

KROGER CO  
Form 10-Q  
December 17, 2008

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended November 8, 2008

OR

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

For the transition period from      to

Commission file number 1-303

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**THE KROGER CO.**

(Exact name of registrant as specified in its charter)

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

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

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

(Address of principal executive offices)

(Zip Code)

**(513) 762-4000**

(Registrant's telephone number, including area code)

**Unchanged**

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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   | <input checked="" type="checkbox"/> | Accelerated filer         | <input type="checkbox"/> |
| Non-accelerated filer (do not check if a smaller reporting company) | <input type="checkbox"/>            | Smaller reporting company | <input type="checkbox"/> |

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 652,453,769 shares of Common Stock (\$1 par value) outstanding as of December 12, 2008.



## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements.

## THE KROGER CO.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share amounts)

(unaudited)

|   | Third Quarter Ended |                      | Three Quarters Ended |                      |
|---|---------------------|----------------------|----------------------|----------------------|
|   | November 8,<br>2008 | November 10,<br>2007 | November 8,<br>2008  | November 10,<br>2007 |
| Sales   | \$ 17,580           | \$ 16,135            | \$ 58,740            | \$ 53,000            |
| Merchandise costs, including advertising, warehousing, and transportation, excluding items shown separately below | 13,552              | 12,402               | 45,476               | 40,551               |
| Operating, general and administrative   | 3,062               | 2,823                | 9,868                | 9,259                |
| Rent  | 152                 | 150                  | 510                  | 488                  |
| Depreciation and amortization   | 335                 | 315                  | 1,094                | 1,030                |
| Operating profit  | 479                 | 445                  | 1,792                | 1,672                |
| Interest expense  | 106                 | 110                  | 370                  | 360                  |
| Earnings before income tax expense  | 373                 | 335                  | 1,422                | 1,312                |
| Income tax expense  | 136                 | 81                   | 522                  | 454                  |
| Net earnings  | \$ 237              | \$ 254               | \$ 900               | \$ 858               |
| Net earnings per basic common share   | \$ 0.37             | \$ 0.37              | \$ 1.38              | \$ 1.23              |
| Average number of common shares used in basic calculation   | 649                 | 678                  | 653                  | 696                  |
| Net earnings per diluted share  | \$ 0.36             | \$ 0.37              | \$ 1.36              | \$ 1.22              |
| Average number of common shares used in diluted calculation   | 656                 | 685                  | 660                  | 704                  |
| Dividends declared per common share   | \$ .09              | \$ .075              | \$ .27               | \$ .225              |

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

## THE KROGER CO.

## CONSOLIDATED BALANCE SHEETS

(in millions, except per share amounts)

(unaudited)

|   | November 8,<br>2008 | February 2,<br>2008 |
|---|---------------------|---------------------|
| <b>ASSETS</b>   |                     |                     |
| Current assets  |                     |                     |
| Cash and temporary cash investments   | \$ 280              | \$ 242              |
| Deposits in-transit   | 610                 | 676                 |
| Receivables   | 807                 | 786                 |
| FIFO inventory  | 6,127               | 5,459               |
| LIFO credit   | (759)               | (604)               |
| Prefunded employee benefits   | —                   | 300                 |
| Prepaid and other current assets  | 254                 | 255                 |
| Total current assets  | 7,319               | 7,114               |
| Property, plant and equipment, net  | 13,085              | 12,498              |
| Goodwill  | 2,246               | 2,144               |
| Other assets  | 531                 | 543                 |
| Total Assets  | \$ 23,181           | \$ 22,299           |
| <b>LIABILITIES</b>  |                     |                     |
| Current liabilities   |                     |                     |
| Current portion of long-term debt including obligations under capital leases and financing obligations            | \$ 1,141            | \$ 1,592            |
| Accounts payable  | 4,337               | 4,050               |
| Accrued salaries and wages  | 789                 | 815                 |
| Deferred income taxes   | 239                 | 239                 |
| Other current liabilities   | 2,110               | 1,993               |
| Total current liabilities   | 8,616               | 8,689               |
| Long-term debt including obligations under capital leases and financing obligations                               |                     |                     |
| Face-value long-term debt including obligations under capital leases and financing obligations                    | 6,853               | 6,485               |
| Adjustment to reflect fair-value interest rate hedges   | 41                  | 44                  |
| Long-term debt including obligations under capital leases and financing obligations                               | 6,894               | 6,529               |
| Deferred income taxes   | 517                 | 367                 |
| Other long-term liabilities   | 1,789               | 1,800               |
| Total Liabilities   | 17,816              | 17,385              |
| Minority interests  | 96                  | —                   |
| Commitments and contingencies (see Note 11)   |                     |                     |
| <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; 954 shares issued in 2008 and 947 shares issued in 2007 | 954                 | 947                 |
| Additional paid-in capital  | 3,257               | 3,031               |

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|  |           |           |
|--|-----------|-----------|
| Accumulated other comprehensive loss   | (115)     | (122)     |
| Accumulated earnings   | 7,203     | 6,480     |
| Common stock in treasury, at cost, 306 shares in 2008 and 284 shares in 2007 | (6,030)   | (5,422)   |
| Total Shareowners Equity   | 5,269     | 4,914     |
| Total Liabilities and Shareowners Equity                                     | \$ 23,181 | \$ 22,299 |

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

## THE KROGER CO.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions and unaudited)

|   | Three Quarters Ended |                      |
|---|----------------------|----------------------|
|   | November 8,<br>2008  | November 10,<br>2007 |
| <b>Cash Flows from Operating Activities:</b>  |                      |                      |
| Net earnings  | \$ 900               | \$ 858               |
| Adjustments to reconcile net earnings to net cash provided by operating activities:         |                      |                      |
| Depreciation and amortization   | 1,094                | 1,030                |
| LIFO charge   | 155                  | 100                  |
| Stock-based employee compensation   | 69                   | 68                   |
| Expense for Company-sponsored pension plans   | 35                   | 49                   |
| Deferred income taxes   | 147                  | (102)                |
| Other   | 28                   | 33                   |
| Changes in operating assets and liabilities net of effects from acquisitions of businesses: |                      |                      |
| Store deposits in-transit   | 66                   | 34                   |
| Receivables   | (20)                 | 34                   |
| Inventories   | (667)                | (659)                |
| Prepaid expenses  | 302                  | 322                  |
| Accounts payable  | 309                  | 349                  |
| Accrued expenses  | —                    | 88                   |
| Income tax payables and receivables   | (25)                 | 121                  |
| Contribution to Company-sponsored pension plans   | (20)                 | (52)                 |
| Other   | (16)                 | 4                    |
| <b>Net cash provided by operating activities</b>  | <b>2,357</b>         | <b>2,277</b>         |
| <b>Cash Flows from Investing Activities:</b>  |                      |                      |
| Payments for capital expenditures   | (1,613)              | (1,628)              |
| Proceeds from sale of assets  | 51                   | 46                   |
| Payments for acquisitions   | (80)                 | (86)                 |
| Other   | (10)                 | (46)                 |
| <b>Net cash used by investing activities</b>  | <b>(1,652)</b>       | <b>(1,714)</b>       |
| <b>Cash Flows from Financing Activities:</b>  |                      |                      |
| Proceeds from issuance of long-term debt  | 778                  | 625                  |
| Dividends paid  | (168)                | (151)                |
| Payments on long-term debt  | (1,017)              | (545)                |
| Borrowings on credit facility   | 133                  | 341                  |
| Excess tax benefits on stock-based awards   | 13                   | 34                   |
| Proceeds from issuance of capital stock   | 164                  | 181                  |
| Treasury stock purchases  | (626)                | (1,152)              |
| Increase (decrease) in book overdrafts  | (19)                 | 78                   |
| Other   | 10                   | 3                    |
| <b>Net cash used by financing activities</b>  | <b>(732)</b>         | <b>(586)</b>         |
| <b>Net decrease in cash and temporary cash investments</b>                                  | <b>(27)</b>          | <b>(23)</b>          |
| Cash from Consolidated Variable Interest Entity   | 65                   | —                    |

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Cash and temporary cash investments:

|                   |    |     |    |     |
|-------------------|----|-----|----|-----|
| Beginning of year |    | 242 |    | 189 |
| End of quarter    | \$ | 280 | \$ | 166 |

Reconciliation of capital expenditures:

|  |    |         |    |         |
|--|----|---------|----|---------|
| Payments for property and equipment          | \$ | (1,613) | \$ | (1,628) |
| Changes in construction-in-progress payables |    | (106)   |    | 36      |
| Total capital expenditures                   | \$ | (1,719) | \$ | (1,592) |

Disclosure of cash flow information:

|  |    |     |    |     |
|--|----|-----|----|-----|
| Cash paid during the year for interest     | \$ | 404 | \$ | 387 |
| Cash paid during the year for income taxes | \$ | 444 | \$ | 327 |

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 a Variable Interest Entity ( VIE ) in which the Company is the primary beneficiary. The February 2, 2008 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 2007 Annual Report on Form 10-K of The Kroger Co. filed with the SEC on April 1, 2008.

The unaudited information in the Consolidated Financial Statements for the third quarter and three quarters ended November 8, 2008 and November 10, 2007 includes the results of operations of the Company for the 12-week and 40-week periods then ended.

*Store Closing and Other Expense Allowances*

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

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needed for its originally intended purpose, is adjusted to income in the proper period.

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

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

|                                 | Future Lease Obligations |       |
|---------------------------------|--------------------------|-------|
|                                 | 2008                     | 2007  |
| Balance at beginning of year    | \$ 74                    | \$ 89 |
| Additions                       | 2                        | 5     |
| Payments                        | (10)                     | (12)  |
| Adjustments                     | 6                        | (8)   |
| Balance at end of third quarter | \$ 72                    | \$ 74 |

The Company recorded asset impairments in the normal course of business totaling \$5 in the third quarter of 2008 and \$4 in the third quarter of 2007. During the first three quarters of 2008 and 2007, the Company recorded asset impairments in the normal course of business totaling \$21 and \$15, respectively.

