

KROGER CO  
Form 10-Q  
June 23, 2011

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

**For the quarterly period ended May 21, 2011**

**OR**

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

**For the transition period from                      to**

**Commission file number 1-303**

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(Exact name of registrant as specified in its charter)

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**Ohio**  
(State or other jurisdiction of  
incorporation or organization)

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

**1014 Vine Street, Cincinnati, OH 45202**

(Address of principal executive offices)

(Zip Code)

**(513) 762-4000**

(Registrant's telephone number, including area code)

**Unchanged**

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

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Non-accelerated filer ☐  
(do not check if a smaller reporting company)

Smaller reporting company ☐

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

There were 605,111,988 shares of Common Stock (\$1 par value) outstanding as of June 17, 2011.

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**PART I FINANCIAL INFORMATION****Item 1. Financial Statements.****THE KROGER CO.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in millions, except per share amounts)

(unaudited)

|                                                                                                                   | <b>First Quarter Ended</b> |                         |
|-------------------------------------------------------------------------------------------------------------------|----------------------------|-------------------------|
|                                                                                                                   | <b>May 21,<br/>2011</b>    | <b>May 22,<br/>2010</b> |
| Sales                                                                                                             | \$ 27,461                  | \$ 24,738               |
| Merchandise costs, including advertising, warehousing, and transportation, excluding items shown separately below | 21,624                     | 19,155                  |
| Operating, general and administrative                                                                             | 4,327                      | 4,182                   |
| Rent                                                                                                              | 200                        | 200                     |
| Depreciation and amortization                                                                                     | 499                        | 478                     |
| Operating profit                                                                                                  | 811                        | 723                     |
| Interest expense                                                                                                  | 138                        | 132                     |
| Earnings before income tax expense                                                                                | 673                        | 591                     |
| Income tax expense                                                                                                | 252                        | 216                     |
| Net earnings including noncontrolling interests                                                                   | 421                        | 375                     |
| Net earnings (loss) attributable to noncontrolling interests                                                      | (11)                       | 1                       |
| Net earnings attributable to The Kroger Co.                                                                       | \$ 432                     | \$ 374                  |
| Net earnings attributable to The Kroger Co. per basic common share                                                | \$ 0.71                    | \$ 0.58                 |
| Average number of common shares used in basic calculation                                                         | 608                        | 641                     |
| Net earnings attributable to The Kroger Co. per diluted common share                                              | \$ 0.70                    | \$ 0.58                 |
| Average number of common shares used in diluted calculation                                                       | 612                        | 645                     |
| Dividends declared per common share                                                                               | \$ 0.105                   | \$ 0.095                |

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

## THE KROGER CO.

## CONSOLIDATED BALANCE SHEETS

(in millions, except per share amounts)

(unaudited)

|                                                                                                        | May 21,<br>2011 | January 29,<br>2011 |
|--------------------------------------------------------------------------------------------------------|-----------------|---------------------|
| <b>ASSETS</b>                                                                                          |                 |                     |
| Current assets                                                                                         |                 |                     |
| Cash and temporary cash investments                                                                    | \$ 431          | \$ 825              |
| Deposits in-transit                                                                                    | 716             | 666                 |
| Receivables                                                                                            | 854             | 845                 |
| FIFO inventory                                                                                         | 5,708           | 5,793               |
| LIFO reserve                                                                                           | (873)           | (827)               |
| Prepaid and other current assets                                                                       | 367             | 319                 |
| Total current assets                                                                                   | 7,203           | 7,621               |
| Property, plant and equipment, net                                                                     | 14,192          | 14,147              |
| Goodwill                                                                                               | 1,140           | 1,140               |
| Other assets                                                                                           | 576             | 597                 |
| Total Assets                                                                                           | \$ 23,111       | \$ 23,505           |
| <b>LIABILITIES</b>                                                                                     |                 |                     |
| Current liabilities                                                                                    |                 |                     |
| Current portion of long-term debt including obligations under capital leases and financing obligations | \$ 587          | \$ 588              |
| Trade accounts payable                                                                                 | 4,226           | 4,227               |
| Accrued salaries and wages                                                                             | 889             | 888                 |
| Deferred income taxes                                                                                  | 220             | 220                 |
| Other current liabilities                                                                              | 2,398           | 2,147               |
| Total current liabilities                                                                              | 8,320           | 8,070               |
| Long-term debt including obligations under capital leases and financing obligations                    |                 |                     |
| Face-value of long-term debt including obligations under capital leases and financing obligations      | 6,745           | 7,247               |
| Adjustment to reflect fair-value interest rate hedges                                                  | 48              | 57                  |
| Long-term debt including obligations under capital leases and financing obligations                    | 6,793           | 7,304               |
| Deferred income taxes                                                                                  | 695             | 750                 |
| Pension and postretirement benefit obligations                                                         | 973             | 946                 |
| Other long-term liabilities                                                                            | 1,126           | 1,137               |
| Total Liabilities                                                                                      | 17,907          | 18,207              |
| Commitments and contingencies (see Note 7)                                                             |                 |                     |
| <b>SHAREOWNERS' EQUITY</b>                                                                             |                 |                     |
| Preferred stock, \$100 par per share, 5 shares authorized and unissued                                 | —               | —                   |
| Common stock, \$1 par per share, 1,000 shares authorized; 959 shares issued in 2011 and 2010           | 959             | 959                 |
| Additional paid-in capital                                                                             | 3,414           | 3,394               |
| Accumulated other comprehensive loss                                                                   | (536)           | (550)               |

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|                                                                              |           |           |
|------------------------------------------------------------------------------|-----------|-----------|
| Accumulated earnings                                                         | 8,592     | 8,225     |
| Common stock in treasury, at cost, 359 shares in 2011 and 339 shares in 2010 | (7,216)   | (6,732)   |
| Total Shareowners' Equity - The Kroger Co.                                   | 5,213     | 5,296     |
| Noncontrolling interests                                                     | (9)       | 2         |
| Total Equity                                                                 | 5,204     | 5,298     |
| Total Liabilities and Equity                                                 | \$ 23,111 | \$ 23,505 |

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

## THE KROGER CO.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions and unaudited)

|                                                                                                                        | Quarter Ended   |                 |
|------------------------------------------------------------------------------------------------------------------------|-----------------|-----------------|
|                                                                                                                        | May 21,<br>2011 | May 22,<br>2010 |
| Cash Flows from Operating Activities:                                                                                  |                 |                 |
| Net earnings including noncontrolling interests                                                                        | \$ 421          | \$ 375          |
| Adjustments to reconcile net earnings including noncontrolling interests to net cash provided by operating activities: |                 |                 |
| Depreciation and amortization                                                                                          | 499             | 478             |
| LIFO charge                                                                                                            | 46              | 15              |
| Stock-based employee compensation                                                                                      | 24              | 26              |
| Expense for Company-sponsored pension plans                                                                            | 23              | 22              |
| Deferred income taxes                                                                                                  | (57)            | (8)             |
| Other                                                                                                                  | 40              | 10              |
| Changes in operating assets and liabilities net of effects from acquisitions of businesses:                            |                 |                 |
| Store deposits in-transit                                                                                              | (50)            | (20)            |
| Receivables                                                                                                            | (3)             | 12              |
| Inventories                                                                                                            | 86              | 148             |
| Prepaid expenses                                                                                                       | (48)            | 255             |
| Trade accounts payable                                                                                                 | 68              | 156             |
| Accrued expenses                                                                                                       | 31              | (55)            |
| Income taxes receivable and payable                                                                                    | 152             | 165             |
| Contribution to Company-sponsored pension plans                                                                        | —               | (27)            |
| Other                                                                                                                  | 3               | 1               |
| Net cash provided by operating activities                                                                              | 1,235           | 1,553           |
| Cash Flows from Investing Activities:                                                                                  |                 |                 |
| Payments for capital expenditures                                                                                      | (521)           | (542)           |
| Proceeds from sale of assets                                                                                           | 3               | 8               |
| Payments for acquisitions                                                                                              | —               | (7)             |
| Other                                                                                                                  | 9               | (3)             |
| Net cash used by investing activities                                                                                  | (509)           | (544)           |
| Cash Flows from Financing Activities:                                                                                  |                 |                 |
| Proceeds from issuance of long-term debt                                                                               | 3               | 3               |
| Dividends paid                                                                                                         | (65)            | (61)            |
| Payments on long-term debt                                                                                             | (507)           | (544)           |
| Excess tax benefits on stock-based awards                                                                              | 2               | 1               |
| Proceeds from issuance of capital stock                                                                                | 60              | 12              |
| Treasury stock purchases                                                                                               | (544)           | (80)            |
| Decrease in book overdrafts                                                                                            | (70)            | (83)            |
| Investment in the remaining interest of a variable interest entity                                                     | —               | (86)            |
| Other                                                                                                                  | 1               | 7               |
| Net cash used by financing activities                                                                                  | (1,120)         | (831)           |
| Net increase (decrease) in cash and temporary cash investments                                                         | (394)           | 178             |
| Cash and temporary cash investments:                                                                                   |                 |                 |

