryforwards | **$ 16** | $ 17 |
| Compensation related costs | **53** | 32 |
| Other | **8** | 4 |
| Total current deferred tax assets | **77** | 53 |
| Current deferred tax liabilities: | | |
| Insurance related costs | **(104)** | (109) |
| Inventory related costs | **(212)** | (212) |
| Total current deferred tax liabilities | **(316)** | (321) |
| Current deferred taxes | **$ (239)** | $ (268) |
| Long-term deferred tax assets: | | |
| Compensation related costs | **$ 268** | $ 332 |
| Lease accounting | **102** | 122 |
| Closed store reserves | **68** | 68 |
| Insurance related costs | **64** | 39 |
| Net operating loss carryforwards | **35** | 29 |
| Other | **23** | 3 |
| Long-term deferred tax assets, net | **560** | 593 |
| Long-term deferred tax liabilities: | | |
| Depreciation | **(926)** | (1,114) |
| Other | **(1)** | (201) |
| Total long-term deferred tax liabilities | **(927)** | (1,315) |
| Long-term deferred taxes | **$ (367)** | $ (722) |

Long-term deferred taxes have decreased compared to 2006 due to the classification of temporary differences on a basis consistent with FIN No. 48. The result was a reclassification of approximately $500 as of the date of adoption.

At February 2, 2008, the Company had net operating loss carryforwards for federal income tax purposes of $22 that expire from 2010 through 2018. In addition, the Company had net operating loss carryforwards for state income tax purposes of $598 that expire from 2008 through 2028. The utilization of certain of the Company's net operating loss carryforwards may be limited in a given year.

At February 2, 2008, the Company had state credits of $31 that expire from 2008 through 2021. The utilization of certain of the Company's credits may be limited in a given year.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

The Company adopted the provisions of FIN No. 48, *Accounting for Uncertainty in Income Taxes* on February 4, 2007. As of adoption, the total amount of gross unrecognized tax benefits for uncertain tax positions, including positions impacting only the timing of tax benefits, was $694. A reconciliation of the beginning and ending amount of unrecognized tax benefits is a follows:

| | 2007 |
|---|---|
| Balance as of February 4, 2007 | $ 694 |
| Additions based on tax positions related to the current year | 49 |
| Reductions based on tax positions related to the current year | (32) |
| Additions for tax positions of prior years | 11 |
| Reductions for tax positions of prior years | (162) |
| Settlements | (90) |
| Reductions due to lapse of statute of limitations | (1) |
| Balance as of February 2, 2008 | $ 469 |

The Company does not anticipate that changes in the amount of unrecognized tax benefits over the next twelve months will have a significant impact on its results of operations or financial position.

As February 2, 2008, the amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate was $120.

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. During the year ended February 2, 2008, the Company recognized approximately $(11) in interest and penalties. The Company had accrued approximately $101 and $118 for the payment of interest and penalties as of February 2, 2008 and February 3, 2007, respectively.

The IRS concluded a field examination of the Company's 2002 2004 U.S. tax returns during the third quarter of 2007. An examination of the Company's 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 our tax years after 1991 and those years remain open to examination. States have a limited time frame to review and adjust federal audit changes reported. Assessments made and refunds allowed are generally limited to the federal audit changes reported.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

**5. DEBT OBLIGATIONS**

Long-term debt consists of:

| | 2007 | 2006 |
|---|---|---|
| Credit facility | **$ 570** | $ 352 |
| 4.95% to 9.20% Senior notes and debentures due through 2031 | **6,766** | 5,916 |
| 5.00% to 9.95% mortgages due in varying amounts through 2034 | **166** | 169 |
| Other | **137** | 144 |
| Total debt | **7,639** | 6,581 |
| Less current portion | **(1,564)** | (878) |
| Total long-term debt | **$ 6,075** | $ 5,703 |

In 2007, the Company issued $600 of senior notes bearing an interest rate of 6.4% due in 2017 and $750 of senior notes bearing an interest rate of 6.15% due in 2020.

As of February 2, 2008, the Company had a $2,500 Five-Year Credit Agreement maturing in 2011, unless earlier terminated by the Company. Borrowings under the credit agreement bear interest at the option of the Company at a rate equal to either (i) the highest, from time to time of (A) the base rate of JP Morgan Chase Bank, N.A., (B) $^1/_2$% over a moving average of secondary market morning offering rates for three-month certificates of deposit adjusted for reserve requirements, and (C) $^1/_2$% over the federal funds rate or (ii) an adjusted Eurodollar rate based upon the London Interbank Offered Rate ("Eurodollar Rate") plus an applicable margin. In addition, the Company pays a facility fee in connection with the credit agreement. Both the applicable margin and the facility fee vary based upon the Company's achievement of a financial ratio or credit rating. At February 2, 2008, the applicable margin was 0.19%, and the facility fee was 0.06%. The credit facility contains covenants, which, among other things, require the maintenance of certain financial ratios, including fixed charge coverage and leverage ratios. The Company may prepay the credit agreement in whole or in part, at any time, without a prepayment penalty. As of February 2, 2008, the Company had $570 outstanding under the credit agreement including borrowings totaling $345 under its P2/F2/A3 rated commercial paper program. Any borrowings under this program are backed by the Company's credit facility and reduce the amount available under the credit facility. The weighted average interest rate on the amounts outstanding under the credit agreement was 3.69% at February 2, 2008.

At February 2, 2008, the Company also maintains four money market lines totaling $125 in the aggregate. In addition to credit agreement borrowings, borrowings under the money market lines and some outstanding letters of credit reduce funds available under the Company's credit agreement. The Company had no borrowings under the money market lines at February 2, 2008. The outstanding letters of credit that reduce funds available under the Company's credit agreement totaled $355 as of February 2, 2008.

Most of the Company's outstanding public debt is subject to early redemption at varying times and premiums, at the option of the Company. In addition, subject to certain conditions, some of the Company's publicly issued debt will be subject to redemption, in whole or in part, at the option of the holder upon the occurrence of a redemption event, upon not less than five days' notice prior to the date of redemption, at a redemption price equal to the default amount, plus a specified premium. "Redemption Event" is defined in the indentures as the occurrence of (i) any person or group, together with any affiliate thereof, beneficially owning 50% or more of the voting power of the Company, (ii) any one person or group, or affiliate thereof, succeeding in having a majority of its nominees elected to the Company's Board of Directors, in each case, without the consent of a majority of the continuing directors of the Company or (iii) both a change of control and a below investment grade rating.

The aggregate annual maturities and scheduled payments of long-term debt, as of year-end 2007, and for the years subsequent to 2007 are:

| | |
|---|---|
| 2008 | $ 1,564 |
| 2009 | 402 |
| 2010 | 555 |
| 2011 | 527 |
| 2012 | 1,400 |
| Thereafter | 3,191 |
| Total debt | $ 7,639 |

## 6. FINANCIAL INSTRUMENTS

*Interest Rate Risk Management*

The Company historically has used derivatives to manage its exposure to changes in interest rates. The interest differential to be paid or received is accrued as interest expense. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, defines derivatives, requires that derivatives be carried at fair value on the balance sheet and provides for hedge accounting when certain conditions are met. In accordance with this standard, the Company's derivative financial instruments are recognized on the balance sheet at fair value. Changes in the fair value of derivative instruments designated as "cash flow" hedges, to the extent the hedges are highly effective, are recorded in other comprehensive income, net of tax effects. Ineffective portions of cash flow hedges, if any, are recognized in current period earnings. Other comprehensive income or loss is reclassified into current period earnings when the hedged transaction affects earnings. Changes in the fair value of derivative instruments designated as "fair value" hedges, along with corresponding changes in the fair values of the hedged assets or liabilities, are recorded in current period earnings.

The Company assesses, both at the inception of the hedge and on an ongoing basis, whether derivatives used as hedging instruments are highly effective in offsetting the changes in the fair value or cash flow of the hedged items. If it is determined that a derivative is not highly effective as a hedge or ceases to be highly effective, the Company discontinues hedge accounting prospectively.

The Company's current program relative to interest rate protection contemplates hedging the exposure to changes in the fair value of fixed-rate debt attributable to changes in interest rates. To do this, the Company uses the following guidelines: (i) use average daily outstanding borrowings to determine annual debt amounts subject to interest rate exposure, (ii) limit the average annual amount subject to interest rate reset and the amount of floating rate debt to a combined total of $2,500 million or less,

(iii) include no leverage products, and (iv) hedge without regard to profit motive or sensitivity to current mark-to-market status.

Annually, the Company reviews with the Financial Policy Committee of the Board of Directors compliance with the guidelines. These guidelines may change as the Company's needs dictate.