## 2. GOODWILL AND BUSINESS ACQUISITIONS

The following table summarizes the changes in the Company's goodwill balance through November 8, 2008.

|                             | <b>Goodwill</b> |       |
|-----------------------------|-----------------|-------|
| Balance at February 2, 2008 | \$              | 2,144 |
| Goodwill recorded           |                 | 102   |
| Balance at November 8, 2008 | \$              | 2,246 |

In the first quarter of 2008, the Company made an investment in The Little Clinic LLC (TLC). TLC operates walk-in medical clinics in seven states, primarily in the Midwest and Southeast. At the date of investment, TLC was determined to be a VIE under FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities* (FIN 46R), with the Company being the primary beneficiary. As a result, the Company consolidated TLC in accordance with FIN 46R. The minority interest was recorded at fair value on the acquisition date. The fair value of TLC was determined based on the amount of the investment made by the Company and the percentage acquired. The Company's assessment of goodwill represents the excess of this amount over the fair value of TLC's net assets as of the investment date.

The pro forma effect of this investment is not material to previously reported results.

## 3. STOCK OPTION PLANS

The Company recognized total stock-based compensation of \$21 and \$20 in the third quarter ended November 8, 2008 and November 10, 2007, respectively. The Company recorded \$69 and \$68 of stock-based compensation for the first three quarters ended November 8, 2008 and November 10, 2007, respectively. These costs were recognized as operating, general and administrative costs in the Company's Consolidated Statements of Operations.

The Company grants options for common stock (stock options) to employees, as well as to its non-employee directors, under various plans at an option price equal to the fair market value of the stock at the date of grant. In addition to stock options, the Company awards restricted stock to employees and its non-employee directors under various plans. Equity awards may be made once each quarter on a predetermined date. It has been the Company's practice to make a general annual grant, which occurred in the second quarter of 2008.

Stock options granted in the first three quarters of 2008 expire 10 years from the date of the grant and vest from one year to five years from the date of grant. Restricted stock awards granted in the first three quarters of 2008 have restrictions that lapse in one year to five years from the date of the awards. All awards become immediately exercisable upon certain changes of control of the Company.



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

*Stock Options*

|                               | Shares subject<br>to option |    | Weighted-average<br>exercise price |
|-------------------------------|-----------------------------|----|------------------------------------|
| Outstanding, February 2, 2008 | 44.8                        | \$ | 20.94                              |
| Granted                       | 3.4                         | \$ | 28.56                              |
| Exercised                     | (7.8)                       | \$ | 21.27                              |
| Canceled or Expired           | (0.2)                       | \$ | 22.81                              |
| Outstanding, November 8, 2008 | 40.2                        | \$ | 21.52                              |

*Restricted Stock*

|                               | Restricted shares<br>outstanding |    | Weighted-average<br>grant-date fair value |
|-------------------------------|----------------------------------|----|---|
| Outstanding, February 2, 2008 | 3.4                              | \$ | 25.89                                     |
| Granted                       | 2.4                              | \$ | 28.50                                     |
| Lapsed                        | (1.6)                            | \$ | 26.70                                     |
| Canceled or Expired           | (0.1)                            | \$ | 25.48                                     |
| Outstanding, November 8, 2008 | 4.1                              | \$ | 27.13                                     |

The weighted-average fair value of stock options granted during the first three quarters ended November 8, 2008 and November 10, 2007, was \$8.67 and \$9.91, respectively. The fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option-pricing model, based on the assumptions shown in the table below. The Black-Scholes model utilizes extensive accounting judgment and financial estimates, including the term employees are expected to retain their stock options before exercising them, the volatility of the Company's stock price over that expected term, the dividend yield over the term, and the number of awards expected to be forfeited before they vest. Using alternative assumptions in the calculation of fair value would produce fair values for stock option grants that could be different than those used to record stock-based compensation expense in the Consolidated Statements of Operations.

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

|                         | 2008      | 2007      |
|-------------------------|-----------|-----------|
| Risk-free interest rate | 3.64%     | 5.06%     |
| Expected dividend yield | 1.50%     | 1.40%     |
| Expected volatility     | 27.89%    | 29.21%    |
| Expected term           | 6.8 Years | 6.9 Years |

#### 4. DEBT OBLIGATIONS

Long-term debt consists of:

|   | November 8,<br>2008 | February 2,<br>2008 |
|---|---------------------|---------------------|
| Credit Facility, Commercial Paper and Money Market Borrowings                   | \$ 703              | \$ 570              |
| 4.95% to 9.20% Senior Notes due through 2038                                    | 6,588               | 6,766               |
| 5.00% to 9.95% mortgages due in varying amounts through 2034                    | 138                 | 166                 |
| Other   | 137                 | 137                 |
| <b>Total debt, excluding capital leases and financing obligations</b>           | <b>7,566</b>        | <b>7,639</b>        |
| Less current portion  | (1,112)             | (1,564)             |
| <b>Total long-term debt, excluding capital leases and financing obligations</b> | <b>\$ 6,454</b>     | <b>\$ 6,075</b>     |

During the first quarter of 2008, the Company issued \$400 of senior notes bearing an interest rate of 5.0% due in 2013 and \$375 of senior notes bearing an interest rate of 6.9% due in 2038.

#### 5. COMPREHENSIVE INCOME

Comprehensive income is as follows:

|  | Third Quarter Ended |                      | Year-To-Date        |                      |
|--|---------------------|----------------------|---------------------|----------------------|
|  | November 8,<br>2008 | November 10,<br>2007 | November 8,<br>2008 | November 10,<br>2007 |
| Net earnings   | \$ 237              | \$ 254               | \$ 900              | \$ 858               |
| Unrealized gain and (losses) on hedging activities, net of tax(1)                |                     | (13)                 | 3                   | (4)                  |
| Amortization of unrealized gains and losses on hedging activities, net of tax(2) |                     |                      | 1                   |                      |
| Amortization of amounts included in net periodic pension expense(3)              | 1                   | 3                    | 3                   | 15                   |
| Other  |                     | 1                    |                     | 2                    |
| <b>Comprehensive income</b>  | <b>\$ 238</b>       | <b>\$ 245</b>        | <b>\$ 907</b>       | <b>\$ 871</b>        |

(1) Amount is net of tax of \$(7) for the third quarter of 2007. Amount is net of tax of \$2 for the first three quarters of 2008 and \$(2) for the first three quarters of 2007.

(2) Amount is net of tax of \$1 for the first three quarters of 2008.

(3) Amount is net of tax of \$1 for the third quarter of 2007. Amount is net of tax of \$2 for the first three quarters of 2008 and \$9 for the first three quarters of 2007.

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During 2008 and 2007, unrealized gains and losses on hedging activities included in other comprehensive income consisted of reclassifications of unrealized gains and losses on cash flow hedges into net earnings. In 2007, other comprehensive income also consisted of market value adjustments to reflect cash flow hedges at fair value as of the respective balance sheet dates.

## 6. BENEFIT PLANS

The following table provides the components of net periodic benefit costs for the Company-sponsored pension plans and other post-retirement benefit plans for the third quarter of 2008 and 2007.

|  | Third Quarter    |       |                |      |
|--|------------------|-------|----------------|------|
|  | Pension Benefits |       | Other Benefits |      |
|  | 2008             | 2007  | 2008           | 2007 |
| Components of net periodic benefit cost: |                  |       |                |      |
| Service cost                             | \$ 11            | \$ 10 | \$ 3           | \$ 3 |
| Interest cost                            | 40               | 34    | 4              | 5    |
| Expected return on plan assets           | (40)             | (38)  |                |      |
| Amortization of:                         |                  |       |                |      |
| Prior service cost                       |                  | 1     | (2)            | (1)  |
| Actuarial loss                           | 8                | 8     |                |      |
| Net periodic benefit cost                | \$ 19            | \$ 15 | \$ 5           | \$ 7 |

The following table provides the components of net periodic benefit costs for the Company-sponsored pension plans and other post-retirement benefit plans for the first three quarters of 2008 and 2007.

|  | Year-To-Date     |       |                |       |
|--|------------------|-------|----------------|-------|
|  | Pension Benefits |       | Other Benefits |       |
|  | 2008             | 2007  | 2008           | 2007  |
| Components of net periodic benefit cost: |                  |       |                |       |
| Service cost                             | \$ 32            | \$ 33 | \$ 8           | \$ 11 |
| Interest cost                            | 124              | 114   | 15             | 16    |
| Expected return on plan assets           | (136)            | (127) |                |       |
| Amortization of:                         |                  |       |                |       |
| Prior service cost                       | 2                | 2     | (5)            | (5)   |
| Actuarial loss                           | 13               | 27    |                |       |
| Net periodic benefit cost                | \$ 35            | \$ 49 | \$ 18          | \$ 22 |

The Company contributed \$20 and \$52 to Company-sponsored pension plans in the first three quarters of 2008 and 2007, respectively.

The Company contributed \$75 and \$73 to employee 401(k) retirement savings accounts in the first three quarters of 2008 and 2007, respectively.

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



**7. INCOME TAXES**

The effective income tax rate was 36.7% and 34.6% for the first three quarters of 2008 and 2007, respectively. The 2008 effective income tax rate differed from the federal statutory rate primarily due to the effect of state income taxes. The 2007 effective income tax rate differed from the statutory rate primarily due to the effect of state income taxes and the favorable resolution of certain tax issues during the third quarter totaling approximately \$40. There were no material changes in unrecognized tax benefits during the first three quarters of 2008.