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|                                               |    |       |    |       |
|-----------------------------------------------|----|-------|----|-------|
| Beginning of year                             |    | 825   |    | 424   |
| End of quarter                                | \$ | 431   | \$ | 602   |
| Reconciliation of capital expenditures:       |    |       |    |       |
| Payments for property and equipment           | \$ | (521) | \$ | (542) |
| Changes in construction-in-progress payables  |    | (59)  |    | (1)   |
| Total capital expenditures                    | \$ | (580) | \$ | (543) |
| Disclosure of cash flow information:          |    |       |    |       |
| Cash paid during the quarter for interest     | \$ | 134   | \$ | 149   |
| Cash paid during the quarter for income taxes | \$ | 149   | \$ | 54    |

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

## THE KROGER CO.

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREOWNERS EQUITY

(in millions, except per share amounts)

(unaudited)

|                                                                    | Common Stock |        | Additional Paid-In Capital |        | Treasury Stock |            | Accumulated Other Comprehensive Gain (Loss) | Accumulated Earnings | Noncontrolling Interest | Total    |
|--------------------------------------------------------------------|--------------|--------|----------------------------|--------|----------------|------------|---------------------------------------------|----------------------|-------------------------|----------|
|                                                                    | Shares       | Amount | Shares                     | Amount | Shares         | Amount     |                                             |                      |                         |          |
| Balances at January 30, 2010                                       | 958          | \$ 958 | \$ 3,361                   |        | 316            | \$ (6,238) | \$ (593)                                    | \$ 7,364             | \$ 74                   | \$ 4,926 |
| Issuance of common stock:                                          |              |        |                            |        |                |            |                                             |                      |                         |          |
| Stock options exercised                                            | 1            | 1      | 10                         |        |                | 2          |                                             |                      |                         | 13       |
| Restricted stock issued                                            |              |        | (3)                        |        |                | 2          |                                             |                      |                         | (1)      |
| Treasury stock activity:                                           |              |        |                            |        |                |            |                                             |                      |                         |          |
| Treasury stock purchases, at cost                                  |              |        |                            |        | 2              | (59)       |                                             |                      |                         | (59)     |
| Stock options exchanged                                            |              |        |                            |        | 1              | (21)       |                                             |                      |                         | (21)     |
| Tax detriments from exercise of stock options                      |              |        | (8)                        |        |                |            |                                             |                      |                         | (8)      |
| Share-based employee compensation                                  |              |        | 26                         |        |                |            |                                             |                      |                         | 26       |
| Other comprehensive gain net of income tax of \$6                  |              |        |                            |        |                |            | 16                                          |                      |                         | 16       |
| Other                                                              |              |        |                            |        |                |            |                                             | (1)                  | (10)                    | (11)     |
| Investment in the remaining interest of a variable interest entity |              |        | (22)                       |        |                |            |                                             |                      | (67)                    | (89)     |
| Cash dividends declared (\$0.095 per common share)                 |              |        |                            |        |                |            |                                             | (61)                 |                         | (61)     |
| Net earnings including noncontrolling interests                    |              |        |                            |        |                |            |                                             | 374                  | 1                       | 375      |
| Balances at May 22, 2010                                           | 959          | \$ 959 | \$ 3,364                   |        | 319            | \$ (6,314) | \$ (577)                                    | \$ 7,676             | \$ (2)                  | \$ 5,106 |
| Balances at January 29, 2011                                       | 959          | \$ 959 | \$ 3,394                   |        | 339            | \$ (6,732) | \$ (550)                                    | \$ 8,225             | \$ 2                    | \$ 5,298 |
| Issuance of common stock:                                          |              |        |                            |        |                |            |                                             |                      |                         |          |
| Stock options exercised                                            |              |        |                            |        | (3)            | 60         |                                             |                      |                         | 60       |
| Restricted stock issued                                            |              |        | (6)                        |        |                | 4          |                                             |                      |                         | (2)      |
| Treasury stock activity:                                           |              |        |                            |        |                |            |                                             |                      |                         |          |
| Treasury stock purchases, at cost                                  |              |        |                            |        | 21             | (504)      |                                             |                      |                         | (504)    |
| Stock options exchanged                                            |              |        |                            |        | 2              | (40)       |                                             |                      |                         | (40)     |
| Share-based employee compensation                                  |              |        | 24                         |        |                |            |                                             |                      |                         | 24       |
| Other comprehensive gain net of income tax of \$8                  |              |        |                            |        |                |            | 14                                          |                      |                         | 14       |
| Other                                                              |              |        | 2                          |        |                | (4)        |                                             |                      |                         | (2)      |
| Cash dividends declared (\$0.105 per common share)                 |              |        |                            |        |                |            |                                             | (65)                 |                         | (65)     |
| Net earnings including noncontrolling interests                    |              |        |                            |        |                |            |                                             | 432                  | (11)                    | 421      |
| Balances at May 21, 2011                                           | 959          | \$ 959 | \$ 3,414                   |        | 359            | \$ (7,216) | \$ (536)                                    | \$ 8,592             | \$ (9)                  | \$ 5,204 |

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

**1. ACCOUNTING POLICIES**

*Basis of Presentation and Principles of Consolidation*

The accompanying financial statements include the consolidated accounts of The Kroger Co., its wholly-owned subsidiaries, and the Variable Interest Entities ( "VIE" ) in which the Company is the primary beneficiary. The January 29, 2011 balance sheet was derived from audited financial statements and, due to its summary nature, does not include all disclosures required by generally accepted accounting principles ( "GAAP" ). Significant intercompany transactions and balances have been eliminated. References to the "Company" in these Consolidated Financial Statements mean the consolidated company.

In the opinion of management, the accompanying unaudited Consolidated Financial Statements include all normal, recurring adjustments that are necessary for a fair presentation of results of operations for such periods but should not be considered as indicative of results for a full year. The financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission ( "SEC" ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted, pursuant to SEC regulations. Accordingly, the accompanying Consolidated Financial Statements should be read in conjunction with the financial statements in the Annual Report on Form 10-K of The Kroger Co. for the fiscal year ended January 29, 2011.

The unaudited information in the Consolidated Financial Statements for the first quarter ended May 21, 2011 and May 22, 2010, includes the results of operations of the Company for the 16-week periods then ended.