The table below summarizes the outstanding interest rate swaps designated as fair value hedges as of February 2, 2008, and February 3, 2007.

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Pay Floating | Pay Fixed | Pay Floating | Pay Fixed |
| Notional amount | $ 1,050 | $ | $ 1,050 | $ |
| Duration in years | 2.07 | | 3.08 | |
| Average variable rate | 5.97% | | 8.07% | |
| Average fixed rate | 6.74% | | 6.74% | |

In addition to the interest rate swaps noted above, in 2005 the Company entered into three forward-starting interest rate swap agreements with a notional amount totaling $750. A forward-starting interest rate swap is an agreement that effectively hedges future benchmark interest rates on debt for an established period of time. The Company entered into the forward-starting interest rate swaps in order to lock into fixed interest rates on forecasted issuances of debt in 2007 and 2008. In 2007, the Company terminated two of these forward-starting interest rate swaps with a notional amount of $500. The unamortized payment and proceeds on the two terminated forward-starting interest rate swaps 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. The one remaining forward-starting interest rate swap as of February 2, 2008 has a ten-year term with an interest rate of 5.11%.

*Commodity Price Protection*

The Company enters into purchase commitments for various resources, including raw materials utilized in its manufacturing facilities and energy to be used in its stores, warehouses, manufacturing facilities and administrative offices. The Company enters into commitments expecting to take delivery of and to utilize those resources in the conduct of normal business. Those commitments for which the Company expects to utilize or take delivery in a reasonable amount of time in the normal course of business qualify as normal purchases and normal sales.

Some of the product the Company purchases is shipped in corrugated cardboard packaging. The corrugated cardboard is sold when it is economical to do so. As of February 2, 2008, the Company maintained three derivative instruments to manage exposure to changes in corrugated cardboard prices. These derivatives have a three-year term. The instruments do not qualify for hedge accounting, in accordance with SFAS No. 133, *Accounting for Derivative Investments and Hedging Activities,* as amended. Accordingly, changes in the fair value of these instruments are marked-to-market in the Company's Consolidated Statements of Operations as operating, general and administrative ("OG&A") expenses. As of February 2, 2008, an accrued liability totaling $1 had been recorded to reflect the fair value of these instruments.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

## 7. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it was practicable to estimate that value:

*Cash and Temporary Cash Investments, Store Deposits In-Transit, Receivables, Prepaid and Other Current Assets, Accounts Payable, Accrued Salaries and Wages and Other Current Liabilities*

The carrying amounts of these items approximated fair value.

*Long-term Investments*

The fair values of these investments were estimated based on quoted market prices for those or similar investments, or estimated cash flows, if appropriate.

*Long-term Debt*

The fair value of the Company's long-term debt, including the current portion thereof and excluding borrowings under the credit facility, was estimated based on the quoted market price for the same or similar issues adjusted for illiquidity based on available market evidence. If quoted market prices were not available, the fair value was based upon the net present value of the future cash flows using the forward interest rate yield curve in effect at the respective year-ends. The carrying values of long-term debt outstanding under the Company's credit facility approximated fair value.

*Interest Rate Protection Agreements*

The fair value of these agreements was based on the net present value of the future cash flows using the forward interest rate yield curve in effect at the respective year-ends.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

The estimated fair values of the Company's financial instruments are as follows:

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | **Carrying Value** | **Estimated Fair Value** | **Carrying Value** | **Estimated Fair Value** |
| Cash and temporary cash investments | **$ 242** | **$ 242** | $ 189 | $ 189 |
| Store deposits in-transit | **$ 676** | **$ 676** | $ 614 | $ 614 |
| Long-term investments for which it is | | | | |
| Practicable | **$ 75** | **$ 75** | $ 60 | $ 60 |
| Not Practicable | **$** | **$** | $ | $ |
| Debt for which it is(1) | | | | |
| Practicable | **$ (7,639)** | **$ (7,973)** | $ (6,581) | $ (6,859) |
| Not Practicable | **$** | **$** | $ | $ |
| Interest Rate Protection Agreements | | | | |
| Receive fixed swaps asset/(liability)(2) | **$ 11** | **$ 11** | $ (28) | $ (28) |
| Forward-starting swap asset/(liability)(3) | **$ (18)** | **$ (18)** | $ 12 | $ 12 |
| Corrugated Cardboard Price Protection Agreements(4) | **$ (1)** | **$ (1)** | $ | $ |

(1)
Excludes capital lease and lease-financing obligations.

(2)
As of February 2, 2008 and February 3, 2007, the Company maintained six interest rate swap agreements, with notional amounts totaling $1,050, to manage its exposure to changes in the fair value of its fixed rate debt resulting from interest rate movements by effectively converting a portion of the Company's debt from fixed to variable rates. These agreements mature at varying times between March 2008 and January 2015. The differential between fixed and variable rates to be paid or received is accrued as interest rates change in accordance with the agreements as an adjustment to interest expense. These interest rate swap agreements are being accounted for as fair value hedges. As of February 2, 2008, other long-term assets totaling $11 were recorded to reflect the fair value of these agreements, offset by increases in the fair value of the underlying debt. As of February 3, 2007, other long-term liabilities totaling $28 were recorded to reflect the fair value of these agreements, offset by decreases in the fair value of the underlying debt.

(3)
As of February 2, 2008 and February 3, 2007, the Company maintained one and three forward-starting interest rate swap agreements, with a notional amount of $250 and $750, respectively, to manage its exposure to changes in future benchmark interest rates. A forward-starting interest rate swap is an agreement that effectively hedges future benchmark interest rates on debt for an established period of time. The Company entered into the forward-starting interest rate swaps in order to lock in fixed interest rates on the Company's forecasted issuances of debt in 2007 and 2008. As of February 2, 2008 and February 3, 2007, other long-term liabilities and assets totaling $18 and $12, respectively, were recorded to reflect the fair value of these agreements.

(4)
See Note 6 for a description of the corrugated cardboard price protection agreements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

## 8. LEASES AND LEASE-FINANCED TRANSACTIONS

The Company operates primarily in leased facilities. Lease terms generally range from 10 to 20 years with options to renew for varying terms. Terms of certain leases include escalation clauses, percentage rent based on sales or payment of executory costs such as property taxes, utilities or insurance and maintenance. Rent expense for leases with escalation clauses or other lease concessions are accounted for on a straight-line basis beginning with the earlier of the lease commencement date or the date the Company takes possession. Portions of certain properties are subleased to others for periods generally ranging from one to 20 years.

Rent expense (under operating leases) consists of:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Minimum rentals | **$ 747** | $ 753 | $ 760 |
| Contingent payments | **11** | 10 | 8 |
| Sublease income | **(114)** | (114) | (107) |
| Total rent expense | **$ 644** | $ 649 | $ 661 |

Minimum annual rentals and payments under capital leases and lease-financed transactions for the five years subsequent to 2007 and in the aggregate are:

| | Capital Leases | Operating Leases | Lease-Financed Transactions |
|---|---|---|---|
| 2008 | $ 54 | $ 774 | $ 5 |
| 2009 | 53 | 736 | 5 |
| 2010 | 51 | 693 | 5 |
| 2011 | 55 | 630 | 6 |
| 2012 | 46 | 578 | 6 |
| Thereafter | 237 | 3,459 | 114 |
| | 496 | $ 6,870 | $ 141 |
| Less estimated executory costs included in capital leases | (1) | | |
| Net minimum lease payments under capital leases | 495 | | |
| Less amount representing interest | (198) | | |
| Present value of net minimum lease payments under capital leases | $ 297 | | |

Total future minimum rentals under noncancellable subleases at February 2, 2008, were $553.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

## 9. EARNINGS PER COMMON SHARE

Basic earnings per common share equals net earnings divided by the weighted average number of common shares outstanding. Diluted earnings per common share equals net earnings divided by the weighted average number of common shares outstanding after giving effect to dilutive stock options and warrants.

The following table provides a reconciliation of earnings and shares used in calculating basic earnings per share to those used in calculating diluted earnings per share.

| | For the year ended February 2, 2008 | | | For the year ended February 3, 2007 | | | For the year ended January 28, 2006 | | |
|---|---|---|---|---|---|---|---|---|---|
| (in millions, except per share amounts) | Earnings (Numer-ator) | Shares (Denomi-nator) | Per Share Amount | Earnings (Numer-ator) | Shares (Denomi-nator) | Per Share Amount | Earnings (Numer-ator) | Shares (Denomi-nator) | Per Share Amount |
| Basic EPS | **$ 1,181** | **690** | **$ 1.71** | $ 1,115 | 715 | $ 1.56 | $ 958 | 724 | $ 1.32 |
| Dilutive effect of stock option awards and warrants | | **8** | | | 8 | | | 7 | |
| Diluted EPS | **$ 1,181** | **698** | **$ 1.69** | $ 1,115 | 723 | $ 1.54 | $ 958 | 731 | $ 1.31 |

For the years ended February 2, 2008, February 3, 2007 and January 28, 2006, there were options outstanding for approximately 2.0 million, 25.4 million and 24.6 million shares of common stock, respectively, that were excluded from the computation of diluted EPS. These shares were excluded because their inclusion would have had an anti-dilutive effect on EPS.