**8. EARNINGS PER COMMON SHARE**

Earnings per basic common share equals net earnings divided by the weighted average number of common shares outstanding. Earnings per diluted common share equals net earnings divided by the weighted average number of common shares outstanding, after giving effect to dilutive stock options and restricted stock. The following tables provide a reconciliation of net earnings and shares used in calculating earnings per basic common share to those used in calculating earnings per diluted common share:

|   | Third Quarter Ended<br>November 8, 2008 |                         |                     | Third Quarter Ended<br>November 10, 2007 |                         |                     |
|---|---|-------------------------|---------------------|--|-------------------------|---------------------|
|   | Earnings<br>(Numerator)                 | Shares<br>(Denominator) | Per Share<br>Amount | Earnings<br>(Numerator)                  | Shares<br>(Denominator) | Per Share<br>Amount |
| Earnings per basic common share                       | \$ 237                                  | 649                     | \$ 0.37             | \$ 254                                   | 678                     | \$ 0.37             |
| Dilutive effect of stock options and restricted stock |   | 7                       |                     |  | 7                       |                     |
| Earnings per diluted common share                     | \$ 237                                  | 656                     | \$ 0.36             | \$ 254                                   | 685                     | \$ 0.37             |

  

|   | Year-To-Date<br>November 8, 2008 |                         |                     | Year-To-Date<br>November 10, 2007 |                         |                     |
|---|----------------------------------|-------------------------|---------------------|-----------------------------------|-------------------------|---------------------|
|   | Earnings<br>(Numerator)          | Shares<br>(Denominator) | Per Share<br>Amount | Earnings<br>(Numerator)           | Shares<br>(Denominator) | Per Share<br>Amount |
| Earnings per basic common share                       | \$ 900                           | 653                     | \$ 1.38             | \$ 858                            | 696                     | \$ 1.23             |
| Dilutive effect of stock options and restricted stock |                                  | 7                       |                     |                                   | 8                       |                     |
| Earnings per diluted common share                     | \$ 900                           | 660                     | \$ 1.36             | \$ 858                            | 704                     | \$ 1.22             |

The Company had options outstanding for approximately 12 shares and 3 shares during the third quarter of 2008 and 2007, respectively, that were excluded from the computations of earnings per diluted common share because their inclusion would have had an anti-dilutive effect on earnings per share. For the first three quarters of 2008 and 2007, the Company had options outstanding for approximately 11 and 2 shares, respectively, that were excluded from the computations of diluted earnings per share because their inclusion would have had an anti-dilutive effect on earnings per share.

**9. RECENTLY ISSUED ACCOUNTING STANDARDS**

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51* (SFAS No. 160). SFAS No. 160 will require the consolidation of noncontrolling interests as a component of equity. SFAS No. 160 will become effective for the Company's fiscal year beginning February 1, 2009. The Company is currently evaluating the effect the adoption of SFAS No. 160 will have on its Consolidated Financial Statements.

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

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No 161). SFAS No. 161 requires enhanced disclosures on an entity's derivative and hedging activities. SFAS No. 161 will become effective for the Company's fiscal year beginning February 1, 2009. The Company is currently evaluating the effect the adoption of SFAS No. 161 will have on its Consolidated Financial Statements.

In June 2008, the FASB issued FSP No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP No. EITF 03-6-1). FSP No. EITF 03-6-1 clarifies that share-based payment awards that entitle their holders to receive nonforfeitable dividends before vesting should be considered participating securities and included in the calculation of basic EPS. FSP No. EITF 03-6-1 will become effective for the Company's fiscal year beginning February 1, 2009. The Company is currently evaluating the effect the adoption of FSP No. EITF 03-6-1 will have on its Consolidated Financial Statements.

In December 2008, the FASB issued FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (FAS 140-4 and FIN 46(R)-8). FAS 140-4 and FIN 46(R)-8 requires additional disclosures about an entity's involvement with variable interest entities and transfers of financial assets. FAS 140-4 and FIN 46(R)-8 will become effective for the Company's fiscal year beginning February 1, 2009. The Company is currently evaluating the effect the adoption of FAS 140-4 and FIN 46(R)-8 will have on its Consolidated Financial Statements.

## 10. GUARANTOR SUBSIDIARIES

The Company's outstanding public debt (the *Guaranteed Notes*) is jointly and severally, fully and unconditionally guaranteed by The Kroger Co. and certain of its subsidiaries (the *Guarantor Subsidiaries*). At November 8, 2008, a total of approximately \$6,588 of *Guaranteed Notes* were outstanding. The *Guarantor Subsidiaries* and non-guarantor subsidiaries are direct or indirect wholly-owned subsidiaries of The Kroger Co. Separate financial statements of The Kroger Co. and each of the *Guarantor Subsidiaries* are not presented because the guarantees are full and unconditional and the *Guarantor Subsidiaries* are jointly and severally liable. The Company believes that separate financial statements and other disclosures concerning the *Guarantor Subsidiaries* would not be material to investors.

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

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

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The following tables present summarized financial information as of November 8, 2008 and February 2, 2008, for the third quarter ended, and the three quarters ended November 8, 2008 and November 10, 2007:

**Condensed Consolidating**

**Balance Sheets**

**As of November 8, 2008**

|  | The Kroger<br>Co. | Guarantor<br>Subsidiaries | Eliminations       | Consolidated     |
|--|-------------------|---------------------------|--------------------|------------------|
| <b>Current assets</b>  |                   |                           |                    |                  |
| Cash, including temporary cash investments   | \$ 24             | \$ 256                    | \$                 | \$ 280           |
| Deposits in-transit  | 67                | 543                       |                    | 610              |
| Receivables  | 205               | 2,483                     | (1,881)            | 807              |
| Net inventories  | 523               | 4,845                     |                    | 5,368            |
| Prepaid and other current assets   | 72                | 182                       |                    | 254              |
| <b>Total current assets</b>  | <b>891</b>        | <b>8,309</b>              | <b>(1,881)</b>     | <b>7,319</b>     |
| Property, plant and equipment, net   | 1,762             | 11,323                    |                    | 13,085           |
| Goodwill   | 107               | 2,139                     |                    | 2,246            |
| Adjustment to reflect fair value interest rate hedges  | 14                |                           |                    | 14               |
| Other assets   | 1,636             | 612                       | (1,731)            | 517              |
| Investment in and advances to subsidiaries   | 12,567            |                           | (12,567)           |                  |
| <b>Total assets</b>  | <b>\$ 16,977</b>  | <b>\$ 22,383</b>          | <b>\$ (16,179)</b> | <b>\$ 23,181</b> |
| <b>Current liabilities</b>   |                   |                           |                    |                  |
| Current portion of long-term debt including obligations under capital leases and financing obligations | \$ 1,141          | \$                        | \$                 | \$ 1,141         |
| Accounts payable   | 2,231             | 5,718                     | (3,612)            | 4,337            |
| Other current liabilities  |                   | 3,138                     |                    | 3,138            |
| <b>Total current liabilities</b>   | <b>3,372</b>      | <b>8,856</b>              | <b>(3,612)</b>     | <b>8,616</b>     |
| <b>Long-term debt including obligations under capital leases and financing obligations</b>             |                   |                           |                    |                  |
| Face value long-term debt including obligations under capital leases and financing obligations         | 6,853             |                           |                    | 6,853            |
| Adjustment to reflect fair value interest rate hedges  | 41                |                           |                    | 41               |
| <b>Long-term debt including obligations under capital leases and financing obligations</b>             | <b>6,894</b>      |                           |                    | <b>6,894</b>     |
| Other long-term liabilities  | 1,346             | 960                       |                    | 2,306            |
| <b>Total liabilities</b>   | <b>11,612</b>     | <b>9,816</b>              | <b>(3,612)</b>     | <b>17,816</b>    |
| Minority interests   | 96                |                           |                    | 96               |
| Shareowners' Equity  | 5,269             | 12,567                    | (12,567)           | 5,269            |
| <b>Total liabilities and shareowners' equity</b>   | <b>\$ 16,977</b>  | <b>\$ 22,383</b>          | <b>\$ (16,179)</b> | <b>\$ 23,181</b> |



## Condensed Consolidating

## Balance Sheets

As of February 2, 2008

|  | The Kroger<br>Co. | Guarantor<br>Subsidiaries | Eliminations       | Consolidated     |
|--|-------------------|---------------------------|--------------------|------------------|
| <b>Current assets</b>  |                   |                           |                    |                  |
| Cash and temporary cash investments  | \$ 26             | \$ 216                    | \$                 | \$ 242           |
| Deposits in-transit  | 76                | 600                       |                    | 676              |
| Receivables  | 152               | 2,515                     | (1,881)            | 786              |
| Net inventories  | 420               | 4,435                     |                    | 4,855            |
| Prepaid and other current assets   | 373               | 182                       |                    | 555              |
| <b>Total current assets</b>  | <b>1,047</b>      | <b>7,948</b>              | <b>(1,881)</b>     | <b>7,114</b>     |
| Property, plant and equipment, net   | 1,684             | 10,814                    |                    | 12,498           |
| Goodwill   | 56                | 2,088                     |                    | 2,144            |
| Adjustment to reflect fair value interest rate hedges  | 11                |                           |                    | 11               |
| Other assets   | 1,412             | 657                       | (1,537)            | 532              |
| Investment in and advances to subsidiaries   | 11,979            |                           | (11,979)           |                  |
| <b>Total assets</b>  | <b>\$ 16,189</b>  | <b>\$ 21,507</b>          | <b>\$ (15,397)</b> | <b>\$ 22,299</b> |
| <b>Current liabilities</b>   |                   |                           |                    |                  |
| Current portion of long-term debt including obligations under capital leases and financing obligations | \$ 1,592          | \$                        | \$                 | \$ 1,592         |
| Accounts payable   | 1,822             | 5,646                     | (3,418)            | 4,050            |
| Other current liabilities  |                   | 3,047                     |                    | 3,047            |
| <b>Total current liabilities</b>   | <b>3,414</b>      | <b>8,693</b>              | <b>(3,418)</b>     | <b>8,689</b>     |
| <b>Long-term debt including obligations under capital leases and financing obligations</b>             |                   |                           |                    |                  |
| Face value long-term debt including obligations under capital leases and financing obligations         | 6,485             |                           |                    | 6,485            |
| Adjustment to reflect fair value interest rate hedges  | 44                |                           |                    | 44               |
| <b>Long-term debt including obligations under capital leases and financing obligations</b>             | <b>6,529</b>      |                           |                    | <b>6,529</b>     |
| Other long-term liabilities  | 1,332             | 835                       |                    | 2,167            |
| <b>Total liabilities</b>   | <b>11,275</b>     | <b>9,528</b>              | <b>(3,418)</b>     | <b>17,385</b>    |
| Shareowners' Equity  | 4,914             | 11,979                    | (11,979)           | 4,914            |
| <b>Total liabilities and shareowners' equity</b>   | <b>\$ 16,189</b>  | <b>\$ 21,507</b>          | <b>\$ (15,397)</b> | <b>\$ 22,299</b> |