Amounts related to certain revenue transactions previously reported in sales and merchandise costs in the Consolidated Statements of Operations have been changed and are now reported within operating, general and administrative expense in the prior period. Amounts were not material to the prior period.

**2. DEBT OBLIGATIONS**

Long-term debt consists of:

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|                                                                          | May 21,<br>2011 | January 29,<br>2011 |
|--------------------------------------------------------------------------|-----------------|---------------------|
| 3.90% to 8.00% Senior Notes due through 2040                             | \$ 6,628        | \$ 7,106            |
| 5.00% to 9.50% Mortgages due in varying amounts through 2034             | 73              | 73                  |
| Other                                                                    | 239             | 255                 |
| Total debt, excluding capital leases and financing obligations           | 6,940           | 7,434               |
| Less current portion                                                     | (548)           | (549)               |
| Total long-term debt, excluding capital leases and financing obligations | \$ 6,392        | \$ 6,885            |

With the proceeds received from the Company's third quarter of 2009 issuance of \$500 of senior notes bearing an interest rate of 3.90% due in 2015, the Company repaid \$500 of senior notes bearing an interest rate of 8.05% that matured in the first quarter of 2010.

In the second quarter of 2010, the Company issued \$300 of senior notes bearing an interest rate of 5.40% due in 2040.

The Company repaid \$478 of senior notes bearing an interest rate of 6.80% that matured in the first quarter of 2011.

### 3. COMPREHENSIVE INCOME

Comprehensive income is as follows:

|                                                                                                | First Quarter Ended |                 |
|------------------------------------------------------------------------------------------------|---------------------|-----------------|
|                                                                                                | May 21,<br>2011     | May 22,<br>2010 |
| Net earnings including noncontrolling interests                                                | \$ 421              | \$ 375          |
| Unrealized gain on available for sale securities, net of income tax(1)                         | 2                   | 7               |
| Amortization of amounts included in net periodic pension expense, net of income tax(2)         | 12                  | 8               |
| Amortization of unrealized gains and losses on cash flow hedging activities, net of income tax |                     | 1               |
| Comprehensive income                                                                           | 435                 | 391             |
| Comprehensive income (loss) attributable to noncontrolling interests                           | (11)                | 1               |
| Comprehensive income attributable to The Kroger Co.                                            | \$ 446              | \$ 390          |

(1) Amount is net of tax of \$1 for the first quarter of 2011.

(2) Amount is net of tax of \$7 for the first quarter of 2011 and \$6 for the first quarter of 2010.

### 4. BENEFIT PLANS

The following table provides the components of net periodic benefit costs for the Company-sponsored pension plans and other post-retirement benefits for the first quarter of 2011 and 2010.

|                                          | Pension Benefits |       | First Quarter |      | Other Benefits |      |
|------------------------------------------|------------------|-------|---------------|------|----------------|------|
|                                          | 2011             | 2010  | 2011          | 2010 | 2011           | 2010 |
| Components of net periodic benefit cost: |                  |       |               |      |                |      |
| Service cost                             | \$ 14            | \$ 14 | \$ 4          | \$ 4 |                |      |
| Interest cost                            | 52               | 52    | 5             | 6    |                |      |
| Expected return on plan assets           | (63)             | (60)  |               |      |                |      |
| Amortization of:                         |                  |       |               |      |                |      |
| Prior service cost                       |                  |       |               |      | (1)            | (2)  |
| Actuarial loss (gain)                    | 20               | 16    |               |      |                | (1)  |
| Net periodic benefit cost                | \$ 23            | \$ 22 | \$ 8          | \$ 7 |                |      |

The Company contributed \$27 to Company-sponsored pension plans in the first quarter of 2010.

The Company contributed \$40 and \$37 to employee 401(k) retirement savings accounts in the first quarter of 2011 and 2010, respectively.

The Company also contributes to various multi-employer pension plans based on obligations arising from most of its collective bargaining agreements. These plans provide retirement benefits to participants based on their service to contributing employers. The Company recognizes expense in connection with these plans as contributions are funded.

**5. EARNINGS PER COMMON SHARE**

Net earnings attributable to The Kroger Co. per basic common share equal net earnings attributable to The Kroger Co. less income allocated to participating securities divided by the weighted average number of common shares outstanding. Net earnings attributable to The Kroger Co. per diluted common share equal net earnings attributable to The Kroger Co. less income allocated to participating securities divided by the weighted average number of common shares outstanding, after giving effect to dilutive stock options. The following table provides a reconciliation of net earnings attributable to The Kroger Co. and shares used in calculating net earnings attributable to The Kroger Co. per basic common share to those used in calculating net earnings attributable to The Kroger Co. per diluted common share:

|                                                                            | First Quarter Ended<br>May 21, 2011 |                         |                     | First Quarter Ended<br>May 22, 2010 |                         |                     |
|----------------------------------------------------------------------------|-------------------------------------|-------------------------|---------------------|-------------------------------------|-------------------------|---------------------|
|                                                                            | Earnings<br>(Numerator)             | Shares<br>(Denominator) | Per Share<br>Amount | Earnings<br>(Numerator)             | Shares<br>(Denominator) | Per Share<br>Amount |
| Net earnings attributable to<br>The Kroger Co. per basic<br>common share   | \$ 429                              | 608                     | \$ 0.71             | \$ 371                              | 641                     | \$ 0.58             |
| Dilutive effect of stock<br>options                                        |                                     | 4                       |                     |                                     | 4                       |                     |
| Net earnings attributable to<br>The Kroger Co. per diluted<br>common share | \$ 429                              | 612                     | \$ 0.70             | \$ 371                              | 645                     | \$ 0.58             |

The Company had undistributed and distributed earnings to participating securities, which for Kroger are unvested restricted shares, totaling \$3 in both the first quarters of 2011 and 2010.

The Company had options outstanding for approximately 13 and 19 shares during the first quarter of 2011 and 2010, respectively, that were excluded from the computations of earnings per diluted common share because their inclusion would have had an anti-dilutive effect on earnings per share.

**6. RECENTLY ADOPTED ACCOUNTING STANDARDS**

In January 2010, the Financial Accounting Standards Board ( FASB ) amended its standards related to fair value measurements and disclosures, which were effective for interim and annual fiscal periods beginning after December 15, 2009, except for disclosures about certain Level 3 activity that became effective for interim and annual periods beginning after December 15, 2010. The new standards require the Company to disclose transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers as well as activity in Level 3 fair value measurements. The new standards also require a more detailed level of disaggregation of the assets and liabilities being measured as well as increased disclosures regarding inputs and valuation techniques of the fair value measurements. The Company adopted the amended standards effective January 31, 2010, except for disclosures about certain Level 3 activity. The Company adopted the amended standards for disclosures about certain Level 3 activity effective January 30, 2011. See Note 8 to the Consolidated Financial Statements for the Company's fair value measurements and disclosures.



## 7. 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 most 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 all 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 (*Ralphs Grocery Company and Subsidiaries, formerly known as Ralphs Supermarkets, Inc. v. Commissioner of Internal Revenue, Docket No. 20364-06*) for a redetermination of deficiencies asserted 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 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 therefore does not qualify for a Section 338(h)(10) election. On January 27, 2011, the Tax Court issued its opinion upholding the Company's position that the acquisition of the stock qualified as a purchase, granting the Company's motion for partial summary judgment and denying the Tax Commissioner's motion. The Company anticipates that all remaining issues in the matter will be resolved and the Tax Court will enter its decision. The parties will then have 90 days to file an appeal. As of May 21, 2011, an adverse decision would have required a cash payment of up to approximately \$527, including interest. Any accounting implications of an adverse decision in this case would be charged through the statement of operations.