## 10. STOCK OPTION PLANS

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

The Company grants options for common stock ("stock options") to employees, as well as to its non-employee directors, under various plans at an option price equal to the fair market value of the stock at the date of grant. Equity awards may be made at one of four meetings of its Board of Directors occurring shortly after the Company's release of quarterly earnings. The 2007 annual grant was made in conjunction with the June meeting of the Company's Board of Directors.

Stock options typically expire 10 years from the date of grant. Stock options vest between one and five years from the date of grant, or for certain stock options, the earlier of the Company's stock reaching certain pre-determined and appreciated market prices or nine years and six months from the date of grant. Under APB No. 25, the Company did not recognize compensation expense for these stock option grants. At February 2, 2008, approximately 11 million shares of common stock were available for future option grants under these plans.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

In addition to the stock options described above, the Company awards restricted stock to employees under various plans. The restrictions on these awards generally lapse between one and five years from the date of the awards and expense is recognized over the lapsing cycle. Under APB No. 25, the Company generally recorded expense for restricted stock awards in an amount equal to the fair market value of the underlying stock on the date of award. As of February 2, 2008, approximately three million shares of common stock were available for future restricted stock awards under the 2005 Long-Term Incentive Plan (the "Plan"). The Company has the ability to convert shares available for stock options under the Plan to shares available for restricted stock awards. Four shares available for common stock option awards can be converted into one share available for restricted stock awards.

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

Historically, stock option awards were granted to various employees throughout the organization. Restricted stock awards, however, were limited to approximately 150 associates, including members of the Board of Directors and certain members of senior management. Beginning in 2006, the Company began issuing a combination of stock option and restricted stock awards to those employees who previously received only stock option awards, in an effort to further align those employees' interests with those of the Company's non-employee shareholders. As a result, the number of stock option awards granted in 2007 and 2006 decreased and the number of restricted stock awards granted increased.

*Stock Options*

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

| | Shares subject to option (in millions) | Weighted-average exercise price |
|---|---|---|
| Outstanding, year-end 2004 | 61.5 | $ 18.20 |
| Granted | 6.8 | $ 16.50 |
| Exercised | (7.7) | $ 9.81 |
| Canceled or Expired | (1.3) | $ 20.92 |
| Outstanding, year-end 2005 | 59.3 | $ 19.03 |
| Granted | 3.2 | $ 20.05 |
| Exercised | (9.5) | $ 13.34 |
| Canceled or Expired | (1.1) | $ 21.01 |
| Outstanding, year-end 2006 | 51.9 | $ 20.09 |
| Granted | 3.4 | $ 28.21 |
| Exercised | (10.1) | $ 19.05 |
| Canceled or Expired | (.4) | $ 20.79 |
| Outstanding, year-end 2007 | 44.8 | $ 20.94 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

A summary of options outstanding and exercisable at February 2, 2008 follows:

| Range of Exercise Prices | Number outstanding | Weighted-average remaining contractual life | Weighted-average exercise price | Options exercisable | Weighted-average exercise price |
|---|---|---|---|---|---|
| | (in millions) | (in years) | | (in millions) | |
| $13.78 - $14.93 | 5.2 | 4.85 | $ 14.91 | 5.2 | $ 14.91 |
| $14.94 - $16.39 | 5.3 | 7.13 | $ 16.35 | 2.7 | $ 16.33 |
| $16.40 - $17.31 | 8.7 | 4.33 | $ 16.97 | 6.7 | $ 16.96 |
| $17.32 - $22.99 | 11.4 | 4.09 | $ 21.80 | 8.6 | $ 22.10 |
| $23.00 - $31.91 | 14.2 | 3.83 | $ 26.57 | 9.1 | $ 26.05 |
| $13.78 - $31.91 | 44.8 | 4.50 | $ 20.94 | 32.3 | $ 20.51 |

The weighted-average remaining contractual life for options exercisable at February 2, 2008, was approximately 3.7 years.

*Restricted stock*

| | Restricted shares outstanding (in millions) | Weighted-average grant-date fair value |
|---|---|---|
| Outstanding, year-end 2005 | .7 | $ 17.85 |
| Granted | 2.2 | $ 20.16 |
| Lapsed | (0.4) | $ 17.46 |
| Canceled or Expired | (0.1) | $ 19.41 |
| Outstanding, year-end 2006 | 2.4 | $ 20.02 |
| Granted | 2.5 | $ 28.20 |
| Lapsed | (1.4) | $ 19.90 |
| Canceled or Expired | (0.1) | $ 22.69 |
| Outstanding, year-end 2007 | 3.4 | $ 25.89 |

*Adoption of SFAS No. 123(R)*

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

In accordance with the provisions of the modified-prospective transition method, results for prior periods have not been restated. Compensation expense for all share-based awards described above was recognized using the straight-line attribution method applied to the fair value of each option grant, over the requisite service period associated with each award. The requisite service period is typically consistent with the vesting period, except as noted below. Because awards typically vest evenly over the requisite service period, compensation cost recognized through February 2, 2008, is at least equal to the grant-date fair value of the vested portion of all outstanding awards. All of the Company stock-based incentive plans are considered equity plans under SFAS No. 123(R).

The weighted-average fair value of stock options granted during 2007, 2006 and 2005 was $9.66, $6.90 and $7.70, 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** | **2005** |
|---|---|---|---|
| Weighted average expected volatility (based on historical volatility) | **29.23%** | 27.60% | 30.83% |
| Weighted average risk-free interest rate | **5.06%** | 5.07% | 4.11% |
| Expected dividend yield | **1.40%** | 1.50% | N/A |
| Expected term (based on historical results) | **6.9 years** | 7.5 years | 8.7 years |

The weighted-average risk-free interest rate was based on the yield of a treasury note as of the grant date, continuously compounded, which matures at a date that approximates the expected term of options. Prior to 2006, the Company did not pay a dividend, so an expected dividend rate was not included in the determination of fair value for options granted during those years. Using a dividend yield of 1.50% to value options issued in 2005 would have decreased the fair value of each option by approximately $1.60. Expected volatility was determined based upon historical stock volatilities; however, implied volatility was also considered. Expected term was determined based upon a combination of historical exercise and cancellation experience as well as estimates of expected future exercise and cancellation experience.

Under SFAS No. 123(R), the Company records expense for restricted stock awards in an amount equal to the fair market value of the underlying stock on the grant date of the award, over the period the awards lapse.

Total stock compensation recognized in 2007, 2006 and 2005 was $87, $72 and $7, respectively. Stock option compensation recognized in 2007 and 2006 was $51 and $50, respectively. Restricted shares compensation recognized in 2007, 2006 and 2005 was $36, $22 and $7 respectively.

If compensation cost for the Company's stock option plans for the year ended January 28, 2006 had been determined based upon the fair value at the grant date for awards under these plans consistent with the methodology prescribed under SFAS No. 123, the net earnings and diluted earnings per common share would have been reduced to the pro forma amounts below:

| | 2005 |
|---|---|
| Net earnings, as reported | $ 958 |
| Stock-based compensation expense included in net earnings, net of income tax benefits | 5 |
| Total stock-based compensation expense determined under fair value method for all awards, net of income tax benefits | (34) |
| Pro forma net earnings | $ 929 |
| Earnings per basic common share, as reported | $ 1.32 |
| Pro forma earnings per basic common share | $ 1.28 |
| Earnings per diluted common share, as reported | $ 1.31 |
| Pro forma earnings per diluted common share | $ 1.27 |

The total intrinsic value of options exercised was $33 and $79 in 2007 and 2006, respectively. The total amount of cash received from the exercise of options granted under share-based payment arrangements was $188. As of February 2, 2008, there was $110 of total unrecognized compensation expense related to non-vested share-based compensation arrangements granted under the Company's equity award plans. This cost is expected to be recognized over a weighted-average period of approximately one year. The total fair value of options that vested was $53 and $44 in 2007 and 2006, respectively.

Shares issued as a result of stock option exercises may be newly issued shares or reissued treasury shares. Proceeds received from the exercise of options, and the related tax benefit, are utilized to repurchase shares of the Company's stock under a stock repurchase program adopted by the Company's Board of Directors. During 2007, the Company repurchased approximately 10 million shares of stock in such a manner.