**Condensed Consolidating****Statements of Operations****For the Quarter Ended November 8, 2008**

|   | <b>The Kroger<br/>Co.</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---------------------------|-----------------------------------|---------------------|---------------------|
| Sales   | \$ 2,293                  | \$ 15,632                         | \$ (345)            | \$ 17,580           |
| Merchandise costs, including warehousing and transportation | 1,861                     | 12,036                            | (345)               | 13,552              |
| Operating, general and administrative                       | 399                       | 2,663                             |                     | 3,062               |
| Rent  | 31                        | 121                               |                     | 152                 |
| Depreciation and amortization                               | 38                        | 297                               |                     | 335                 |
| Operating profit (loss)                                     | (36)                      | 515                               |                     | 479                 |
| Interest expense  | 105                       | 1                                 |                     | 106                 |
| Equity in earnings of subsidiaries                          | 417                       |                                   | (417)               |                     |
| Earnings (loss) before income tax expense                   | 276                       | 514                               | (417)               | 373                 |
| Income tax expense  | 39                        | 97                                |                     | 136                 |
| Net earnings (loss)   | \$ 237                    | \$ 417                            | \$ (417)            | \$ 237              |

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

|   | <b>The Kroger<br/>Co.</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---------------------------|-----------------------------------|---------------------|---------------------|
| Sales   | \$ 2,122                  | \$ 14,322                         | \$ (309)            | \$ 16,135           |
| Merchandise costs, including warehousing and transportation | 1,714                     | 10,997                            | (309)               | 12,402              |
| Operating, general and administrative                       | 406                       | 2,417                             |                     | 2,823               |
| Rent  | 30                        | 120                               |                     | 150                 |
| Depreciation and amortization                               | 34                        | 281                               |                     | 315                 |
| Operating profit (loss)                                     | (62)                      | 507                               |                     | 445                 |
| Interest expense  | 108                       | 2                                 |                     | 110                 |
| Equity in earnings of subsidiaries                          | 545                       |                                   | (545)               |                     |
| Earnings (loss) before income tax expense                   | 375                       | 505                               | (545)               | 335                 |
| Income tax expense (benefit)                                | 121                       | (40)                              |                     | 81                  |
| Net earnings (loss)   | \$ 254                    | \$ 545                            | \$ (545)            | \$ 254              |



**Condensed Consolidating****Statements of Operations****For the Three Quarters Ended November 8, 2008**

|   | <b>The Kroger<br/>Co.</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---------------------------|-----------------------------------|---------------------|---------------------|
| Sales   | \$ 7,711                  | \$ 51,961                         | \$ (932)            | \$ 58,740           |
| Merchandise costs, including warehousing and transportation | 6,339                     | 40,069                            | (932)               | 45,476              |
| Operating, general and administrative                       | 1,338                     | 8,530                             |                     | 9,868               |
| Rent  | 104                       | 406                               |                     | 510                 |
| Depreciation and amortization                               | 124                       | 970                               |                     | 1,094               |
| Operating profit (loss)                                     | (194)                     | 1,986                             |                     | 1,792               |
| Interest expense  | 366                       | 4                                 |                     | 370                 |
| Equity in earnings of subsidiaries                          | 1,522                     |                                   | (1,522)             |                     |
| Earnings (loss) before income tax expense                   | 962                       | 1,982                             | (1,522)             | 1,422               |
| Income tax expense  | 62                        | 460                               |                     | 522                 |
| Net earnings (loss)   | \$ 900                    | \$ 1,522                          | \$ (1,522)          | \$ 900              |

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

|   | <b>The Kroger<br/>Co.</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---------------------------|-----------------------------------|---------------------|---------------------|
| Sales   | \$ 6,934                  | \$ 47,018                         | \$ (952)            | \$ 53,000           |
| Merchandise costs, including warehousing and transportation | 5,639                     | 35,864                            | (952)               | 40,551              |
| Operating, general and administrative                       | 1,320                     | 7,939                             |                     | 9,259               |
| Rent  | 97                        | 391                               |                     | 488                 |
| Depreciation and amortization                               | 112                       | 918                               |                     | 1,030               |
| Operating profit (loss)                                     | (234)                     | 1,906                             |                     | 1,672               |
| Interest expense  | 355                       | 5                                 |                     | 360                 |
| Equity in earnings of subsidiaries                          | 1,572                     |                                   | (1,572)             |                     |
| Earnings (loss) before income tax expense                   | 983                       | 1,901                             | (1,572)             | 1,312               |
| Income tax expense  | 125                       | 329                               |                     | 454                 |
| Net earnings (loss)   | \$ 858                    | \$ 1,572                          | \$ (1,572)          | \$ 858              |

## Condensed Consolidating

## Statements of Cash Flows

For the Three Quarters Ended November 8, 2008

|  | The Kroger Co. | Guarantor<br>Subsidiaries | Consolidated |
|--|----------------|---------------------------|--------------|
| Net cash (used) provided by operating activities | \$ (117)       | \$ 2,474                  | \$ 2,357     |
| Cash flows from investing activities:            |                |                           |              |
| Capital expenditures, excluding acquisitions     | (152)          | (1,461)                   | (1,613)      |
| Other  | (47)           | 8                         | (39)         |
| Net cash used by investing activities            | (199)          | (1,453)                   | (1,652)      |
| Cash flows from financing activities:            |                |                           |              |
| Dividends paid                                   | (168)          |                           | (168)        |
| Proceeds from issuance of long-term debt         | 778            |                           | 778          |
| Payments for long-term debt                      | (1,017)        |                           | (1,017)      |
| Proceeds from issuance of capital stock          | 177            |                           | 177          |
| Treasury stock purchases                         | (626)          |                           | (626)        |
| Other  | 171            | (47)                      | 124          |
| Net change in advances to subsidiaries           | 934            | (934)                     |              |
| Net cash (used) provided by financing activities | 249            | (981)                     | (732)        |
| Net increase (decrease) in cash                  | (67)           | 40                        | (27)         |
| Cash from consolidated Variable Interest Entity  | 65             |                           | 65           |
| Cash:  |                |                           |              |
| Beginning of year                                | 26             | 216                       | 242          |
| End of quarter                                   | \$ 24          | \$ 256                    | \$ 280       |

## Condensed Consolidating

## Statements of Cash Flows

For the Three Quarters Ended November 10, 2007

|  | The Kroger Co. | Guarantor<br>Subsidiaries | Consolidated |
|--|----------------|---------------------------|--------------|
| Net cash provided by operating activities    | \$ 1,208       | \$ 1,069                  | \$ 2,277     |
| Cash flows from investing activities:        |                |                           |              |
| Capital expenditures, excluding acquisitions | (141)          | (1,487)                   | (1,628)      |
| Other  | (27)           | (59)                      | (86)         |
| Net cash used by investing activities        | (168)          | (1,546)                   | (1,714)      |
| Cash flows from financing activities:        |                |                           |              |
| Dividends paid                               | (151)          |                           | (151)        |
| Proceeds from issuance of long-term debt     | 625            |                           | 625          |
| Payments for long-term debt                  | (545)          |                           | (545)        |
| Proceeds from issuance of common stock       | 215            |                           | 215          |
| Treasury stock purchases                     | (1,152)        |                           | (1,152)      |
| Other  | 341            | 81                        | 422          |
| Net change in advances to subsidiaries       | (377)          | 377                       |              |
| Net cash used by financing activities        | (1,044)        | 458                       | (586)        |
| Net decrease in cash                         | (4)            | (19)                      | (23)         |
| Cash:  |                |                           |              |
| Beginning of year                            | 25             | 164                       | 189          |
| End of quarter                               | \$ 21          | \$ 145                    | \$ 166       |

## 11. COMMITMENTS AND CONTINGENCIES

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

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

The principal contingencies are described below:

*Insurance* The Company's workers' compensation risks are self-insured in certain states. In addition, other workers' compensation risks and certain levels of insured general liability risks are based on retrospective premium plans, deductible plans, and self-insured retention plans. The liability for workers' compensation risks is accounted for on a present value basis. Actual claim settlements and expenses incident thereto may differ from the provisions for loss. Property risks have been underwritten by a subsidiary and are reinsured with unrelated insurance companies. Operating divisions and subsidiaries have paid premiums, and the insurance subsidiary has provided loss allowances, based upon actuarially determined estimates.