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 28, 2008, pursuant to a stipulation between the parties, the court entered a final judgment in favor of the defendants. The Attorney General appealed a trial court ruling to the Ninth Circuit Court of Appeals and the defendants appealed a separate ruling. On August 17, 2010, the Ninth Circuit Court of Appeals held that the Agreement violated Section 1 of the Sherman Act, and it remanded the matter to the District Court for entry of a judgment in favor of the plaintiff and for any further proceedings consistent with its opinion. On February 11, 2011, the Court determined to re-hear the appeal *en banc*. 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.

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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, results of operations, or cash flows.

The Company continually evaluates its exposure to loss contingencies arising from pending or threatened litigation and believes it has made provisions where it is reasonably possible to estimate and where an adverse outcome is probable. 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 effect on the Company's financial condition, results of operations, or cash flows.

*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.

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

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

The determination of the obligation and expense for the Company's defined benefit retirement pension plan and other post-retirement benefits is dependent on the Company's selection of assumptions used by actuaries in calculating those amounts. Those assumptions are described in the Company's 2010 Annual Report on Form 10-K and include, among other things, the discount rate, the expected long-term rate of return on plan assets, and the rates of increase in compensation and health care costs. Actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally affect the recognized expense and recorded obligation in such future periods. While the Company believes that the assumptions are appropriate, significant differences in actual experience or significant changes in assumptions may materially affect the pension and other post-retirement obligations and future expense.

The Company did not make any contributions to its Company-sponsored defined benefit pension plans in the first quarter of 2011. We do not expect to make any cash contributions to the Company-sponsored defined benefit pension plans in 2011. Contributions may be made if required under the Pension Protection Act to avoid any benefit restrictions. The Company expects that any contributions made during 2011 will reduce its minimum required contributions in future years. Among other things, investment performance of plan assets, the interest rates required to be used to calculate pension obligations and future changes in legislation will determine the amounts of any additional contributions. In addition, the Company expects its cash contributions and expense to the 401(k) Retirement Savings Account Plan from automatic and matching contributions to participants to increase slightly in 2011, compared to 2010.

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

Based on the most recent information available to it, the Company believes that the present value of actuarial accrued liabilities in most or all of these multi-employer plans exceeds the value of the assets held in trust to pay benefits. Because the Company is one of a number of employers contributing to these plans, it is difficult to ascertain what the Company's share of the underfunding would be, although we anticipate the Company's contributions to these plans will increase each year. The Company believes that levels of underfunding have not changed significantly since year end. As a result, the Company expects meaningful increases in expense as a result of increases in multi-employer pension plan contributions over the next five years, to reduce this underfunding. Moreover, if the Company were to exit certain markets or otherwise cease making contributions to these funds, the Company could trigger a substantial withdrawal liability. Any adjustment for withdrawal liability will be recorded when it is probable that a liability exists and can be reasonably determined.



**8. FAIR VALUE MEASUREMENTS AND DERIVATIVE FINANCIAL INSTRUMENTS**

The Company has certain derivative and financial instruments recorded at fair value, which primarily relate to fair value hedges on fixed to floating interest rate swaps on certain debt and available for sale securities. These instruments have not materially changed in fair value since disclosure in the Annual Report on Form 10-K of The Kroger Co. for the fiscal year ended January 29, 2011.

**Fair Value of Other Financial Instruments**

*Current and Long-term Debt*

The fair value of the Company's long-term debt, including current maturities, 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 on the net present value of the future cash flows using the forward interest rate yield curve in effect at May 21, 2011, and January 29, 2011. At May 21, 2011, the fair value of total debt was \$7,759 compared to a carrying value of \$6,940. At January 29, 2011, the fair value of total debt was \$8,191 compared to a carrying value of \$7,434.

*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. At May 21, 2011, and January 29, 2011, the carrying and fair value of long-term investments for which fair value is determinable was \$58 and \$69, respectively.

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

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

**OVERVIEW**

First quarter 2011 total sales were \$27.5 billion compared with \$24.7 billion for the same period of 2010. This increase was attributable to identical supermarket sales increases, higher average retail fuel prices and increased fuel gallon sales. The average price for a gallon of fuel sold at our fuel stations was 30.0% higher in the first quarter of 2011 compared to the first quarter of 2010. Identical supermarket sales without fuel increased 4.6% in the first quarter of 2011. Identical supermarket sales, excluding fuel, increased primarily due to product cost inflation, increased transaction count, an increase in the average sale per shopping trip and an increase in the number of households shopping with us. Our first quarter identical supermarket sales performance, excluding fuel, was broad-based across the country. Each one of our eighteen supermarket divisions had positive identical supermarket sales growth. This continues our trend of positive identical supermarket sales growth for 30 consecutive quarters. Our Customer 1st strategy continues to deliver solid results.

For the first quarter of 2011, net earnings totaled \$432 million, or \$0.70 per diluted share, compared to \$374 million, or \$0.58 per diluted share for the same period of 2010. The results for the first quarter of 2011, compared to the first quarter of 2010, benefited from increased supermarket sales, productivity improvements, and effective cost controls, partially offset by increases in LIFO, credit card fees, health care, and pension costs. Net earnings from our fuel operations remained consistent with the first quarter of 2011, compared to the first quarter of 2010.

Based on the strength of our results for the first quarter of 2011, which is partially offset by the higher estimated LIFO charge for the year, we have increased both the lower and upper range of our guidance for both annual identical supermarket sales and net earnings per diluted share for fiscal year 2011. Please refer to the Outlook section for more information on our expectations. Our Customer 1st strategy is continuing to connect with customers. We have shown that our focus on people, products, prices and the shopping experience is meaningful to customers through both good and challenging times. As a result, we believe the ability to create and deliver shareholder value in a variety of operating environments is a key part of our value proposition for investors.

**RESULTS OF OPERATIONS**

*Net Earnings*

Net earnings totaled \$432 million for the first quarter of 2011, an increase of 15.5% from net earnings of \$374 million for the first quarter of 2010. The increase in our net earnings for the first quarter of 2011, compared to the first quarter of 2010, resulted primarily from an increase in non-fuel operating profit, partially offset by a higher effective tax rate. Net earnings from our fuel operations remained consistent with the first quarter of 2011, compared to the first quarter of 2010. The increase in non-fuel operating profit for the first quarter of 2011, compared to the first quarter of 2010, resulted primarily from the benefit of increased supermarket sales, productivity improvements and effective cost controls, partially offset by increases in our LIFO charge, credit card fees, health care and pension costs.

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Net earnings of \$0.70 per diluted share for the first quarter of 2011 represented an increase of 20.7% over net earnings of \$0.58 per diluted share for the first quarter of 2010. Net earnings per diluted share increased in the first quarter of 2011, compared to the first quarter of 2010, due to increased net earnings and the repurchase of 45 million shares of our common stock over the past four quarters.

## Sales

## Total Sales

(\$ in millions)

|                                      |           | First Quarter       |           |                     |  |
|--------------------------------------|-----------|---------------------|-----------|---------------------|--|
|                                      | 2011      | Percentage Increase | 2010      | Percentage Increase |  |
| Total supermarket sales without fuel | \$ 21,537 | 4.7%                | \$ 20,563 | 3.1%                |  |
| Total supermarket fuel sales         | 4,041     | 52.0%               | 2,659     | 63.9%               |  |
| Total supermarket sales              | 25,578    | 10.1%               | 23,222    | 7.7%                |  |
| Other sales(1)                       | 1,883     | 24.2%               | 1,516     | 27.6%               |  |
| Total sales                          | \$ 27,461 | 11.0%               | \$ 24,738 | 8.7%                |  |

- (1) Other sales primarily relate to sales by convenience stores, including fuel; jewelry stores; manufacturing plants to outside customers; variable interest entities; and in-store health clinics.