For share-based awards granted prior to the adoption of SFAS No. 123(R), the Company's stock option grants generally contained retirement-eligibility provisions that caused the options to vest upon the earlier of the stated vesting date or retirement. Compensation expense was calculated over the stated vesting periods, regardless of whether certain employees became retirement-eligible during the respective vesting periods. Upon the adoption of SFAS No. 123(R), the Company continued this method of recognizing compensation expense for awards granted prior to the adoption of SFAS No. 123(R). For awards granted on or after January 29, 2006, options vest based on the stated vesting date, even if an employee retires prior to the vesting date. The requisite service period ends, however, on the employee's retirement-eligible date. As a result, the Company recognizes expense for stock option grants containing such retirement-eligibility provisions over the shorter of the vesting period or the period until employees become retirement-eligible (the requisite service period). As a result of retirement eligibility provisions in stock option awards granted on or after January 29, 2006, approximately $13 of compensation expense was recognized in 2007 prior to the completion of stated vesting periods.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

## 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 believes that it 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 February 2, 2008, an adverse decision would require a cash payment of approximately $419, including interest.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

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 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 evaluation or predictions could arise that could have a material adverse impact on the Company's financial condition or results of operation.

*Guarantees* Most of the Company's outstanding public debt is jointly and severally, fully and unconditionally guaranteed by The Kroger Co. and some of the Company's subsidiaries. See Note 17 to the Consolidated Financial Statements for a more detailed discussion of those arrangements. In addition, the Company has guaranteed half of the indebtedness of two real estate entities in which Kroger has a 50% ownership interest. The Company's share of the responsibility for this indebtedness, should the entities be unable to meet their obligations, totals approximately $7. Based on the covenants underlying this indebtedness as of February 2, 2008, it is unlikely that the Company will be responsible for repayment of these obligations. The Company also agreed to guarantee, up to $10, the indebtedness of an entity of which Kroger has a 25% ownership interest. The Company's share of the responsibility, as of February 2, 2008, should the entity be unable to meet its obligations, totals approximately $9 and is collateralized by $8 of inventory located in the Company's stores.

*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 is unable to fulfill its 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.

## 12. SUBSEQUENT EVENTS

On March 19, 2008, the Company announced the issuance of $400 of senior notes bearing an interest rate of 5.00% and $375 of senior notes bearing an interest rate of 6.90%, which will be due April, 2013 and April 2038, respectively.

## 13. STOCK

*Preferred Stock*

The Company has authorized 5 million shares of voting cumulative preferred stock; 2 million were available for issuance at February 2, 2008. The stock has a par value of $100 per share and is issuable in series.

*Common Stock*

The Company has authorized one billion shares of common stock, $1 par value per share. On May 20, 1999, the shareholders authorized an amendment to the Amended Articles of Incorporation to increase the authorized shares of common stock from 1 billion to 2 billion when the Board of Directors determines it to be in the best interest of the Company.

*Common Stock Repurchase Program*

The Company maintains stock repurchase programs that comply with Securities Exchange Act Rule 10b5-1 to allow for the orderly repurchase of Kroger stock, from time to time. The Company made open market purchases totaling $1,151, $374 and $239 under these repurchase programs in fiscal 2007, 2006 and 2005, respectively. In addition to these repurchase programs, in December 1999, the Company began a program to repurchase common stock to reduce dilution resulting from its employee stock option plans. This program is solely funded by proceeds from stock option exercises, and the tax benefit. The Company repurchased approximately $270, $259 and $13 under the stock option program during fiscal 2007, 2006 and 2005, respectively.

## 14. BENEFIT PLANS

The Company administers non-contributory defined benefit retirement plans for substantially all non-union employees and some union-represented employees as determined by the terms and conditions of collective bargaining agreements. These included several qualified pension plans (the "Qualified Plans") and a non-qualified plan (the "Non-Qualified Plan"). The Non-Qualified Plan pays benefits to any employee that earns in excess of the maximum allowed for the Qualified Plans by Section 415 of the Internal Revenue Code. The Company only funds obligations under the Qualified Plans. Funding for the pension plans is based on a review of the specific requirements and on evaluation of the assets and liabilities of each plan.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

In addition to providing pension benefits, the Company provides certain health care benefits for retired employees. The majority of the Company's employees may become eligible for these benefits if they reach normal retirement age while employed by the Company. Funding of retiree health care benefits occurs as claims or premiums are paid.

Effective February 3, 2007, the Company adopted the recognition and disclosure provisions of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans-an amendment of FASB Statement No. 87, 99, 106 and 132(R),* which requires the recognition of the funded status of its retirement plans on the Consolidated Balance Sheet. Actuarial gains or losses, prior service costs or credits and transition obligations that have not yet been recognized are required to be recorded as a component of Accumulated Other Comprehensive Income ("AOCI"). The Company currently uses a December 31 measurement date. Effective for 2008, the statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. The Company will adopt the measurement date change in fiscal 2008.

Amounts recognized in AOCI as of February 2, 2008 consist of the following (pre-tax):

| February 2, 2008 | Pension Benefits | Other Benefits | Total |
|---|---|---|---|
| Unrecognized net actuarial loss (gain) | $ 241 | $ (38) | $ 203 |
| Unrecognized prior service cost (credit) | 6 | (35) | (29) |
| Unrecognized transition obligation | 1 | | 1 |
| Total liabilities | $ 248 | $ (73) | $ 175 |

Amounts in AOCI expected to be recognized as components of net periodic pension or postretirement benefit costs in 2008 are as follows (pre-tax):

| February 2, 2008 | Pension Benefits | Other Benefits | Total |
|---|---|---|---|
| Net actuarial loss | $ 10 | $ | $ 10 |
| Prior service cost (credit) | 2 | (6) | (4) |
| Total liabilities | $ 12 | $ (6) | $ 6 |

Other changes recognized in other comprehensive income in 2007 are as follows (pre-tax):

| February 2, 2008 | Pension Benefits | Other Benefits | Total |
|---|---|---|---|
| Incurred prior service cost | $ 2 | $ | $ 2 |
| Incurred net actuarial gain | (156) | (65) | (221) |
| Amortization of prior service cost | (3) | 6 | 3 |
| Amortization of net actuarial loss | (37) | | (37) |
| Total recognized in other comprehensive income | (194) | (59) | (253) |
| Total recognized in net periodic benefit cost and other comprehensive income | $ (125) | $ (36) | $ (161) |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

Information with respect to change in benefit obligation, change in plan assets, the funded status of the plans recorded in the Consolidated Balance Sheets, net amounts recognized at end of fiscal years, weighted average assumptions and components of net periodic benefit cost follow:

| | Pension Benefits | | | | | |
|---|---|---|---|---|---|---|
| | Qualified Plans | | Non-Qualified Plan | | Other Benefits | |
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Change in benefit obligation: | | | | | | |
| Benefit obligation at beginning of fiscal year | **$ 2,419** | $ 2,284 | **$ 113** | $ 105 | **$ 373** | $ 356 |
| Service cost | **42** | 123 | **2** | 2 | **10** | 13 |
| Interest cost | **141** | 130 | **9** | 6 | **19** | 20 |
| Plan participants' contributions | **1** | | | | **9** | 11 |
| Amendments | **2** | | | | | |
| Actuarial (gain) loss | **(143)** | (4) | **23** | 7 | **(65)** | 4 |
| Benefits paid | **(120)** | (114) | **(8)** | (7) | **(26)** | (31) |
| Benefit obligation at end of fiscal year | **$ 2,342** | $ 2,419 | **$ 139** | $ 113 | **$ 320** | $ 373 |
| Change in plan assets: | | | | | | |
| Fair value of plan assets at beginning of fiscal year | **$ 2,098** | $ 1,814 | **$** | $ | **$** | $ |
| Actual return on plan assets | **200** | 248 | | | | |
| Employer contributions | **51** | 150 | **8** | 7 | **17** | 20 |
| Plan participants' contributions | **1** | | | | **9** | 11 |
| Benefits paid | **(120)** | (114) | **(8)** | (7) | **(26)** | (31) |
| Fair value of plan assets at end of fiscal year | **$ 2,230** | $ 2,098 | **$** | $ | **$** | $ |
| Funded status at end of fiscal year | **$ (112)** | $ (321) | **$ (139)** | $ (113) | **$ (320)** | $ (373) |
| Net asset (liability) recognized at end of fiscal year | **$ (112)** | $ (321) | **$ (139)** | $ (113) | **$ (320)** | $ (373) |

As of February 2, 2008 and February 3, 2007, pension plan assets included no shares of The Kroger Co. common stock.