*Litigation* On October 6, 2006, the Company petitioned the Tax Court (*In Re: Ralphs Grocery Company and Subsidiaries, formerly known as Ralphs Supermarkets, Inc., Docket No. 20364-06*) for a redetermination of deficiencies set by the Commissioner of Internal Revenue. The dispute at issue involves a 1992 transaction in which Ralphs Holding Company acquired the stock of Ralphs Grocery Company and made an election under Section 338(h)(10) of the Internal Revenue Code. The Commissioner has determined that the acquisition of the stock was not a purchase as defined by Section 338(h)(3) of the Internal Revenue Code and that the acquisition does not qualify as a purchase. The Company believes that it has strong arguments in favor of its position and believes it is more likely than not that its position will be sustained. However, due to the inherent uncertainty involved in the litigation process, there can be no assurances that the Tax Court will rule in favor of the Company. As of November 8, 2008, an adverse decision would require a cash payment up to approximately \$432, including interest.

On February 2, 2004, the Attorney General for the State of California filed an action in Los Angeles federal court (*California, ex rel Lockyer v. Safeway, Inc. dba Vons, a Safeway Company; Albertson's, Inc. and Ralphs Grocery Company, a division of The Kroger Co.*, United States District Court Central District of California, Case No. CV04-0687) alleging that the Mutual Strike Assistance Agreement (the Agreement) between the Company, Albertson's, Inc. and Safeway Inc. (collectively, the Retailers), which was designed to prevent the union from placing disproportionate pressure on one or more of the Retailers by picketing such Retailer(s) but not the other Retailer(s) during the labor dispute in southern California, violated Section 1 of the Sherman Act. The lawsuit seeks declarative and injunctive relief. On May 28, 2008, pursuant to a stipulation between the parties, the court entered a final judgment in favor of the defendants. As a result of the stipulation and final judgment, there are no further claims to be litigated at the trial court level. The Attorney General has appealed a trial court ruling to the Ninth Circuit Court of Appeals and the defendants are appealing a separate ruling. Although this lawsuit is subject to uncertainties inherent in the litigation process, based on the information presently available to the Company, management does not expect that the ultimate resolution of this action will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

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

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

*Guarantees* The Company has guaranteed half of the indebtedness of two real estate entities in which Kroger has a 50% ownership interest. The Company's share of the responsibility for this indebtedness, should the entities be unable to meet their obligations, totals approximately \$7. Based on the covenants underlying this indebtedness as of November 8, 2008 it is unlikely that the Company will be responsible for repayment of these obligations. The Company also agreed to guarantee, up to \$25, the indebtedness of an entity in which Kroger has a 25% ownership interest. The Company's share of the responsibility, as of November 8, 2008, should the entity be unable to meet its obligations, totals approximately \$25 and is collateralized by approximately \$12 of inventory located in the Company's stores. In addition, the Company has guaranteed half of the lease payments of a location leased by an entity in which Kroger has a 50% ownership interest. The net present value of the guaranteed rental payments is approximately \$6.

*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 2007 Annual Report on Form 10-K and include, among others, the discount rate, the expected long-term rate of return on plan assets, and the rates of increase in compensation and health care costs. Actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally affect the recognized expense and recorded obligation in such future periods. While the Company believes that the assumptions are appropriate, significant differences in actual experience or significant changes in assumptions may materially affect the pension and other post-retirement obligations and future expense.

The Company contributed \$20 and \$52 to its Company-sponsored defined benefit pension plans in the first three quarters of 2008 and 2007, respectively. The Company expects these contributions will reduce its minimum required contributions in future years. Among other things, investment performance of plan assets, the interest rates required to be used to calculate pension obligations and future changes in legislation will determine the amounts of any additional contributions. In addition, we expect to make matching cash contributions to our 401(k) Retirement Savings Account Plan, a defined contribution plan, of approximately \$100 in 2008.

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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 funding levels have deteriorated significantly in the recent market downturn. As a result, the Company's contributions to these plans will increase substantially after 2009, assuming current market levels. Moreover, if the Company were to exit certain markets or otherwise cease making contributions to these funds, the Company could trigger a substantial withdrawal liability. Any adjustment for withdrawal liability will be recorded when it is probable that a liability exists and can be reasonably determined, in accordance with SFAS No. 87, *Employers' Accounting for Pensions*.

## 12. FAIR VALUE INTEREST RATE HEDGES

During the first quarter of 2008, the Company terminated a forward-starting interest rate swap in a notional amount of \$250, classified as a cash flow hedge, and made a payment totaling \$12. The unamortized payment has been recorded net of tax in other comprehensive income and will be amortized to earnings as the payments of interest to which the hedge relates are made.

During the third quarter of 2008, the Company terminated three interest rate swaps with a total notional amount of \$300, classified as fair value hedges, and received payments totaling \$7. The unamortized proceeds are recorded as adjustments to the carrying values of the underlying debt and are being amortized over the remaining term of the debt.

The Company has unamortized proceeds from nine interest rate swaps once classified as fair value hedges totaling approximately \$35. The unamortized proceeds are recorded as adjustments to the carrying values of the underlying debt and are being amortized over the remaining term of the debt.

At the end of the third quarter of 2008, the Company maintained three interest rate swap agreements that are being accounted for as fair value hedges. As of November 8, 2008, other long-term assets totaling \$6 have been recorded to reflect the fair value of these agreements, offset by increases in the fair value of the underlying debt.

At the end of the third quarter of 2008, the Company maintained three interest rate swap agreements that became ineffective fair value hedges during the quarter. The interest rate swap agreements were entered into and had a fair value of \$0 at the end of the second quarter of 2008. As of November 8, 2008, other long-term and current assets totaling \$8 and \$2, respectively, have been recorded to reflect the fair value of these agreements, offset by a reduction in interest expense in the third quarter of 2008.

## 13. FAIR VALUE OF FINANCIAL INSTRUMENTS

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a market-based framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 does not expand or require any new fair value measurements. SFAS 157 is effective for financial assets and financial liabilities for fiscal years beginning after November 15, 2007. FASB Staff Position (FSP) 157-2 *Partial Deferral of the Effective Date of Statement No. 157* (FSP 157-2), deferred the effective date of SFAS No. 157 for most non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008. Effective February 3, 2008, the Company adopted SFAS 157, except for non-financial assets and non-financial liabilities as deferred until February 1, 2009 by FSP 157-2.

SFAS 157 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of the fair value hierarchy defined by SFAS 157 are as follows:



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Level 1 Quoted prices are available in active markets for identical assets or liabilities;

Level 2 Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable;

Level 3 Unobservable pricing inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing an asset or liability.

For those financial instruments carried at fair value in the consolidated financial statements, the following table summarizes the fair value of these instruments at November 8, 2008:

### Fair Value Measurements Using

|                               | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total |
|-------------------------------|--|---|--|-------|
| Available-for-Sale Securities | \$ 13  | \$  | \$   | \$ 13 |
| Interest Rate Hedges          |  | 16  |  | 16    |
| Total                         | \$ 13  | \$ 16   | \$   | \$ 29 |

**14. Subsequent Events**

On November 25, 2008, the Company issued \$600 of senior notes bearing an interest rate of 7.5% due in 2014.

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

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

**OVERVIEW**

Third quarter 2008 total sales increased 9.0% to \$17.6 billion compared to the third quarter of 2007. Our identical supermarket sales increased 7.8%, with fuel, and 5.6%, without fuel, compared to the third quarter of 2007 and reflect the strength of our customer- focused strategy and inflation. This identical sales growth was positive across all departments and supermarket divisions. As noted in the past, we are still seeing slowness in sales of discretionary general merchandise and jewelry.

For the third quarter of 2008, net earnings totaled \$237 million, or \$0.36 per diluted share, a decrease of \$.01 compared to the third quarter of 2007. These results included strong retail fuel operations results which were partially offset by an increased LIFO charge and an after-tax charge of \$16 million, or \$.03 per diluted share, related to our \$25 million insurance deductible for disruption and damage caused by Hurricane Ike.

Based on our performance during the third quarter of 2008, we are increasing 2008 earnings per share guidance to \$1.88 to \$1.91 per diluted share, excluding the \$.03 per diluted share charge related to Hurricane Ike. Our previous guidance for earnings per diluted share was \$1.85 to \$1.90. Our updated earnings guidance reflects 11% to 13% growth over fiscal 2007 earnings of \$1.69 per diluted share and implies a fourth quarter earnings range of \$0.49 to \$0.52 per diluted share. We believe that this growth, plus Kroger's dividend yield of slightly more than 1%, creates a strong return for shareholders. In addition, our guidance for full year identical supermarket sales growth remains 4.5% to 5.5%, excluding fuel. Our ability to achieve our guidance is subject to the uncertainties described under "Outlook" below.

**RESULTS OF OPERATIONS**

*Net Earnings*

Net earnings totaled \$237 million for the third quarter of 2008, a decrease of 6.7% from net earnings of \$254 million for the third quarter of 2007. This was a result of strong retail fuel margins, and increased sales and operating profit, offset by a LIFO charge of \$69 million pre-tax, compared to a LIFO charge of \$40 million pre-tax in 2007, and an after tax charge of \$16 million from disruption and damage caused by Hurricane Ike. Additionally, the third quarter of 2007 included a tax benefit of approximately \$40 million from the favorable resolution of certain tax issues. Net earnings totaled \$900 million for the first three quarters of 2008, an increase of 4.9% from net earnings of \$858 for the first three quarters of 2007. The increase in our net earnings for the first three quarters of 2008 was the result of increased sales and operating profit, offset by a LIFO charge of \$155 million pre-tax, compared to a LIFO charge of \$100 million pre-tax in 2007, and an after tax charge of \$16 million from disruption and damage caused by Hurricane Ike. Net earnings for the first three quarters of 2007 included an estimated \$18 million pre-tax expense related to labor unrest at one of our distribution centers and a tax benefit of approximately \$40 million from the favorable resolution of certain tax issues.