The increase in total sales and total supermarket sales for the first quarter of 2011, compared to the first quarter of 2010, was primarily the result of our identical supermarket sales increase, excluding fuel, of 4.6% and an increase in supermarket fuel sales of 52.0%. Total supermarket fuel sales increased over the same period in 2010 due to a 30.0% increase in average retail fuel prices and a 16.9% increase in fuel gallons sold. The increase in the average supermarket retail fuel price was caused by an increase in the product cost of fuel. Identical supermarket sales, excluding fuel, increased primarily due to product cost inflation, increased transaction count, an increase in the average sale per shopping trip and an increase in the number of households shopping with us.

We define a supermarket as identical when it has been in operation without expansion or relocation for five full quarters. Fuel center discounts received at our fuel centers and earned based on in-store purchases are included in all of the supermarket identical sales results calculations illustrated below. Differences between total supermarket sales and identical supermarket sales primarily relate to changes in supermarket square footage. Identical supermarket sales include all sales at identical Fred Meyer multi-department stores. Our identical supermarket sales results are summarized in the table below. We used the identical supermarket dollar figures presented to calculate first quarter 2011 percent changes.

## Identical Supermarket Sales

(\$ in millions)

|                        | First Quarter |           |  |  |
|------------------------|---------------|-----------|--|--|
|                        | 2011          | 2010      |  |  |
| Including fuel centers | \$ 24,684     | \$ 22,472 |  |  |
| Excluding fuel centers | \$ 20,788     | \$ 19,873 |  |  |
| Including fuel centers | 9.8%          | 6.8%      |  |  |
| Excluding fuel centers | 4.6%          | 2.4%      |  |  |

*FIFO Gross Margin*

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

Our FIFO gross margin rate was 21.42% for the first quarter of 2011, as compared to 22.63% for the first quarter of 2010. Retail fuel sales lower our FIFO gross margin rate due to the very low FIFO gross margin on retail fuel sales as compared to non-fuel sales. Excluding the effect of retail fuel operations, our first quarter 2011 FIFO gross margin rate decreased 4 basis points, as a percentage of sales, compared to the first quarter of 2010. This decrease in the first quarter of 2011, compared to the first quarter of 2010, resulted primarily from continued investments in lower prices for our customers and higher diesel fuel costs related to our logistics operations, offset partially by favorable shrink results.

*LIFO Charge*

The LIFO charge was \$46 million in the first quarter of 2011 and \$15 million in the first quarter of 2010. The LIFO charge increased in the first quarter of 2011, compared to the first quarter of 2010, primarily due to our expected increase in annualized product cost inflation in most major categories for 2011 compared to 2010.

*Operating, General and Administrative Expenses*

Operating, general and administrative ( OG&A ) expenses consist primarily of employee-related costs such as wages, health care benefit costs and retirement plan costs, utilities, and credit card fees. Rent expense, depreciation and amortization expense, and interest expense are not included in OG&A.

OG&A expenses, as a percentage of sales, decreased 115 basis points to 15.76% for the first quarter of 2011 from 16.91% for the first quarter of 2010, primarily due to the benefit of increased supermarket sales and higher average retail fuel prices. Retail fuel sales lower our OG&A rate due to the very low OG&A rate, as a percentage of sales, of retail fuel sales compared to non-fuel sales. OG&A expenses, as a percentage of sales excluding fuel, decreased 36 basis points in the first quarter of 2011, compared to the first quarter of 2010. This decrease in our OG&A rate, as a percentage of sales excluding the effect of fuel, resulted primarily from the benefit of increased supermarket sales, productivity improvements and effective cost controls, offset partially by increased credit card fees and health care and pension costs.

*Rent Expense*

Rent expense was \$200 million in both the first quarters of 2011 and 2010. Rent expense, as a percentage of sales, was 0.73% in the first quarter of 2011, compared to 0.81% in the first quarter of 2010. Rent expense, as a percentage of sales excluding fuel, decreased five basis points in the first quarter of 2011 compared to the first quarter of 2010. The decrease in rent expense, as a percentage of sales excluding fuel, reflects our continued emphasis on owning rather than leasing, whenever possible, and the benefit of increased supermarket sales.

*Depreciation Expense*

Depreciation expense was \$499 million, or 1.82% of total sales, for the first quarter of 2011 compared to \$478 million, or 1.93% of total sales, for the first quarter of 2010. The increase in depreciation expense, in total dollars, was the result of additional depreciation on capital expenditures, including acquisitions and lease buyouts, of \$1.9 billion during the last rolling four quarter period ending with the first quarter of 2011. The decrease in our depreciation and amortization expense for the first quarter of 2011, compared to the first quarter of 2010, as a percentage of sales, is primarily due to the benefit of increased supermarket sales and higher average retail fuel prices. Excluding the effect of retail fuel operations, depreciation, as a percentage of sales, decreased two basis points in the first quarter of 2011, compared to the same period of 2010.

*Interest Expense*

Net interest expense was \$138 million, or 0.50% of total sales, for the first quarter of 2011 compared to \$132 million, or 0.53% of total sales, for the first quarter of 2010. The increase in net interest expense for the first quarter of 2011, compared to the first quarter of 2010, resulted primarily from a higher weighted average debt balance and a decrease in the benefit from interest rate swaps.

*Income Taxes*

Our effective income tax rate was 37.4% for the first quarter of 2011 and 36.5% for the first quarter of 2010. The 2011 and 2010 effective income tax rates differed from the federal statutory rate primarily due to the effect of state income taxes.

## LIQUIDITY AND CAPITAL RESOURCES

### *Cash Flow Information*

#### Net cash provided by operating activities

We generated \$1.2 billion of cash from operating activities during the first quarter of 2011, compared to \$1.6 billion in the first quarter of 2010. The cash provided by operating activities came from net earnings including noncontrolling interests, adjusted for non-cash expenses, and changes in working capital. Changes in working capital provided cash from operating activities of \$239 million in the first quarter of 2011 and \$662 million in the first quarter of 2010. This decrease in the change in working capital was primarily due to an increase in prepaid expenses in the first quarter of 2011, compared to a decrease in the first quarter of 2010. This increase in prepaid expenses was primarily due to a decision not to pre-fund our voluntary employee benefit account at the end of fiscal year 2010 compared to a \$300 million pre-funding at the end of fiscal year 2009.

The amount of cash paid for income taxes increased in the first quarter of 2011, compared to the first quarter of 2010, primarily due to an overpayment of 2009 taxes applied to 2010.

#### Net cash used by investing activities

We used \$509 million of cash for investing activities during the first quarter of 2011 compared to \$544 million during the first quarter of 2010. The amount of cash used for investing activities decreased in the first quarter of 2011 versus 2010, primarily due to decreased cash payments for capital expenditures.

#### Net cash used by financing activities

We used \$1.1 billion of cash for financing activities in the first quarter of 2011 compared to \$831 million in the first quarter of 2010. The increase in the amount of cash used for financing activities for the first quarter of 2011, compared to the first quarter of 2010, was primarily related to the increase in treasury stock purchases, offset partially by decreased payments on long-term debt and our investment in the remaining interest of a variable interest entity in the first quarter of 2010. Proceeds from the issuance of common stock resulted from exercises of employee stock options.