| | Pension Benefits | | | Other Benefits | | |
|---|---|---|---|---|---|---|
| **Weighted average assumptions** | **2007** | **2006** | **2005** | **2007** | **2006** | **2005** |
| Discount rate Benefit obligation | **6.50%** | 5.90% | 5.70% | **6.50%** | 5.90% | 5.70% |
| Discount rate Net periodic benefit cost | **5.90%** | 5.70% | 5.75% | **5.90%** | 5.70% | 5.75% |
| Expected return on plan assets | **8.50%** | 8.50% | 8.50% | | | |
| Rate of compensation increase | **3.56%** | 3.50% | 3.50% | | | |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

The Company's discount rate assumption was intended to reflect the rate at which the pension benefits could be effectively settled. It takes into account the timing and amount of benefits that would be available under the plan. The Company's methodology for selecting the discount rate as of year-end 2007 was to match the plan's cash flows to that of a yield curve that provides the equivalent yields on zero-coupon corporate bonds for each maturity. Benefit cash flows due in a particular year can theoretically be "settled" by "investing" them in the zero-coupon bond that matures in the same year. The discount rate is the single rate that produces the same present value of cash flows. The selection of the 6.50% discount rate as of year-end 2007 represents the equivalent single rate under a broad-market AA yield curve constructed by an outside consultant. We utilized a discount rate of 5.90% for year-end 2006. The 60 basis point increase in the discount rate decreased the projected pension benefit obligation as of February 2, 2008, by approximately $184.

To determine the expected return on pension plan assets, the Company contemplates current and forecasted plan asset allocations as well as historical and forecasted returns on various asset categories. The average annual return on pension plan assets was 8.5% for the ten calendar years ended December 31, 2007, net of all fees and expenses. Our actual return for the pension plan calendar year ending December 31, 2007, on that same basis, was 9.5%. The Company utilized a pension return assumption of 8.5% in 2007, 2006 and 2005.

The Company uses the RP-2000 projected 2015 mortality table in calculating the pension obligation.

| | Pension Benefits | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Qualified Plans | | | Non-Qualified Plan | | | Other Benefits | | |
| | **2007** | **2006** | **2005** | **2007** | **2006** | **2005** | **2007** | **2006** | **2005** |
| Components of net periodic benefit cost: | | | | | | | | | |
| Service cost | **$ 42** | $ 123 | $ 118 | **$ 2** | $ 2 | $ 1 | **$ 10** | $ 13 | $ 12 |
| Interest cost | **141** | 130 | 113 | **9** | 6 | 6 | **19** | 20 | 19 |
| Expected return on plan assets | **(165)** | (152) | (130) | | | | | | |
| Amortization of: | | | | | | | | | |
| Transition asset | | (1) | (1) | | | | | | |
| Prior service cost | **1** | 3 | 3 | **2** | 2 | 2 | **(6)** | (7) | (7) |
| Actuarial (gain) loss | **31** | 41 | 24 | **6** | 2 | 2 | | | |
| Curtailment charge | | 5 | | | | | | | |
| Net periodic benefit cost | **$ 50** | $ 149 | $ 127 | **$ 19** | $ 12 | $ 11 | **$ 23** | $ 26 | $ 24 |

The following table provides the projected benefit obligation ("PBO"), accumulated benefit obligation ("ABO") and the fair value of plan assets for all Company-sponsored pension plans.

| | Qualified Plans | | Non-Qualified Plan | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| PBO at end of fiscal year | **$ 2,342** | $ 2,419 | **$ 139** | $ 113 |
| ABO at end of fiscal year | **$ 2,144** | $ 2,232 | **$ 118** | $ 103 |
| Fair value of plan assets at end of year | **$ 2,230** | $ 2,098 | **$** | $ |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

The following table provides information about the Company's estimated future benefit payments.

| | Pension Benefits | Other Benefits |
|---|---|---|
| 2008 | $ 139 | $ 22 |
| 2009 | $ 141 | $ 24 |
| 2010 | $ 145 | $ 25 |
| 2011 | $ 151 | $ 26 |
| 2012 | $ 159 | $ 26 |
| 2013 2017 | $ 932 | $ 145 |

The Company discontinued the accrual of additional benefits under the Company's cash balance formula of the Consolidated Retirement Benefit Plan (the "Cash Balance Plan") effective January 1, 2007. Participants in the Cash Balance Plan will continue to earn interest credits on their accrued benefit balance as of December 31, 2006, based on average Treasury rates, but will no longer accrue cash balance pay credits under the Cash Balance Plan after December 31, 2006. Projected pension benefit payments, as noted above, are lower than estimates in prior years as a result of the discontinuation of benefit accruals under the Cash Balance Plan. As a result of the decision to curtail benefits under the Cash Balance Plan, the Company recorded a charge totaling $5, pre-tax, in fiscal 2006, which represented the previously unrecognized prior service costs.

Net periodic benefit cost decreased in 2007 compared to 2006 and 2005 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. Participants under that formula continue to earn interest on prior contributions but no additional pay credits will be earned. The 401(k) retirement savings plan provides to eligible employees both matching contributions and automatic contributions from Kroger based on participant contributions, plan compensation, and length of service. The Company contributed and expensed $90 to employee 401(k) retirement savings accounts in 2007.

The following table provides information about the target and actual pension plan asset allocations. Allocation percentages are shown as of December 31 for each respective year. The pension plan measurement date is the December 31st nearest the fiscal year-end.

| | Target allocations | Actual allocations | |
|---|---|---|---|
| | **2007** | **2007** | **2006** |
| Pension plan asset allocation, as of December 31: | | | |
| Domestic equity securities | **17.5%** | **15.2%** | 21.1% |
| International equity securities | **20.5** | **21.4** | 27.5 |
| Investment grade debt securities | **21.8** | **21.6** | 23.3 |
| High yield debt securities | **9.7** | **9.9** | 7.7 |
| Private equity | **5.0** | **5.9** | 4.9 |
| Hedge funds | **17.0** | **17.2** | 7.4 |
| Real estate | **1.4** | **1.7** | 1.4 |
| Other | **7.1** | **7.1** | 6.7 |
| Total | **100.0%** | **100.0%** | 100.0% |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

Investment objectives, policies and strategies are set by the Pension Investment Committee (the "Committee") appointed by the CEO. The primary objectives include holding, protecting and investing the assets and distributing benefits to participants and beneficiaries of the pension plans. Investment objectives have been established based on a comprehensive review of the capital markets and each underlying plan's current and projected financial requirements. The time horizon of the investment objectives is long-term in nature and plan assets are managed on a going-concern basis.

Investment objectives and guidelines specifically applicable to each manager of assets are established and reviewed annually. Derivative instruments may be used for specified purposes. Any use of derivative instruments for a purpose or in a manner not specifically authorized is prohibited, unless approved in advance by the Committee.

The current target allocations shown represent 2007 targets that were established in 2006. To maintain actual asset allocations consistent with target allocations, assets are reallocated or rebalanced periodically. In addition, cash flow from employer contributions and participant benefit payments is used to fund underweight asset classes and divest overweight asset classes, as appropriate. The Company expects that cash flow will be sufficient to meet most rebalancing needs. Although the Company is not required to make cash contributions to its Company-sponsored pension plans during fiscal 2008, contributions may be made if required under the Pension Protection Act to avoid any benefit restrictions. The Company expects any voluntary contributions made during 2008 will reduce its minimum required contributions in future years.

The measurement date for post-retirement benefit obligations is the December 31st nearest the fiscal year-end. Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. The Company used a 8.50% initial health care cost trend rate and a 5.00% ultimate health care cost trend rate to determine its expense. A one-percentage-point change in the assumed health care cost trend rates would have the following effects:

| | 1% Point Increase | 1% Point Decrease |
|---|---|---|
| Effect on total of service and interest cost components | $ 4 | $ (3) |
| Effect on postretirement benefit obligation | $ 32 | $ (28) |

On December 8, 2003, the President signed into law the Medicare Prescription Drug Improvement and Modernization Act of 2003. The law provides for a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit at least actuarially equivalent to the benefit established by the law. The Company has concluded that the plan is at least "actuarially equivalent" to the Medicare Part D plan for certain covered groups only and will be eligible for the subsidy for those groups. The effect of the subsidy reduced the Company's postretirement benefit obligation as of February 2, 2008 and February 3, 2007 by $4 and $6, respectively, and did not have a material effect on the Company's net periodic benefit cost in either of those years. The remaining groups' benefits are not "actuarially equivalent" to the Medicare Part D plan, and the Company has made the decision to pay as secondary coverage to Medicare Part D for those groups.

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

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.

The Company recognizes expense in connection with these plans as contributions are funded, in accordance with GAAP. The Company made contributions to these plans, and recognized expense, of $207 in 2007, $204 in 2006, and $196 in 2005.