Net earnings totaled \$0.36 per diluted share for the third quarter of 2008, a decrease of 2.7% from net earnings of \$0.37 per diluted share for the third quarter of 2007. This was a result of decreased net earnings in the third quarter of 2008, compared to 2007, offset by the repurchase of our stock over the past four quarters. Net earnings of \$1.36 per diluted share for the first three quarters of 2008 represented an increase of 11.5% over net earnings of \$1.22 per diluted share for the first three quarters of 2007. Earnings per share growth for the first three quarters of 2008, compared to 2007, resulted from increased net earnings and the repurchase of our stock over the past four quarters.

## Sales

**Total Sales**

(in millions)

|                                      | Third Quarter    |                     |                  |                     | Year-To-Date     |                     |                  |                     |
|--------------------------------------|------------------|---------------------|------------------|---------------------|------------------|---------------------|------------------|---------------------|
|                                      | 2008             | Percentage Increase | 2007             | Percentage Increase | 2008             | Percentage Increase | 2007             | Percentage Increase |
| Total supermarket sales without fuel | \$ 14,625        | 6.1%                | \$ 13,787        | 7.6%                | \$ 48,355        | 6.5%                | \$ 45,388        | 6.1%                |
| Total supermarket fuel sales         | \$ 1,818         | 33.5%               | \$ 1,362         | 34.6%               | \$ 6,463         | 50.1%               | \$ 4,307         | 24.3%               |
| Total supermarket sales              | \$ 16,443        | 8.5%                | \$ 15,149        | 9.6%                | \$ 54,818        | 10.3%               | \$ 49,695        | 7.4%                |
| Other sales(1)                       | 1,137            | 15.3%               | 986              | 13.3%               | 3,922            | 18.7%               | 3,305            | 10.5%               |
| <b>Total sales</b>                   | <b>\$ 17,580</b> | <b>9.0%</b>         | <b>\$ 16,135</b> | <b>9.8%</b>         | <b>\$ 58,740</b> | <b>10.8%</b>        | <b>\$ 53,000</b> | <b>7.6%</b>         |

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

The change in our total sales for the third quarter and first three quarters of 2008 as compared to the same periods in 2007 was primarily the result of identical supermarket sales increases, increased fuel gallon sales, and inflation across all departments, including significantly higher fuel retail prices during the first three quarters of 2008. We estimate that our product cost inflation, excluding retail fuel operations, during the third quarter of 2008 was 6.0%, compared to 3.0% during the third quarter of 2007. Identical supermarket sales and total sales, excluding fuel, increased due to increased transaction count, average transaction size, and inflation across all departments. Identical supermarket sales growth for the third quarter of 2008 as compared to the third quarter of 2007 was 7.8% with fuel and 5.6% excluding supermarket fuel operations.

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 the fuel center 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. Our identical supermarket sales results are summarized in the table below. We used the identical supermarket dollar figures presented to calculate third quarter 2008 percentage changes.

**Identical Supermarket Sales**

(\$ in millions)

|                        | Third Quarter |           |
|------------------------|---------------|-----------|
|                        | 2008          | 2007      |
| Including fuel centers | \$ 15,604     | \$ 14,479 |
| Excluding fuel centers | \$ 13,928     | \$ 13,185 |

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|                        |      |      |
|------------------------|------|------|
| Including fuel centers | 7.8% | 7.7% |
| Excluding fuel centers | 5.6% | 5.7% |

We define a supermarket as comparable when it has been in operation for five full quarters, including expansions and relocations. Fuel center discounts received at the fuel center and earned based on in-store purchases are included in all of the supermarket comparable sales results calculations illustrated below. Our comparable supermarket sales results are summarized in the table below. We used the comparable supermarket dollar figures presented to calculate third quarter 2008 percentage changes.

### Comparable Supermarket Sales

(\$ in millions)

|                        | Third Quarter |           |
|------------------------|---------------|-----------|
|                        | 2008          | 2007      |
| Including fuel centers | \$ 16,222     | \$ 15,001 |
| Excluding fuel centers | \$ 14,450     | \$ 13,649 |
| Including fuel centers | 8.1%          | 8.0%      |
| Excluding fuel centers | 5.9%          | 5.9%      |

#### 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 decreased 8 basis points to 23.30% for the third quarter of 2008 from 23.38% for the third quarter of 2007. Our retail fuel sales lower our FIFO gross margin rate due to the very low FIFO gross margin on retail fuel sales as compared to non-fuel sales. Excluding the effect of retail fuel operations, our FIFO gross margin rate decreased 15 basis points for the third quarter of 2008 compared to the third quarter of 2007. Our FIFO gross margin, excluding the effect of retail fuel operations, declined during the third quarter of 2008 due to high inflation in product costs and our continued strategy of providing savings to customers through strategic price reductions.

Our FIFO gross margin rate declined 83 basis points to 22.85% for the first three quarters of 2008 from 23.68% for the first three quarters of 2007. Excluding the effect of retail fuel operations, our FIFO gross margin rate decreased 18 basis points for the first three quarters of 2008 compared to the first three quarters of 2007, due to high inflation in product costs and our continued strategy of providing savings to customers through strategic price reductions.

#### LIFO Charge

The LIFO charge in the third quarter of 2008 was \$69 million compared to \$40 million in the third quarter of 2007. The LIFO charge for the first three quarters of 2008 was \$155 million compared to \$100 million in the first three quarters of 2007. Like many food retailers, we continue to experience product cost inflation at levels not seen in several years. This increase in product cost inflation caused the increase in the LIFO charge in both the third quarter of 2008 and the first three quarters of 2008 compared to the comparable periods in 2007.

*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 percent of sales, decreased 8 basis points to 17.42% for the third quarter of 2008 from 17.50% for the third quarter of 2007. The growth in our retail fuel sales lowers our OG&A rate due to the very low OG&A rate on retail fuel sales as compared to non-fuel sales. OG&A expenses, as a percent of sales excluding fuel, increased 40 basis points in the third quarter of 2008 compared to the third quarter of 2007. The increase in our OG&A rate in the third quarter of 2008, excluding the effect of retail fuel operations, resulted primarily from the \$25 million charge related to Hurricane Ike and increased health care, incentive expense, oil and energy costs.



OG&A expenses, as a percent of sales, decreased 67 basis points to 16.80% for the first three quarters of 2008 from 17.47% for the first three quarters of 2007. The growth in our retail fuel sales lowers our OG&A rate due to the very low OG&A rate on retail fuel sales as compared to non-fuel sales. OG&A expenses, as a percent of sales excluding fuel, decreased 3 basis points in the first three quarters of 2008 compared to the first three quarters of 2007. The decrease in our OG&A rate in 2008, excluding the effect of retail fuel operations, resulted primarily from increased identical supermarket sales growth and lower benefit costs associated with certain labor contracts, partially offset by the \$25 million charge related to Hurricane Ike and increased credit card fees, oil and energy costs.

#### *Rent Expense*

Rent expense was \$152 million, or 0.86% of sales, for the third quarter of 2008, compared to \$150 million, or 0.93% of sales, for the third quarter of 2007. For the year-to-date period, rent expense was \$510 million, or 0.87% of total sales in 2008, compared to \$488 million, or 0.92% of sales, in 2007. The decrease in rent expense, as a percent of sales, in both the third quarter and the first three quarters of 2008, compared to the same periods of 2007, results from strong sales growth and our strategy to own rather than lease whenever possible. The increase in rent expense in the first three quarters of 2008, in total dollars, compared to the first three quarters of 2007, was primarily due to lease buyout payments received in the first quarter of 2007.

#### *Depreciation Expense*

Depreciation expense was \$335 million, or 1.91% of total sales, for the third quarter of 2008 compared to \$315 million, or 1.95% of total sales, for the third quarter of 2007. Depreciation expense was \$1,094 million, or 1.86% of total sales, for the first three quarters of 2008 compared to \$1,030 million, or 1.94% of total sales, for the first three quarters of 2007. The increase in depreciation expense, in total dollars, was the result of higher capital expenditures over the last four quarters ending with the third quarter of 2008 compared to the comparable period ending with the third quarter of 2007.

#### *Interest Expense*

Net interest expense was \$106 million, or 0.60% of total sales, in the third quarter of 2008 and \$110 million, or 0.68% of total sales, in the third quarter of 2007. For the year-to-date period, interest expense was \$370 million, or 0.63% of total sales, in 2008 and \$360 million, or 0.68% of total sales, in 2007. The decrease in net interest expense for the third quarter of 2008, when compared to the third quarter of 2007, resulted from income related to the mark-to-market of ineffective fair value swaps during the quarter, partially offset by a higher average debt balance during the third quarter of 2008 compared to the third quarter of 2007. The increase in net interest expense for the year-to-date periods of 2008, when compared to the same periods of 2007, resulted primarily from higher debt outstanding.

#### *Income Taxes*

Our effective income tax rate was 36.5% for the third quarter of 2008 and 24.2% for the third quarter of 2007. For the year-to-date period, our effective income tax rate was 36.7% in 2008 and 34.6% in 2007. The effective income tax rate for both the third quarter and first three quarters of 2008 differed from the federal statutory rate primarily due to the effect of state income taxes. In both the third quarter and first three quarters of 2007, the effective income tax rate differed from the federal statutory rate primarily due to the effect of state taxes and the favorable

resolution of certain tax issues during the third quarter of 2007 that affected tax expense by approximately \$40 million.