### *Debt Management*

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As of May 21, 2011, we maintained a \$2 billion, unsecured revolving credit facility that, unless extended, terminates on May 15, 2014. Outstanding borrowings under the credit agreement and commercial paper borrowings, and some outstanding letters of credit, reduce funds available under the credit agreement. In addition to the credit agreement, we maintained three uncommitted money market lines totaling \$100 million in the aggregate. The money market lines allow us to borrow from banks at mutually agreed upon rates, usually at rates below the rates offered under the credit agreement. As of May 21, 2011, we had no borrowings under our credit agreement, money market lines or outstanding commercial paper. The outstanding letters of credit that reduce funds available under our credit agreement totaled \$66 million as of May 21, 2011.

Our bank credit facility and the indentures underlying our publicly issued debt contain various restrictive covenants. As of May 21, 2011, we were in compliance with these financial covenants. Furthermore, management believes it is not reasonably likely that Kroger will fail to comply with these financial covenants in the foreseeable future.

Total debt, including both the current and long-term portions of capital leases and lease-financing obligations, decreased \$145 million to \$7.4 billion as of the end of the first quarter of 2011, from \$7.5 billion as of the end of the first quarter of 2010. Total debt decreased \$511 million as of the end of the first quarter of 2011, from \$7.9 billion as of year-end 2010. The decrease as of the end of the first quarter of 2011, compared to the end of the first quarter of 2010, resulted from the payment at maturity in the first quarter of 2011 of \$478 million of senior notes bearing an interest rate of 6.80%, partially offset by the issuance in the second quarter of 2010 of \$300 million of senior notes bearing an interest rate of 5.40%. As of May 21, 2011, our cash and temporary cash investments were \$431 million compared to \$825 million as of January 29, 2011. This decrease was primarily due to the increased share repurchase activity noted below.

### *Common Stock Repurchase Program*

During the first quarter of 2011, we invested \$544 million to repurchase 23.1 million shares of Kroger stock at an average price of \$23.55 per share. These shares were reacquired under three separate stock repurchase programs. The first was a \$500 million repurchase program that was authorized by Kroger's Board of Directors on June 24, 2010. The second is a \$1 billion repurchase program, replacing the first program, that was authorized by Kroger's Board of Directors on March 3, 2011. The third is a program that uses the cash proceeds from the exercises of stock options by participants in Kroger's stock option and long-term incentive plans as well as the associated tax benefits.

### *Liquidity Needs*

We estimate our liquidity needs over the next twelve month period to be approximately \$2.4 billion, which includes anticipated requirements for working capital, capital expenditures, interest payments, and scheduled principal payments of debt, offset by cash and temporary cash investments on hand at the end of the first quarter of 2011. Based on current operating trends, we believe that cash flows from operating activities and other sources of liquidity, including borrowings under our commercial paper program and bank credit facility, will be adequate to meet our liquidity needs for the next twelve months and for the foreseeable future beyond the next twelve months. In addition to the sources of liquidity noted above, we also expect to be able to fund future scheduled principal payments of long-term debt from our cash flows from operating activities and, if necessary, by issuing additional debt. We believe we have adequate coverage of our debt covenants to continue to maintain our current debt ratings and to respond effectively to competitive conditions.

## **CAPITAL EXPENDITURES**

Capital expenditures, excluding acquisitions and the purchase of leased facilities, totaled \$573 million for the first quarter of 2011, compared to \$532 million for the first quarter of 2010. During the first quarter of 2011, we opened, acquired, expanded, or relocated ten food stores and also completed 38 within-the-wall remodels. Total food store square footage decreased 0.1% from the first quarter of 2010. Excluding acquisitions and operational closings, total food store square footage increased 1.0% in the first quarter of 2011, as compared to the first quarter of 2010. Capital expenditures for the purchase of leased facilities totaled \$7 million in the first quarter of 2011, compared to \$10 million in the first quarter of 2010.

## **CRITICAL ACCOUNTING POLICIES**

We have chosen accounting policies that we believe are appropriate to report accurately and fairly our operating results and financial position, and we apply those accounting policies in a consistent manner. Except as noted below, our critical accounting policies are summarized in our 2010 Annual Report on Form 10-K for the fiscal year ended January 29, 2011.

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

**RECENTLY ADOPTED ACCOUNTING STANDARDS**

In January 2010, the Financial Accounting Standards Board ( FASB ) amended its standards related to fair value measurements and disclosures, which were effective for interim and annual fiscal periods beginning after December 15, 2009, except for disclosures about certain Level 3 activity that became effective for interim and annual periods beginning after December 15, 2010. The new standards require us to disclose transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers as well as activity in Level 3 fair value measurements. The new standards also require a more detailed level of disaggregation of the assets and liabilities being measured as well as increased disclosures regarding inputs and valuation techniques of the fair value measurements. We adopted the amended standards effective January 31, 2010, except for disclosures about certain Level 3 activity. We adopted the amended standards for disclosures about certain Level 3 activity effective January 30, 2011. See Note 8 to the Consolidated Financial Statements for our fair value measurements and disclosures.

## OUTLOOK

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

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

- We expect net earnings per diluted share in the range of \$1.85-\$1.95 for 2011. Based on the current operating environment, we expect to achieve results near the top end of this range. This range reflects the strength of our first quarter results and the higher estimated LIFO charge of \$150 million. We expect the second and third quarter earnings per diluted share growth rates to be near the low end of our full-year earnings per share growth expectations due to tax benefits recognized in 2010.
- We expect identical supermarket sales growth, excluding fuel sales, of 3.5%-4.5% in 2011.
- For 2011, we will continue to focus on improving sales growth, in accordance with our Customer 1st strategy, by making investments in gross margin and customer shopping experiences. We expect to finance these investments primarily with operating cost reductions. We would expect a slight increase in non-fuel operating margin for 2011, compared to 2010 excluding the non-cash goodwill impairment charge, assuming net earnings per diluted share is near the top end of our range for 2011.
- For 2011, we expect fuel margins, which can be highly volatile, to be approximately \$0.115 per gallon, and we expect continued strong growth in total fuel gallons sold.
- For 2011, we expect our annualized LIFO charge to be approximately \$150 million. This forecast is based on estimated product cost inflation for products in our inventory of 3.0%-4.0%.
- For 2011, we expect interest expense to be approximately \$445 million.
- We plan to use cash flow primarily for capital investments, to maintain our current debt coverage ratios, to pay cash dividends, and to repurchase stock. As market conditions change, we may re-evaluate these uses of cash flow.
- We expect to obtain sales growth from new square footage, as well as from increased productivity from existing locations.
- Capital expenditures reflect our strategy of growth through expansion, as well as focusing on productivity increases from our existing store base through remodels. In addition, we will continue our emphasis on self-development and ownership of real estate, logistics and technology improvements. The continued capital spending in technology is focused on improving store operations, logistics, manufacturing procurement, category management, merchandising and buying practices, and should reduce merchandising costs. We intend to continue using cash flow from operations to finance capital expenditure requirements. We expect capital investments for 2011 to be in the range of \$1.7-\$1.9 billion, excluding acquisitions and purchases of leased facilities. We expect total food store square footage to grow approximately 1.0%-1.5% before acquisitions and operational closings.