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. Although underfunding can result in the imposition of excise taxes on contributing employers, factors such as increased contributions, increased asset values or future service benefit changes 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 estimated, in accordance with GAAP.

The Company also administers other defined contribution plans for eligible union and non-union employees. The cost of these plans for 2007, 2006 and 2005 was $8.

## 15. RECENTLY ADOPTED ACCOUNTING STANDARDS

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 the Company's accrual for uncertain tax positions by a corresponding amount. Additionally, the Company decreased goodwill and accrual for uncertain tax positions by $72 to reflect the measurement under the rules of FIN No. 48 of an uncertain tax position related to previous business combinations.

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

To the extent interest and penalties would be assessed by taxing authorities on any underpayment of income tax, such amounts have been accrued and classified as a component of income tax expense in the Company's 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 IRS concluded a field examination of the Company's 2002 2004 U.S. tax returns during the third quarter of 2007. An examination of the Company's 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 the Company anticipates 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 the Company's 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 third quarter, the Company reclassified unrecognized tax benefits of $168 from other long-term liabilities to deferred income taxes and accrued taxes payable. See Note 4 for further discussion of the adoption of FIN 48.

Effective February 3, 2007, the Company adopted the recognition and disclosure provisions of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans-an amendment of FASB Statement No. 87, 99, 106 and 132(R),* which requires the recognition of the funded status of its retirement plans on the Consolidated Balance Sheet. Actuarial gains or losses, prior service costs or credits and transition obligations that have not yet been recognized are required to be recorded as a component of Accumulated Other Comprehensive Income ("AOCI"). The Company currently uses a December 31 measurement date. Effective for 2008, the statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. The Company will adopt the measurement date change in fiscal 2008. See Note14 for further discussion of the adoption of SFAS 158.

Effective January 29, 2006, the Company adopted the provisions of SFAS No. 123(R), *Share-Based Payment,* using the modified-prospective method. Under this method, the Company recognizes compensation expense for all share-based awards granted prior to, but not yet vested as of, January 29, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, *Accounting for Stock-Based Compensation.* For all share-based awards granted on or after January 29, 2006, the Company recognizes compensation expense based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). See Note10 for further discussion of the adoption of SFAS 123(R).

**16. 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 be 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 the Company's fiscal year beginning February 1, 2009. The Company is currently evaluating the effect the adoption of SFAS No. 160 will have on its 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 the Company's fiscal year beginning February 1, 2009. The Company is currently evaluating the effect the adoption of SFAS No. 141R will have on its Consolidated Financial Statements.

In March 2007, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities.* SFAS No. 161 requires enhanced disclosures on an entity's derivative and hedging activities. SFAS No. 161 will become effective for the Company's fiscal year beginning February 1, 2009. The Company is currently evaluating the effect the adoption of SFAS No. 161 will have on its Consolidated Financial Statements.

**17. GUARANTOR SUBSIDIARIES**

The Company's outstanding public debt (the "Guaranteed Notes") is jointly and severally, fully and unconditionally guaranteed by The Kroger Co. and some of its subsidiaries (the "Guarantor Subsidiaries"). At February 2, 2008, a total of approximately $6,766 of Guaranteed Notes was outstanding. The Guarantor Subsidiaries and non-guarantor subsidiaries are 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, except, however, the obligations of each guarantor under its guarantee are limited to the maximum amount as will result in obligations of such guarantor under its guarantee not constituting a fraudulent conveyance or fraudulent transfer for purposes of Bankruptcy Law, the Uniform Fraudulent Conveyance Act, the Uniform Fraudulent Transfer Act, or any similar Federal or state law (e.g., adequate capital to pay dividends under corporate laws).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

The following tables present summarized financial information as of February 2, 2008 and February 3, 2007 and for the three years ended February 2, 2008.

**Condensed Consolidating Balance Sheets As of February 2, 2008**

| | The Kroger Co. | Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|
| Current assets | | | | |
| Cash and temporary cash investments | $ 26 | $ 216 | $ | $ 242 |
| Deposits in-transit | 76 | 600 | | 676 |
| Receivables | 152 | 2,515 | (1,881) | 786 |
| Net inventories | 420 | 4,435 | | 4,855 |
| Prepaid and other current assets | 373 | 182 | | 555 |
| Total current assets | 1,047 | 7,948 | (1,881) | 7,114 |
| Property, plant and equipment, net | 1,684 | 10,814 | | 12,498 |
| Goodwill | 56 | 2,088 | | 2,144 |
| Adjustment to reflect fair value interest rate hedges | 11 | | | 11 |
| Other assets | 1,412 | 657 | (1,537) | 532 |
| Investment in and advances to subsidiaries | 11,979 | | (11,979) | |
| Total Assets | $ 16,189 | $ 21,507 | $ (15,397) | $ 22,299 |
| Current liabilities | | | | |
| Current portion of long-term debt including obligations under capital leases and financing obligations | $ 1,592 | $ | $ | $ 1,592 |
| Accounts payable | 1,822 | 5,646 | (3,418) | 4,050 |
| Other current liabilities | | 3,045 | | 3,045 |
| Total current liabilities | 3,414 | 8,691 | (3,418) | 8,687 |
| Long-term debt including obligations under capital leases and financing obligations | | | | |
| Face value long-term debt including obligations under capital leases and financing obligations | 6,485 | | | 6,485 |
| Adjustment to reflect fair value interest rate hedges | 44 | | | 44 |
| Long-term debt including obligations under capital leases and financing obligations | 6,529 | | | 6,529 |
| Other long-term liabilities | 1,332 | 837 | | 2,169 |
| Total Liabilities | 11,275 | 9,528 | (3,418) | 17,385 |
| Shareowners' Equity | 4,914 | 11,979 | (11,979) | 4,914 |
| Total Liabilities and Shareowners' equity | $ 16,189 | $ 21,507 | $ (15,397) | $ 22,299 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

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

| | The Kroger Co. | Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|
| Current assets | | | | |
| Cash and temporary cash investments | $ 25 | $ 164 | $ | $ 189 |
| Deposits in-transit | 69 | 545 | | 614 |
| Receivables | 168 | 1,982 | (1,372) | 778 |
| Net inventories | 406 | 4,203 | | 4,609 |
| Prepaid and other current assets | 371 | 194 | | 565 |
| Total current assets | 1,039 | 7,088 | (1,372) | 6,755 |
| Property, plant and equipment, net | 1,429 | 10,350 | | 11,779 |
| Goodwill | 56 | 2,136 | | 2,192 |
| Other assets | 1,184 | 612 | (1,307) | 489 |
| Investment in and advances to subsidiaries | 11,510 | | (11,510) | |
| Total Assets | $ 15,218 | $ 20,186 | $ (14,189) | $ 21,215 |
| Current liabilities | | | | |
| Current portion of long-term debt including obligations under capital leases and financing obligations | $ 906 | $ | $ | $ 906 |
| Accounts payable | 1,614 | 4,869 | (2,679) | 3,804 |
| Other current liabilities | | 2,871 | | 2,871 |
| Total current liabilities | 2,520 | 7,740 | (2,679) | 7,581 |
| Long-term debt including obligations under capital leases and financing obligations | | | | |
| Face value long-term debt including obligations under capital leases and financing obligations | 6,136 | | | 6,136 |
| Adjustment to reflect fair value interest rate hedges | 18 | | | 18 |
| Long-term debt including obligations under capital leases and financing obligations | 6,154 | | | 6,154 |
| Other long-term liabilities | 1,621 | 936 | | 2,557 |
| Total Liabilities | 10,295 | 8,676 | (2,679) | 16,292 |
| Shareowners' Equity | 4,923 | 11,510 | (11,510) | 4,923 |
| Total Liabilities and Shareowners' equity | $ 15,218 | $ 20,186 | $ (14,189) | $ 21,215 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

**Condensed Consolidating**
**Statements of Operations**
**For the Year ended February 2, 2008**

| | The Kroger Co. | Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|
| Sales | $ 9,022 | $ 62,482 | $ (1,269) | $ 70,235 |
| Merchandise costs, including warehousing and transportation | 6,877 | 48,171 | (1,269) | 53,779 |
| Operating, general and administrative | 1,666 | 10,489 | | 12,155 |
| Rent | 125 | 519 | | 644 |
| Depreciation and amortization | 148 | 1,208 | | 1,356 |
| Operating profit | 206 | 2,095 | | 2,301 |
| Interest expense | 468 | 6 | | 474 |
| Equity in earnings of subsidiaries | 1,511 | | (1,511) | |
| Earnings (loss) before tax expense | 1,249 | 2,089 | (1,511) | 1,827 |
| Tax expense | 68 | 578 | | 646 |
| Net earnings (loss) | $ 1,181 | $ 1,511 | $ (1,511) | $ 1,181 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