## LIQUIDITY AND CAPITAL RESOURCES

### *Cash Flow Information*

#### Net cash provided by operating activities

We generated \$2.4 billion of cash from operating activities during the first three quarters of 2008, compared to \$2.3 billion in the first three quarters of 2007. The cash provided by operating activities in 2008 came from strong net earnings adjusted for non-cash expenses. In addition, cash used for increases in inventory balances was offset by increases in accounts payable and decreases in prepaid expenses since year-end. Our inventory balances, at the end of the third quarter of 2008 compared to the fourth quarter of 2007, have increased due to higher inflation in product costs and purchases of merchandise for the holiday season. Our inventory balances, at the end of the third quarter of 2007 compared to the fourth quarter of 2006, have increased due to higher inflation in product costs and purchases of merchandise for the holiday season. The decrease in prepaid expenses reflects prepayments of certain employee benefits at year-end. During the first three quarters of 2008 and 2007, respectively, we contributed \$20 million and \$52 million to Kroger-sponsored pension plans.

The amount of cash paid for income taxes was higher in the first three quarters of 2008 compared to the first three quarters of 2007 due to higher quarterly income and the timing of federal estimated payments as a result of revised regulations.

#### Net cash used by investing activities

We used \$1.7 billion of cash for investing activities during both the first three quarters of 2008 and 2007. The amount of cash used for investing activities in both the first three quarters of 2008 and 2007 reflects payments for capital expenditures and acquisitions, offset slightly with proceeds from the sale of assets.

#### Net cash used by financing activities

We used \$732 million of cash for financing activities in the first three quarters of 2008 compared to \$586 million in the first three quarters of 2007. The increase in the amount of cash used for financing activities was primarily related to the decrease in book overdrafts. Increased payments on long-term debt and proceeds received from the issuance of long-term debt offset decreased borrowings on the credit facility and treasury stock purchases. Proceeds from the issuance of common stock resulted from exercises of employee stock options. In the third quarter of 2008, to preserve liquidity and financial flexibility, we reduced the amount of stock repurchased during the quarter, decreasing the uses of cash for stock purchases during the quarter and in the first three quarters of 2008, compared to the same periods in 2007.

### *Debt Management*

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As of November 8, 2008, we maintained a committed \$2.5 billion, five-year revolving credit facility that, unless extended, terminates in 2011. Outstanding borrowings under the credit agreement and commercial paper borrowings, and some outstanding letters of credit, reduce funds available under the credit agreement. In addition to the credit agreement, we maintained three uncommitted money market lines totaling \$75 million in the aggregate. The money market lines allow us to borrow from banks at mutually agreed upon rates, usually at rates below the rates offered under the credit agreement. As of November 8, 2008, we had net outstanding commercial paper of \$240 million and total borrowings under our credit agreement of \$395 million, that reduced amounts available under our credit agreement. In addition, as of November 8, 2008, we had borrowings under our money market lines totaling \$68 million. The outstanding letters of credit that reduced the funds available under our credit agreement totaled \$363 million as of November 8, 2008.

Our bank credit facility and the indentures underlying our publicly issued debt contain various restrictive covenants. As of November 8, 2008, we were in compliance with these financial covenants. Furthermore, management believes it is not reasonably likely that Kroger will fail to comply with these financial covenants in the foreseeable future.

Total debt, including both the current and long-term portions of capital leases and lease-financing obligations, increased \$545 million to \$8.0 billion as of the end of the third quarter of 2008, from \$7.5 billion as of the end of the third quarter of 2007. Total debt decreased \$86 million as of the end of the third quarter of 2008 from \$8.1 billion as of year-end 2007. The increase as of the end of the third quarter of 2008, compared to the end of the third quarter of 2007, resulted from the net proceeds and payments on senior notes during the last quarter of 2007, along with the issuance of \$400 million of senior notes bearing an interest rate of 5.00%, \$375 million of senior notes bearing an interest rate of 6.90% and increased borrowings under our money market lines and credit agreement, offset by decreased outstanding commercial paper and the repayment of \$200 million of senior notes bearing an interest rate of 6.375% and \$750 million of senior notes bearing an interest rate of 7.45% that came due in 2008.

While credit markets remain under stress, we have ample sources of liquidity available on our committed lines of credit to meet both short and long-term financing needs. However, 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.

#### *Common Stock Repurchase Program*

During the third quarter of 2008, we invested \$87 million to repurchase 3.1 million shares of Kroger stock at an average price of \$27.89 per share. For the first three quarters of 2008, we invested \$626 million to repurchase 23.7 million shares of Kroger stock at an average price of \$26.41 per share. These shares were reacquired under two separate stock repurchase programs. The first is a \$1 billion repurchase program that was authorized by Kroger's Board of Directors on January 18, 2008. The second 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. As of November 8, 2008, we had approximately \$493 million remaining under the January 2008 repurchase program. In the third quarter of 2008, to preserve liquidity and financial flexibility, we reduced the amount of stock repurchased during the quarter, decreasing the uses of cash for stock purchases during the quarter and in the first three quarters of 2008, compared to the same periods in 2007.

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

## **CAPITAL EXPENDITURES**

Capital expenditures, excluding acquisitions, totaled \$604 million for the third quarter of 2008 compared to \$555 million for the third quarter of 2007. Year-to-date, capital expenditures, excluding acquisitions, totaled \$1.7 billion in 2008 and \$1.6 billion in the comparable period in 2007. During the third quarter of 2008, we opened, acquired, expanded or relocated 14 food stores and also completed 55 within-the-wall remodels. During the first three quarters of 2008, we opened, acquired, expanded or relocated 47 food stores and also completed 142 within-the-wall remodels. Total food store square footage increased 1.0% in the third quarter of 2008 from the third quarter of 2007. Excluding acquisitions and operational closings, total food store square footage increased 1.7% over the third quarter of 2007.

## **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 2007 Annual Report on Form 10-K filed with the SEC on April 1, 2008.

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.

*Fair Value of Financial Instruments*

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a market-based framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 does not expand or require any new fair value measurements. SFAS 157 is effective for financial assets and financial liabilities for fiscal years beginning after November 15, 2007. FASB Staff Position (FSP) 157-2 *Partial Deferral of the Effective Date of Statement No. 157* (FSP 157-2), deferred the effective date of SFAS No. 157 for most non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008. Effective February 3, 2008, we adopted SFAS 157, except for non-financial assets and non-financial liabilities as deferred until February 1, 2009 by FSP 157-2.

SFAS 157 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of the fair value hierarchy defined by SFAS 157 are as follows:

Level 1 Quoted prices are available in active markets for identical assets or liabilities;

Level 2 Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable;

Level 3 Unobservable pricing inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing an asset or liability.

For those financial instruments carried at fair value in the consolidated financial statements, the following table summarizes the fair value of these instruments at November 8, 2008:

**Fair Value Measurements Using**

|                               | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) |    | Significant Other<br>Observable Inputs<br>(Level 2) |    | Significant<br>Unobservable<br>Inputs<br>(Level 3) |  | Total |
|-------------------------------|--|----|---|----|--|--|-------|
| Available-for-Sale Securities | \$   | 13 | \$  |    | \$   |  | \$ 13 |
| Interest Rate Hedges          |  |    |   | 16 |  |  | 16    |
| Total                         | \$   | 13 | \$  | 16 | \$   |  | \$ 29 |

**RECENTLY ISSUED ACCOUNTING STANDARDS**

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

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

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161). SFAS No. 161 requires enhanced disclosures on an entity's derivative and hedging activities. SFAS No. 161 will become effective for the Company's fiscal year beginning February 1, 2009. We are currently evaluating the effect the adoption of SFAS No. 161 will have on our Consolidated Financial Statements.

In June 2008, the FASB issued FSP No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP No. EITF 03-6-1). FSP No. EITF 03-6-1 clarifies that share-based payment awards that entitle their holders to receive nonforfeitable dividends before vesting should be considered participating securities and included in the calculation of basic EPS. FSP No. EITF 03-6-1 will become effective for the Company's fiscal year beginning February 1, 2009. We are currently evaluating the effect the adoption of FSP No. EITF 03-6-1 will have on our Consolidated Financial Statements.



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In December 2008, the FASB issued FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (FAS 140-4 and FIN 46(R)-8). FAS 140-4 and FIN 46(R)-8 requires additional disclosures about an entity's involvement with variable interest entities and transfers of financial assets. FAS 140-4 and IN 46(R)-8 will become effective for the Company's fiscal year beginning February 1, 2009. We are currently evaluating the effect the adoption of FIN 46(R)-8 will have on our Consolidated Financial Statements.

## OUTLOOK

This discussion and analysis contains certain forward-looking statements about Kroger's future performance. These statements are based on management's assumptions and beliefs in light of the information currently available. Such statements relate to, among other things: projected change in net earnings; identical supermarket sales growth; expected pension plan contributions; our ability to generate operating cash flow; projected capital expenditures; square footage growth; opportunities to reduce costs; cash flow requirements; and our operating plan for the future; and are indicated by words such as plan, guidance, will, expect, goal, should, intend, strategy, believe, anticipate, or 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 21 E of the Securities Exchange Act of 1934. While we believe that the statements are accurate, uncertainties about the general economy, our labor relations, our ability to execute our plans on a timely basis and other uncertainties described below could cause actual results to differ materially.