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- Based on current operating trends, we believe that cash flow from operations and other sources of liquidity, including borrowings under our commercial paper program and bank credit facility, will be adequate to meet anticipated requirements for working capital, capital expenditures, interest payments and scheduled principal payments for the foreseeable future. We also believe we have adequate coverage of our debt covenants to continue to respond effectively to competitive conditions.
- We believe we have adequate sources of cash, if needed, under our credit facility and other borrowing sources.
- We expect that our OG&A results will be affected by increased costs, such as higher employee benefit costs and credit card fees, offset by improved productivity from process changes and leverage gained through sales increases.
- We expect that our effective tax rate for 2011 will be approximately 37.0%, excluding the resolution of any tax issues.
- We expect rent expense, as a percentage of total sales and excluding closed-store activity, will decrease due to the emphasis our current strategy places on ownership of real estate.
- We believe that in 2011 there will be opportunities to reduce our operating costs in such areas as administration, productivity improvements, and shrink. We intend to invest most of these savings in our core business to drive profitable sales growth and offer improved value and shopping experiences for our customers.
- We do not expect to make a cash contribution to the Company-sponsored defined benefit pension plans during 2011. If a contribution is made to the Company-sponsored defined benefit pension plans, we expect any elective contributions made during 2011 will decrease our required contributions in future years. Among other things, investment performance of plan assets, the interest rates required to be used to calculate the pension obligations, and future changes in legislation, will determine the amounts of any additional contributions. We expect 2011 expense for Company-sponsored defined benefit pension plans to be approximately \$80 million. In addition, we expect 401(k) Retirement Savings Account Plan cash contributions and expense from automatic and matching contributions to participants to increase slightly in 2011, compared to 2010.
- We expect to contribute approximately \$300 million to multi-employer pension plans in 2011, subject to collective bargaining. In addition, we expect meaningful increases in expense as a result of increases in multi-employer pension plan contributions over the next few years as we negotiate changes in contributions and benefits.
- We do not anticipate additional goodwill impairments in 2011.
- We have various labor agreements that will be negotiated in 2011, covering store employees in southern California, Memphis and West Virginia. We will also negotiate agreements with the Teamsters who represent some of our associates in distribution and manufacturing operations in the Midwest. Upon the expiration of our collective bargaining agreements, work stoppages by the affected workers could occur if we are unable to negotiate new contracts with labor unions. A prolonged work stoppage affecting a substantial number of locations could have a material adverse effect on our results. In all of these contracts, rising health care and pension costs will continue to be an important issue in negotiations.
- We expect our business model to produce annual earnings per diluted share growth on average of 6.0% to 8.0% over a rolling three to five year time horizon. Including our dividend, our business model is expected to generate total shareholder return on average of 8.0% to 10.0% over a rolling three to five year time period.

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

- The extent to which our sources of liquidity are sufficient to meet our requirements may be affected by the state of the financial markets and the effect that such condition has on our ability to issue commercial paper at acceptable rates. Our ability to borrow under our committed lines of credit, including our bank credit facilities, could be impaired if one or more of our lenders under those lines is unwilling or unable to honor its contractual obligation to lend to us.
- Changes in market conditions could affect our cash flow.



- Our ability to achieve sales and earnings goals may be affected by: labor negotiations or disputes; industry consolidation; pricing and promotional activities of existing and new competitors, including non-traditional competitors, and the aggressiveness of that competition; our response to these actions; the state of the economy, including interest rates, the inflationary and deflationary trends in certain commodities, and the unemployment rate; the effect that increased fuel costs have on consumer spending; changes in government-funded benefit programs; manufacturing commodity costs; diesel fuel costs related to our logistics operations; trends in consumer spending; the extent to which our customers exercise caution in their purchasing in response to economic conditions; the inconsistent pace of the economic recovery; changes in inflation or deflation in product and operating costs; stock repurchases; and the success of our future growth plans. Our ability to achieve sales and earnings goals may also be affected by our ability to manage the factors identified above.
- The extent to which the adjustments we are making to our strategy create value for our shareholders will depend primarily on the reaction of our customers and our competitors to these adjustments, as well as operating conditions, including inflation or deflation, increased competitive activity, and cautious spending behavior of our customers.
- Our product cost inflation could vary from our estimate due to general economic conditions, weather, availability of raw materials and ingredients in the products that we sell and their packaging, and other factors beyond our control.
- Our ability to pass on product cost increases will depend on the reactions of our customers and competitors to those increases.
- Our ability to use free cash flow to continue to maintain our debt coverage and to reward our shareholders could be affected by unanticipated increases in net total debt, our inability to generate free cash flow at the levels anticipated, and our failure to generate expected earnings.
- Our LIFO charge and the timing of our recognition of LIFO expense will be affected primarily by changes in product costs during the year.
- If actual results differ significantly from anticipated future results for certain reporting units including variable interest entities, an impairment loss for any excess of the carrying value of the reporting units' goodwill over the implied fair value would have to be recognized.
- In addition to the factors identified above, our identical store sales growth could be affected by increases in Kroger private label sales, the effect of our 'sister stores' (new stores opened in close proximity to an existing store) and reductions in retail pricing.
- Our operating margins, without fuel, could decline or fail to meet expectations if we are unable to pass on any cost increases, if we fail to deliver the cost savings contemplated or if changes in the cost of our inventory and the timing of those changes differ from our expectations.
- We could fail to realize our expected operating margin per gallon of fuel and fuel gallons sold based upon changes in the price of fuel, a change in our operating costs, or if a pattern of rapid changes in fuel costs occurs.
- We have estimated our exposure to the claims and litigation arising in the normal course of business, as well as to the material litigation facing Kroger, and believe we have made provisions where it is reasonably possible to estimate and where an adverse outcome is probable. Unexpected outcomes in these matters, however, could result in an adverse effect on our earnings.
- Consolidation in the food industry is likely to continue and the effects on our business, either favorable or unfavorable, cannot be foreseen.
- Rent expense, which includes subtenant rental income, could be adversely affected by the state of the economy, increased store closure activity and future consolidation.

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- Depreciation expense, which includes the amortization of assets recorded under capital leases, is computed principally using the straight-line method over the estimated useful lives of individual assets, or the remaining terms of leases. Use of the straight-line method of depreciation creates a risk that future asset write-offs or potential impairment charges related to store closings would be larger than if an accelerated method of depreciation were followed.
- Our effective tax rate may differ from the expected rate due to changes in laws, the status of pending items with various taxing authorities, and the deductibility of certain expenses.
- The actual amount of automatic and matching cash contributions to our 401(k) Retirement Savings Account Plan will depend on the number of participants, savings rate, plan compensation, and length of service of participants.
- Our contributions and recorded expense related to multi-employer pension funds could increase more than anticipated. Should asset values in these funds deteriorate, if employers withdraw from these funds without providing for their share of the liability, or should our estimates prove to be understated, our contributions could increase more rapidly than we have anticipated.
- If volatility in the financial markets continues or worsens, our contributions to Company-sponsored defined benefit pension plans could increase more than anticipated in future years.
- Changes in laws or regulations, including changes in accounting standards, taxation requirements and environmental laws may have a material effect on our financial statements.
- Changes in the general business and economic conditions in our operating regions may affect the shopping habits of our customers, which could affect sales and earnings.
- Changes in our product mix may negatively affect certain financial indicators. For example, we continue to add supermarket fuel centers to our store base. Since gasoline generates low profit margins, we expect to see our FIFO gross profit margins decline as gasoline sales increase. Although this negatively affects our FIFO gross margin, gasoline sales provide a positive effect on OG&A expense as a percentage of sales.
- Our capital expenditures, expected square footage growth, and number of store projects completed over the next fiscal year could differ from our estimate if we are unsuccessful in acquiring suitable sites for new stores, if development costs vary from those budgeted, if our logistics and technology or store projects are not completed on budget or within the time frame projected, or if economic conditions fail to improve, or worsen.
- Interest expense could be adversely affected by the interest rate environment, changes in our credit ratings, fluctuations in the amount of outstanding debt, decisions to incur prepayment penalties on the early redemption of debt and any factor that adversely affects our operations and results in an increase in debt.
- Impairment losses, including goodwill, could be affected by changes in our assumptions of future cash flows, market values or business valuations in the market. Our cash flow projections include several years of projected cash flows which would be affected by changes in the economic environment, real estate market values, competitive activity, inflation and customer behavior.
- Our estimated expense and obligation for Kroger-sponsored pension plans and other post-retirement benefits could be affected by changes in the assumptions used in calculating those amounts. These assumptions include, among others, the discount rate, the expected long-term rate of return on plan assets, average life expectancy and the rate of increases in compensation and health care costs.
- Adverse weather conditions could increase the cost our suppliers charge for their products, or may decrease customer demand for certain products. Increases in demand for certain commodities could also increase the cost our suppliers charge for their products. Additionally, increases in the cost of inputs, such as utility costs or raw material costs, could negatively affect financial ratios and earnings.
- Although we presently operate only in the United States, civil unrest in foreign countries in which our suppliers do business may affect the prices we are charged for imported goods. If we are unable to pass on these increases to our customers, our FIFO gross margin and net earnings would suffer.