**Condensed Consolidating**
**Statements of Operations**
**For the Year ended February 3, 2007**

| | The Kroger Co. | Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|
| Sales | $ 8,731 | $ 58,383 | $ (1,003) | $ 66,111 |
| Merchandise costs, including warehousing and transportation | 6,630 | 44,488 | (1,003) | 50,115 |
| Operating, general and administrative | 1,697 | 10,142 | | 11,839 |
| Rent | 132 | 517 | | 649 |
| Depreciation and amortization | 136 | 1,136 | | 1,272 |
| Operating profit | 136 | 2,100 | | 2,236 |
| Interest expense | 480 | 8 | | 488 |
| Equity in earnings of subsidiaries | 1,843 | | (1,843) | |
| Earnings before income tax expense | 1,499 | 2,092 | (1,843) | 1,748 |
| Income tax expense | 384 | 249 | | 633 |
| Net earnings | $ 1,115 | $ 1,843 | $ (1,843) | $ 1,115 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

**Condensed Consolidating**
**Statements of Operations**
**For the Year ended January 28, 2006**

| | The Kroger Co. | Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|
| Sales | $ 8,693 | $ 52,822 | $ (962) | $ 60,553 |
| Merchandise costs, including warehousing and transportation | 6,502 | 40,021 | (958) | 45,565 |
| Operating, general and administrative | 1,657 | 9,368 | 2 | 11,027 |
| Rent | 165 | 502 | (6) | 661 |
| Depreciation and amortization | 139 | 1,126 | | 1,265 |
| Operating profit | 230 | 1,805 | | 2,035 |
| Interest expense | 498 | 12 | | 510 |
| Equity in earnings of subsidiaries | 1,164 | | (1,164) | |
| Earnings before income tax expense | 896 | 1,793 | (1,164) | 1,525 |
| Income tax expense (benefit) | (62) | 629 | | 567 |
| Net earnings | $ 958 | $ 1,164 | $ (1,164) | $ 958 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

**Condensed Consolidating**
**Statements of Cash Flows**
**For the Year ended February 2, 2008**

| | The Kroger Co. | Guarantor Subsidiaries | Consolidated |
|---|---|---|---|
| Net cash (used) provided by operating activities | $ (433) | $ 3,014 | $ 2,581 |
| Cash flows from investing activities: | | | |
| Payments for capital expenditures | (210) | (1,916) | (2,126) |
| Other | (29) | (63) | (92) |
| Net cash used by investing activities | (239) | (1,979) | (2,218) |
| Cash flows from financing activities: | | | |
| Proceeds from issuance of long-term debt | 1,590 | | 1,590 |
| Payments on long-term debt | (560) | | (560) |
| Proceeds from issuance of capital stock | 224 | | 224 |
| Treasury stock purchases | (1,421) | | (1,421) |
| Dividends paid | (202) | | (202) |
| Other | | 59 | 59 |
| Net change in advances to subsidiaries | 1,042 | (1,042) | |
| Net cash (used) provided by financing activities | 673 | (983) | (310) |
| Net decrease in cash and temporary cash investments | 1 | 52 | 53 |
| Cash and temporary cash investments: | | | |
| Beginning of year | 25 | 164 | 189 |
| End of year | $ 26 | $ 216 | $ 242 |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

**Condensed Consolidating**
**Statements of Cash Flows**
**For the Year ended February 3, 2007**

| | The Kroger Co. | Guarantor Subsidiaries | Consolidated |
|---|---|---|---|
| Net cash provided by operating activities | $ 152 | $ 2,199 | $ 2,351 |
| Cash flows from investing activities: | | | |
| Payments for capital expenditures | (143) | (1,540) | (1,683) |
| Other | 56 | 40 | 96 |
| Net cash used by investing activities | (87) | (1,500) | (1,587) |
| Cash flows from financing activities: | | | |
| Proceeds from issuance of long-term debt | 362 | | 362 |
| Payments on long-term debt | (556) | | (556) |
| Proceeds from issuance of capital stock | 168 | | 168 |
| Treasury stock purchases | (633) | | (633) |
| Dividends paid | (140) | | (140) |
| Other | 18 | (4) | 14 |
| Net change in advances to subsidiaries | 702 | (702) | |
| Net cash used by financing activities | (79) | (706) | (785) |
| Net decrease in cash and temporary cash investments | (14) | (7) | (21) |
| Cash and temporary cash investments: | | | |
| Beginning of year | 39 | 171 | 210 |
| End of year | $ 25 | $ 164 | $ 189 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

**Condensed Consolidating**
**Statements of Cash Flows**
**For the Year ended January 28, 2006**

| | The Kroger Co. | Guarantor Subsidiaries | Consolidated |
|---|---|---|---|
| Net cash provided by operating activities | $ 1,171 | $ 1,021 | $ 2,192 |
| Cash flows from investing activities: | | | |
| Payments fro capital expenditures | (188) | (1,118) | (1,306) |
| Other | 11 | 16 | 27 |
| Net cash used by investing activities | (177) | (1,102) | (1,279) |
| Cash flows from financing activities: | | | |
| Proceeds from issuance of long-term debt | 14 | | 14 |
| Payments on long-term debt | (764) | (33) | (797) |
| Proceeds from issuance of capital stock | 78 | | 78 |
| Treasury stock purchases | (252) | | (252) |
| Other | 77 | 33 | (110) |
| Net change in advances to subsidiaries | (140) | 140 | |
| Net cash provided (used) by financing activities | (987) | 140 | (847) |
| Net increase in cash and temporary cash investments | 7 | 59 | 66 |
| Cash and temporary cash investments: | | | |
| Beginning of year | 32 | 112 | 144 |
| End of year | $ 39 | $ 171 | $ 210 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONCLUDED**

**18. QUARTERLY DATA (UNAUDITED)**

| **2007** | **Quarter** First (16 Weeks) | Second (12 Weeks) | Third (12 Weeks) | Fourth (12 Weeks) | **Total Year** (52 Weeks) |
|---|---|---|---|---|---|
| **Sales** | **$ 20,726** | **$ 16,139** | **$ 16,135** | **$ 17,235** | **$ 70,235** |
| **Net earnings** | **$ 337** | **$ 267** | **$ 254** | **$ 323** | **$ 1,181** |
| **Net earnings per basic common share** | **$ 0.48** | **$ 0.38** | **$ 0.37** | **$ 0.48** | **$ 1.71** |
| **Average number of shares used in basic calculation** | **706** | **702** | **678** | **668** | **690** |
| **Net earnings per diluted common share** | **$ 0.47** | **$ 0.38** | **$ 0.37** | **$ 0.48** | **$ 1.69** |
| **Average number of shares used in diluted calculation** | **715** | **709** | **685** | **676** | **698** |

| **2006** | **Quarter** First (16 Weeks) | Second (12 Weeks) | Third (12 Weeks) | Fourth (13 Weeks) | **Total Year** (53 Weeks) |
|---|---|---|---|---|---|
| Sales | $ 19,415 | $ 15,138 | $ 14,699 | $ 16,859 | $ 66,111 |
| Net earnings | $ 306 | $ 209 | $ 215 | $ 385 | $ 1,115 |
| Net earnings per basic common share | $ 0.42 | $ 0.29 | $ 0.30 | $ 0.55 | $ 1.56 |
| Average number of shares used in basic calculation | 722 | 719 | 712 | 706 | 715 |
| Net earnings per diluted common share | $ 0.42 | $ 0.29 | $ 0.30 | $ 0.54 | $ 1.54 |
| Average number of shares used in diluted calculation | 729 | 725 | 720 | 715 | 723 |

**CERTIFICATIONS**

On July 19, 2007, we submitted a Section 12(a) CEO Certification to the New York Stock Exchange with no qualifications. We also filed with the SEC the Rule 13a-14(a)/15d-14(a) Certifications as an exhibit to Form 10-K for fiscal years 2006 and 2007.

Kroger has a variety of plans under which employees may acquire common stock of Kroger. Employees of Kroger and its subsidiaries own shares through a profit sharing plan, as well as 401(k) plans and a payroll deduction plan called the Kroger Stock Exchange. If employees have questions concerning their shares in the Kroger Stock Exchange, or if they wish to sell shares they have purchased through this plan, they should contact:

The Bank of New York Mellon
Employee Investment Plans Division
P. O. Box 7090
Troy, MI 48007-7090
Toll Free 1-800-872-3307

Questions regarding Kroger's 401(k) plan should be directed to the employee's Human Resources Department or 1-800-2KROGER. Questions concerning any of the other plans should be directed to the employee's Human Resources Department.