- We expect earnings per share in the range of \$1.88-\$1.91 for 2008, excluding the \$0.03 per diluted share charge related to Hurricane Ike. This represents earnings per share growth of approximately 11%-13% in 2008. In addition, our shareholder return is enhanced by our dividend.
- We expect identical supermarket sales growth, excluding fuel sales, of 4.5%-5.5% in 2008.
- In 2008, we will continue to focus on sales growth and balancing investments in gross margin and improved customer service with operating cost reductions to provide a better shopping experience for our customers. We expect non-fuel operating margins to decline.
- In 2008, we expect the LIFO charge to be approximately \$200 million. Our actual LIFO expense for 2008 will be determined in the fourth quarter, based on inflation rates and product mix of our inventories at that time.
- We plan to use cash flow for capital investments, debt reduction and to pay cash dividends. As market conditions change, we plan to re-evaluate the above uses of cash flow and our stock repurchase activity.
- We expect to obtain sales growth from new square footage, as well as from increased productivity from existing locations.
- We expect our net total debt to EBITDA ratio to show slight improvement over time.
- Capital expenditures reflect our strategy of growth through expansion of existing stores, as well as focusing on productivity increase 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 is expected to reduce merchandising costs. We intend to continue using cash flow from operations to finance capital expenditure requirements. We expect capital investments for 2008 to be in the range of \$2.0 billion - \$2.2 billion, excluding acquisitions and possible purchases of properties currently leased by the Company. We expect total food store square footage to grow approximately 2.0%-2.5% before acquisitions and operational closings.
- Based on current operating trends, we believe that cash flow from operations and other sources of liquidity, including borrowings under our commercial paper program and bank credit facility, will be adequate to meet anticipated requirements for working capital, capital expenditures, 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 expect that our OG&A results will be affected by increased costs, such as higher energy costs, pension costs and credit card fees, as well as any potential future labor disputes, offset by improved productivity from process changes, cost savings negotiated

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in recently completed labor agreements and leverage gained through sales increases.

- We expect that our effective tax rate for 2008 will be approximately 37%.

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- We expect rent expense, as a percent of total sales and excluding closed-store activity, will decrease due to the emphasis our current strategy places on ownership of real estate.
- We believe we have adequate sources of cash if needed under our credit agreement.
- We believe there will be opportunities to reduce our operating costs in such areas as administration, productivity improvements, shrink and warehousing. These savings will be invested in our core business to drive profitable sales growth and offer improved value and shopping experiences for our customers.
- Although we are not required to make cash contributions to Company-sponsored defined benefit pension plans during 2008 and 2009, we contributed \$20 million to these plans during the first three quarters of 2008 and expect to contribute between \$150 million to \$200 million to these plans in 2009 due to current market conditions. We expect any elective contributions made during 2008 and 2009 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 also expect 2009 expense for Company-sponsored pension plans to be comparable to 2008. In addition, we expect to contribute and expense \$100 million in 2008 to the 401(k) Retirement Savings Account Plan as automatic and matching contributions to participants.
- We do not expect a significant increase in our contributions to multi-employer pension plans in 2009 compared to 2008 subject to collective bargaining and capital market conditions. In addition, we believe our contributions to multi-employer pension plans will increase substantially, after 2009, if current market conditions persist.
- In 2008, Kroger expects to recognize approximately \$15 million of expense from the credit extended to our customers through our company branded credit card. This represents an increase in net charge-offs of approximately \$9 million due to the weak economy and portfolio maturation. This rate is still below the credit card industry average and the credit portfolio continues to have an above-average credit score.

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 impact 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.
- The labor agreements covering associates in Las Vegas, Phoenix and Portland, that expired in 2008, have all been extended. In addition, we have various labor agreements expiring in 2009, covering associates in Albuquerque, Atlanta, Dallas, Dayton, Denver and Roanoke. In all of these store contracts, rising health care and pension costs will continue to be an important issue in negotiations. The likely increase in pension costs and how they align with other labor priorities will need to be addressed in bargaining. A prolonged work stoppage affecting a substantial number of locations could have a material adverse effect on our results.
- If market conditions change, it could affect our uses of free cash flow.
- Our ability to achieve sales and earnings goals may be affected by: labor disputes; industry consolidation; pricing and promotional activities of existing and new competitors, including non-traditional competitors; our response to these actions; the state of the economy, including the inflationary and deflationary trends in certain commodities; trends in consumer spending; stock repurchases; and the success of our future growth plans.
- If actual results differ significantly from anticipated future results for certain reporting units and variable interest entities, an impairment loss for any excess of the carrying value of the division's goodwill over the implied fair value would have to be recognized.
- Our ratio of net total debt to EBITDA may not improve if our sales or earnings goals are not achieved, if our net total debt increases above our expectations, or if an adverse decision occurs regarding our Ralph's tax court petition.

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- In addition to the factors identified above, our identical supermarket sales growth could be affected by increases in Kroger private label sales.

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- Our operating margins, without fuel, could fail to remain flat or slightly declining as expected if we are unsuccessful at containing our operating costs.
- We have estimated our exposure to the claims and litigation arising in the normal course of business, as well as in material litigation facing Kroger, and believe we have made adequate provisions for them where it is reasonably possible to estimate and where we believe an adverse outcome is probable. Unexpected outcomes in these matters, however, could result in an adverse effect on our earnings.
- Consolidation in the food industry is likely to continue and the effects on our business, either favorable or unfavorable, cannot be foreseen.
- Rent expense, which includes subtenant rental income, could be adversely affected by the state of the economy, increased store closure activity and future consolidation.
- Depreciation expense, which includes the amortization of assets recorded under capital leases, is computed principally using the straight-line method over the estimated useful lives of individual assets, or the remaining terms of leases. Use of the straight-line method of depreciation creates a risk that future asset write-offs or potential impairment charges related to store closings would be larger than if an accelerated method of depreciation was followed.
- Our effective tax rate may differ from the expected rate due to changes in laws, the status of pending items with various taxing authorities and the deductibility of certain expenses.
- The actual amount of automatic and matching cash contributions to our 401(k) Retirement Savings Account Plan will depend on the savings rate, compensation, and length of service of participants.
- If current market conditions persist, our contributions and recorded expense related to multi-employer pension plans could increase more than anticipated. Should asset values in these funds deteriorate, or 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 current market conditions persist, our contributions to Company-sponsored defined benefit pension plans could increase more than anticipated.
- Changes in laws or regulations, including changes in accounting standards, taxation requirements and environmental laws may have a material effect on our financial statements.
- Changes in the general business and economic conditions in our operating regions, including the rate of inflation, population growth and employment and job growth in the markets in which we operate, may affect our ability to hire and train qualified employees to operate our stores. This would negatively affect earnings and sales growth.
- 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 expenses as a percent of sales.
- Our capital expenditures, expected square footage growth, and number of store projects completed during the year could differ from our estimate if we are unsuccessful in acquiring suitable sites for new stores, if development costs vary from those budgeted or if our logistics and technology projects are not completed in the time frame expected or on budget.
- Interest expense could be adversely affected by the interest rate environment, changes in the Company's credit ratings, fluctuations in the amount of outstanding debt, decisions to incur prepayment penalties on the early redemption of debt and any factor that adversely affects our operations and results in an increase in debt.
- Adverse weather conditions could increase the cost our suppliers charge for their products, or may decrease the customer demand for certain products. 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 will suffer.

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 2008 and 2009.

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 filed with the SEC on April 1, 2008.

**Item 4. Controls and Procedures.**

The Chief Executive Officer and the Chief Financial Officer, together with a disclosure review committee appointed by the Chief Executive Officer, evaluated Kroger's disclosure controls and procedures as of the quarter ended November 8, 2008. Based on that evaluation, Kroger's Chief Executive Officer and Chief Financial Officer concluded that Kroger's disclosure controls and procedures were effective as of the end of the period covered by this report.

In connection with the evaluation described above, there was no change in Kroger's internal control over financial reporting during the quarter ended November 8, 2008, 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, are pending against the Company. Some of these suits purport or have been determined to be class actions and/or seek substantial damages. Any damages that may be awarded in antitrust cases will be automatically trebled. Although it is not possible at this time to evaluate the merits of all of these claims and lawsuits, nor their likelihood of success, the Company is of the belief that any resulting liability will not have a material adverse effect on the Company's financial position.

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

**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> |
|--|---|-------------------------------------|--|--|
| First four weeks                       |   |                                     |  |  |
| August 17, 2008 to September 13, 2008  | 2,256,706                               | \$ 28.02                            | 2,250,000  | \$ 510   |
| Second four weeks                      |   |                                     |  |  |
| September 14, 2008 to October 11, 2008 | 845,006                                 | \$ 27.63                            | 825,718  | \$ 494   |
| Third four weeks                       |   |                                     |  |  |
| October 12, 2008 to November 8, 2008   | 30,262                                  | \$ 25.31                            | 30,000   | \$ 493   |
| <b>Total</b>                           | <b>3,131,974</b>                        | <b>\$ 27.89</b>                     | <b>3,105,718</b>   | <b>\$ 493</b>  |

- (1) The reported periods conform to the Company's fiscal calendar composed of thirteen 28-day periods. The third quarter of 2008 contained three 28-day periods.
- (2) Shares were repurchased under (i) a \$1 billion stock repurchase program, authorized by the Board of Directors on January 18, 2008, and (ii) a program announced on December 6, 1999, to repurchase common stock to reduce dilution resulting from our employee stock option plans which program is limited to proceeds received from exercises of stock options and the tax benefits associated therewith. The programs have no expiration date but may be terminated by the Board of Directors at any time. Total shares purchased include shares that were surrendered to the Company by participants in the Company's long-term incentive plans to pay for taxes on restricted stock awards.
- (3) Amounts shown in this column reflect amounts remaining under the \$1 billion stock repurchase program referenced in clause (i) of Note 2 above. Amounts to be invested under the program utilizing option exercise proceeds are dependent upon option exercise activity.

**Item 6. Exhibits.**

- EXHIBIT 3.1 - Amended Articles of Incorporation are hereby incorporated by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended May 20, 2006, filed with the SEC on June 29, 2006.
- EXHIBIT 3.2 - 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.

**SIGNATURES**

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

**THE KROGER CO.**

Dated: December 17, 2008

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

Dated: December 17, 2008

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

**Exhibit Index**

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