- Earnings and sales also may be affected by adverse weather conditions, particularly to the extent that hurricanes, tornadoes, floods, earthquakes, and other conditions disrupt our operations or those of our suppliers; create shortages in the availability or increases in the cost of products that we sell in our stores or materials and ingredients we use in our manufacturing facilities; or raise the cost of supplying energy to our various operations, including the cost of transportation.

We cannot fully foresee the effects of changes in economic conditions on Kroger's business. We have assumed economic and competitive situations will not change significantly for 2011.

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

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

There have been no material changes in our exposure to market risk from the information provided in Item 7A. Quantitative and Qualitative Disclosures About Market Risk on our Form 10-K for the fiscal year ended January 29, 2011.

**Item 4. Controls and Procedures.**

The Chief Executive Officer and the Chief Financial Officer, together with a disclosure review committee appointed by the Chief Executive Officer, evaluated Kroger's disclosure controls and procedures as of the quarter ended May 21, 2011. Based on that evaluation, Kroger's Chief Executive Officer and Chief Financial Officer concluded that Kroger's disclosure controls and procedures were effective as of the end of the period covered by this report.

In connection with the evaluation described above, there was no change in Kroger's internal control over financial reporting during the quarter ended May 21, 2011, that has materially affected, or is reasonably likely to materially affect, Kroger's internal control over financial reporting.

**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings.**

Various claims and lawsuits arising in the normal course of business, including suits charging violations of certain antitrust, wage and hour, or civil rights laws, as well as product liability cases, 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, results of operations, or cash flows. For a further discussion of our legal proceedings, see Note 7 to our Consolidated Financial Statements.

The Company continually evaluates its exposure to loss contingencies arising from pending or threatened litigation and believes it has made provisions where it is reasonably possible to estimate and where an adverse outcome is probable. 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, results of operations, or cash flows.

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

(c)

**ISSUER PURCHASES OF EQUITY SECURITIES**

| <b>Period(1)</b>                      | <b>Total Number of Shares Purchased</b> | <b>Average Price Paid Per Share</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(2)</b> | <b>Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs(3) (in millions)</b> |
|---------------------------------------|-----------------------------------------|-------------------------------------|--------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|
| <b>First four weeks</b>               |                                         |                                     |                                                                                            |                                                                                                              |
| January 30, 2011 to February 26, 2011 | 3,543,845                               | \$ 22.06                            | 3,543,845                                                                                  | \$ 30                                                                                                        |
| <b>Second four weeks</b>              |                                         |                                     |                                                                                            |                                                                                                              |
| February 27, 2011 to March 26, 2011   | 13,593,470                              | \$ 23.67                            | 13,593,470                                                                                 | \$ 710                                                                                                       |
| <b>Third four weeks</b>               |                                         |                                     |                                                                                            |                                                                                                              |
| March 27, 2011 to April 23, 2011      | 3,704,015                               | \$ 23.98                            | 3,704,015                                                                                  | \$ 642                                                                                                       |
| <b>Fourth four weeks</b>              |                                         |                                     |                                                                                            |                                                                                                              |
| April 24, 2011 to May 21, 2011        | 2,367,668                               | \$ 24.42                            | 2,367,668                                                                                  | \$ 603                                                                                                       |
| <b>Total</b>                          | <b>23,208,998</b>                       | <b>\$ 23.55</b>                     | <b>23,208,998</b>                                                                          | <b>\$ 603</b>                                                                                                |

- (1) The reported periods conform to the Company's fiscal calendar composed of thirteen 28-day periods. The first quarter of 2011 contained four 28-day periods.
- (2) Shares were repurchased under (i) a \$1 billion stock repurchase program, authorized by the Board of Directors on March 3, 2011, (ii) a \$500 million stock repurchase program, authorized by the Board of Directors on June 24, 2010, and (iii) a program announced on December 6, 1999, to repurchase common stock to reduce dilution resulting from our employee stock option and long-term incentive plans, which program is limited to proceeds received from exercises of stock options and the tax benefits associated therewith. The programs have no expiration date but may be terminated by the Board of Directors at any time. During the first quarter of fiscal year 2011, the \$1 billion stock-repurchase program referred to in clause (i) replaced the \$500 million stock repurchase program referred to in clause (ii). Accordingly, the Company does not intend to make further purchases under the program referenced in clause (ii). Total shares purchased include shares that were surrendered to the Company by participants under the Company's long-term incentive plans to pay for taxes on restricted stock awards.
- (3) The amounts shown in this column in the first four-week period reflect amounts remaining under the \$500 million stock repurchase program referenced in clause (ii) of Note 2 above. The amounts shown in this column in the second, third and fourth four-week periods reflect amounts remaining under the \$1 billion stock repurchase program referenced in clause (i) of Note 2 above. Amounts to be invested under the program utilizing option exercise proceeds are dependent upon option exercise activity.

**Item 6. Exhibits.**

- EXHIBIT 3.1 - Amended Articles of Incorporation are hereby incorporated by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended May 22, 2010, filed with the SEC on June 28, 2010.
- EXHIBIT 3.2 - The Company's regulations are hereby incorporated by reference to Exhibit 3.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended May 26, 2007, filed with the SEC on July 3, 2007.
- EXHIBIT 4.1 - Instruments defining the rights of holders of long-term debt of the Company and its subsidiaries are not filed as Exhibits because the amount of debt under each instrument is less than 10% of the consolidated assets of the Company. The Company undertakes to file these instruments with the Commission upon request.
- EXHIBIT 31.1 - Rule 13a-14(a) / 15d-14(a) Certifications - Chief Executive Officer.
- EXHIBIT 31.2 - Rule 13a-14(a) / 15d-14(a) Certifications - Chief Financial Officer.
- EXHIBIT 32.1 - Section 1350 Certifications.
- EXHIBIT 99.1 - Additional Exhibits - Statement of Computation of Ratio of Earnings to Fixed Charges.
- EXHIBIT 101.INS - XBRL Instance Document.
- EXHIBIT 101.SCH - XBRL Taxonomy Extension Schema Document.
- EXHIBIT 101.CAL - XBRL Taxonomy Extension Calculation Linkbase Document.
- EXHIBIT 101.DEF - XBRL Taxonomy Extension Definition Linkbase Document.
- EXHIBIT 101.LAB - XBRL Taxonomy Extension Label Linkbase Document.
- EXHIBIT 101.PRE - XBRL Taxonomy Extension Presentation Linkbase Document.

**SIGNATURES**

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

**THE KROGER CO.**

Dated: June 23, 2011

By: /s/ David B. Dillon  
David B. Dillon  
Chairman of the Board and Chief Executive Officer

Dated: June 23, 2011

By: /s/ J. Michael Schlotman  
J. Michael Schlotman  
Senior Vice President and Chief Financial Officer

**Exhibit Index**

|                   |                                                                                                                                                                                                                                                                                                                            |
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