SHAREOWNERS: BNY Mellon Shareowner Services is Registrar and Transfer Agent for Kroger's Common Stock. For questions concerning payment of dividends, changes of address, etc., individual shareowners should contact:

BNY Mellon Shareowner Services
P. O. Box 358015
Pittsburgh, PA 15252-8015

The Bank's toll-free number is: 1-866-405-6566.

Shareholder questions and requests for forms available on the Internet should be directed to: www.bnymellon.com/shareowner.

FINANCIAL INFORMATION: Call (513) 762-1220 to request printed financial information, including Kroger's most recent report on Form 10-Q or 10-K, or press release. Written inquiries should be addressed to Shareholder Relations, The Kroger Co., 1014 Vine Street, Cincinnati, Ohio 45202-1100. Information also is available on Kroger's corporate website at www.thekrogerco.com.

## EXECUTIVE OFFICERS

**Donald E. Becker**
Executive Vice President

**David B. Dillon**
Chairman of the Board and
Chief Executive Officer

**Kevin M. Dougherty**
Group Vice President

**Joseph A. Grieshaber, Jr.**
Group Vice President

**Paul W. Heldman**
Executive Vice President,
Secretary and General Counsel

**Scott M. Henderson**
Vice President and Treasurer

**Christopher T. Hjelm**
Senior Vice President and
Chief Information Officer

**Carver L. Johnson**
Group Vice President and
Chief Diversity Officer

**Calvin J. Kaufman**
Group Vice President
President Manufacturing

**Lynn Marmer**
Group Vice President

**Don W. McGeorge**
President and
Chief Operating Officer

**W. Rodney McMullen**
Vice Chairman

**M. Marnette Perry**
Senior Vice President

**J. Michael Schlotman**
Senior Vice President and
Chief Financial Officer

**Paul J. Scutt**
Senior Vice President

**M. Elizabeth Van Oflen**
Vice President and Controller

**Della Wall**
Group Vice President

**R. Pete Williams**
Senior Vice President

## OPERATING UNIT HEADS

**John E. Bays**
Dillon Stores

**Paul L. Bowen**
Jay C

**William H. Breetz, Jr.**
Southwest Division

**Geoffrey J. Covert**
Cincinnati Division

**Jay Cummins**
Mid-Atlantic Division

**Russell J. Dispense**
King Soopers

**Michael J. Donnelly**
Ralphs

**Michael L. Ellis**
Fred Meyer Stores

**Peter M. Engel**
Fred Meyer Jewelers

**Jon C. Flora**
Fry's

**Donna Giordano**
QFC

**Rick Going**
Michigan Division

**John P. Hackett**
Mid-South Division

**James Hallsey**
Smith's

**David G. Hirz**
Food 4 Less

**Jeffrey A. Parker**
Kwik Shop

**Kathleen Kelly**
Kroger Personal Finance
(50% owned by Kroger)

**Bruce A. Lucia**
Atlanta Division

**Bruce A. Macaulay**
Columbus Division

**Robert Moeder**
Central Division

**Phyllis J. Norris**
City Market

**Darel Pfeiff**
Turkey Hill Minit Markets

**D. Mark Prestidge**
Delta Division

**Mark W. Salisbury**
Tom Thumb

**Arthur Stawski, Sr.**
Loaf 'N Jug

**Ron Stewart**
Quik Stop

**Van Tarver**
Convenience Stores and
Supermarket Petroleum

Explanation of Responses:

Explanation of Responses:

Please mark your votes as indicated in this example **X**

**The Board of Directors recommends a vote FOR the nominees and FOR Proposals 2 and 3.**

1.ELECTION OF DIRECTORS:

| | FOR | AGAINST | ABSTAIN | | FOR | AGAINST | ABSTAIN | | FOR | AGAINST | ABSTAIN |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1.1 Reuben V. Anderson | o | o | o | 1.6 David B. Lewis | o | o | o | 1.11 Susan M. Phillips | o | o | o |
| 1.2 Robert D. Beyer | o | o | o | 1.7 Don W. McGeorge | o | o | o | 1.12 Steven R. Rogel | o | o | o |
| 1.3 David B. Dillon | o | o | o | 1.8 W. Rodney McMullen | o | o | o | 1.13 James A. Runde | o | o | o |
| 1.4 Susan J. Kropf | o | o | o | 1.9 Jorge P. Montoya | o | o | o | 1.14 Ronald L. Sargent | o | o | o |
| 1.5 John T. LaMacchia | o | o | o | 1.10 Clyde R. Moore | o | o | o | 1.15 Bobby S. Shackouls | o | o | o |

| | FOR | AGAINST | ABSTAIN |
|---|---|---|---|
| 2. Approval of 2008 Long-Term Incentive and Cash Bonus Plan. | o | o | o |
| 3. Approval of PricewaterhouseCoopers LLP, as auditors. | o | o | o |

**The Board of Directors recommends a vote AGAINST Proposals 4, 5, 6, 7 and 8.**

| | FOR | AGAINST | ABSTAIN |
|---|---|---|---|
| 4. Approve shareholder proposal, if properly presented, to recommend preparation of climate change report. | o | o | o |
| 5. Approve shareholder proposal, if properly presented, to recommend purchasing preference for suppliers using controlled-atmosphere killing of chickens. | o | o | o |
| 6. Approve shareholder proposal, if properly presented, to recommend phase out of sale of eggs | o | o | o |

from hens confined in battery cages.

| | | | | |
|---|---|---|---|---|
| 7. | Approve shareholder proposal, if properly presented, to recommend preparation of product toxicity report. | o | o | o |
| 8. | Approve shareholder proposal, if properly presented, to recommend adoption of proposed compensation principles for senior executives. | o | o | o |

Signature Co-owner sign here Date

**Please sign below exactly as name appears hereon. Joint owners should each sign. Where applicable, indicate position or representative capacity.**

**FOLD AND DETACH HERE**

**WE ENCOURAGE YOU TO TAKE ADVANTAGE OF INTERNET OR TELEPHONE VOTING,**

**BOTH ARE AVAILABLE 24 HOURS A DAY, 7 DAYS A WEEK.**

**Internet and telephone voting are available through 11:59 PM Eastern Time**

**June 25, 2008**

**Your Internet or telephone vote authorizes the named proxies to vote your shares in the same manner**

**as if you marked, signed and returned your proxy card.**

| INTERNET | TELEPHONE |
|---|---|
| **http://www.eproxy.com/kr** | **1-866-580-9477** |

Use the Internet to vote your proxy. Have your proxy card in hand when you access the web site.

**OR**

Use any touch-tone telephone in the United States, Canada and Puerto Rico to vote your proxy. Have your proxy card in hand when you call.

If you vote your proxy by Internet or by telephone, you do NOT need to mail back your proxy card.

To vote by mail, mark, sign and date your proxy card and return it in the enclosed postage-paid envelope.

Choose **MLink**SM for fast, easy and secure 24/7 on-line access to your future proxy materials, investment plan statements, tax documents and more. Simply log on to **Investor ServiceDirect**® at www.bnymellon.com/shareowner/isd where step-by-step instructions will prompt you through enrollment.

For shareholders who have elected to receive The Kroger Co. Proxy Statement and Annual Report electronically, you can now view the 2008 Annual Meeting materials on the Internet by pointing your browser to **http://www.kroger.com/reports.**

**P R O X Y**

## This Proxy is Solicited on Behalf of the Board of Directors

## for the Annual Meeting to be Held on June 26, 2008

The undersigned hereby appoints each of DAVID B. DILLON, STEVEN R. ROGEL, and JOHN T. LA MACCHIA, or if more than one is present and acting then a majority thereof, proxies, with full power of substitution and revocation, to vote the common shares of The Kroger Co. that the undersigned is entitled to vote at the annual meeting of shareholders, and at any adjournment thereof, with all the powers the undersigned would possess if personally present, including authority to vote on the matters shown on the reverse in the manner directed, and upon any other matter that properly may come before the meeting. The undersigned hereby revokes any proxy previously given to vote those shares at the meeting or at any adjournment.

**The proxies are directed to vote as specified on the reverse hereof and in their discretion on all other matters coming before the meeting. Except as specified to the contrary on the reverse, the shares represented by this proxy will be voted FOR all nominees listed, FOR Proposals 2 and 3, and AGAINST Proposals 4, 5, 6, 7 and 8.**

If you wish to vote in accordance with the recommendations of the Board of Directors, all you need do is sign and return this card. The Proxy Committee cannot vote your shares unless you vote your proxy by Internet or telephone or sign and return the card.

**(Continued and to be marked, dated and signed, on the other side)**

**Address Change/Comments**

**FOLD AND DETACH HERE**

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