

KRAFT FOODS INC
Form 10-Q
August 08, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

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 1-16483

Kraft Foods Inc.

(Exact name of registrant as specified in its charter)

Virginia
(State or other jurisdiction of
incorporation or organization)

Three Lakes Drive, Northfield, Illinois
(Address of principal executive offices)

52-2284372
(I.R.S. Employer
Identification No.)

60093
(Zip Code)

Registrant's telephone number, including area code (847) 646-2000

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

At July 31, 2006, there were 471,739,795 shares of the registrant's Class A Common Stock outstanding, and 1,180,000,000 shares of the registrant's Class B Common Stock outstanding.

KRAFT FOODS INC.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(in millions of dollars)

(Unaudited)

	June 30, 2006	December 31, 2005
ASSETS		
Cash and cash equivalents	\$ 402	\$ 316
Receivables (less allowances of \$85 in 2006 and \$92 in 2005)	3,549	3,385
Inventories:		
Raw materials	1,484	1,363
Finished product	2,066	1,980
		3,550 3,343
Deferred income taxes	625	879
Other current assets	248	230
Total current assets	8,374	8,153
Property, plant and equipment, at cost	17,046	16,598
Less accumulated depreciation	7,284	6,781
		9,762 9,817
Goodwill	24,985	24,648
Other intangible assets, net	10,428	10,516
Prepaid pension assets	3,690	3,617
Other assets	983	877
TOTAL ASSETS	\$ 58,222	\$ 57,628

See notes to condensed consolidated financial statements.

Continued

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Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (Continued)

(in millions of dollars)

(Unaudited)

	June 30, 2006	December 31, 2005
LIABILITIES		
Short-term borrowings	\$ 1,105	\$ 805
Current portion of long-term debt	2,268	1,268
Due to Altria Group, Inc. and affiliates	485	652
Accounts payable	2,084	2,270
Accrued liabilities:		
Marketing	1,451	1,529
Employment costs	637	625
Other	1,270	1,338
Income taxes	398	237
Total current liabilities	9,698	8,724
Long-term debt	7,478	8,475
Deferred income taxes	5,869	6,067
Accrued postretirement health care costs	1,980	1,931
Other liabilities	2,829	2,838
Total liabilities	27,854	28,035
Contingencies (Note 7)		
SHAREHOLDERS EQUITY		
Class A common stock, no par value (555,000,000 shares issued in 2006 and 2005)		
Class B common stock, no par value (1,180,000,000 shares issued and outstanding in 2006 and 2005)		
Additional paid-in capital	23,525	23,835
Earnings reinvested in the business	10,578	9,453
Accumulated other comprehensive losses (including currency translation of \$(856) in 2006 and \$(1,290) in 2005)	(1,205)	(1,663)
		32,898
Less cost of repurchased stock (81,646,640 Class A shares in 2006 and 65,119,245 Class A shares in 2005)	(2,530)	(2,032)
Total shareholders equity	30,368	29,593
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 58,222	\$ 57,628

See notes to condensed consolidated financial statements.

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Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(in millions of dollars, except per share data)

(Unaudited)

	For the Six Months Ended	
	June 30,	
	2006	2005
Net revenues	\$ 16,742	\$ 16,393
Cost of sales	10,626	10,379
Gross profit	6,116	6,014
Marketing, administration and research costs	3,477	3,538
Asset impairment and exit costs	428	179
Losses (gains) on sales of businesses, net	11	(115)
Amortization of intangibles	5	5
Operating income	2,195	2,407
Interest and other debt expense, net	243	350
Earnings from continuing operations before income taxes and minority interest	1,952	2,057
Provision for income taxes	262	598
Earnings from continuing operations before minority interest	1,690	1,459
Minority interest in earnings from continuing operations, net	2	2
Earnings from continuing operations	1,688	1,457
Loss from discontinued operations, net of income taxes		(272)
Net earnings	\$ 1,688	\$ 1,185
Per share data:		
Basic earnings per share:		
Continuing operations	\$ 1.02	\$ 0.86
Discontinued operations		(0.16)
Net earnings	\$ 1.02	\$ 0.70
Diluted earnings per share:		
Continuing operations	\$ 1.02	\$ 0.86
Discontinued operations		(0.16)

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Net earnings	\$ 1.02	\$ 0.70
Dividends declared	\$ 0.46	\$ 0.41

See notes to condensed consolidated financial statements.

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Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(in millions of dollars, except per share data)

(Unaudited)

	For the Three Months Ended	
	June 30,	
	2006	2005
Net revenues	\$ 8,619	\$ 8,334
Cost of sales	5,435	5,275
Gross profit	3,184	3,059
Marketing, administration and research costs	1,770	1,777
Asset impairment and exit costs	226	29
Losses on sales of businesses, net	8	1
Amortization of intangibles	3	2
Operating income	1,177	1,250
Interest and other debt expense, net	147	174
Earnings from continuing operations before income taxes and minority interest	1,030	1,076
Provision for income taxes	347	316
Earnings from continuing operations before minority interest	683	760
Minority interest in earnings from continuing operations, net	1	2
Earnings from continuing operations	682	758
Loss from discontinued operations, net of income taxes		(286)
Net earnings	\$ 682	\$ 472
Per share data:		
Basic earnings per share:		
Continuing operations	\$ 0.41	\$ 0.45
Discontinued operations		(0.17)
Net earnings	\$ 0.41	\$ 0.28
Diluted earnings per share:		
Continuing operations	\$ 0.41	\$ 0.45
Discontinued operations		(0.17)

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Net earnings	\$ 0.41	\$ 0.28
Dividends declared	\$ 0.23	\$ 0.205

See notes to condensed consolidated financial statements.

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Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Shareholders Equity

For the Year Ended December 31, 2005 and

the Six Months Ended June 30, 2006

(in millions of dollars, except per share data)

(Unaudited)

	Class A and B Common Stock	Accumulated Other Comprehensive Earnings/(Losses)			Total	Cost of Repurchased Stock	Total Share- holders Equity	
		Additional Paid-in Capital	Earnings Reinvested in the Business	Currency Translation Adjustments				Other
Balances, January 1, 2005	\$	\$ 23,762	\$ 8,304	\$ (890)	\$ (315)	\$ (1,205)	\$ (950)	\$ 29,911
Comprehensive earnings:								
Net earnings			2,632					2,632
Other comprehensive losses, net of income taxes:								
Currency translation adjustments				(400)		(400)		(400)
Additional minimum pension liability					(48)	(48)		(48)
Change in fair value of derivatives accounted for as hedges					(10)	(10)		(10)
Total other comprehensive losses								(458)
Total comprehensive earnings								2,174
Exercise of stock options and issuance of other stock awards		52	(12)				118	158
Cash dividends declared (\$0.87 per share)			(1,471)					(1,471)
Class A common stock repurchased							(1,200)	(1,200)
Other		21						21
Balances, December 31, 2005		23,835	9,453	(1,290)	(373)	(1,663)	(2,032)	29,593
Comprehensive earnings:								
Net earnings			1,688					1,688
Other comprehensive earnings (losses), net of income taxes:								
Currency translation adjustments				434		434		434
Additional minimum pension liability					(21)	(21)		(21)
					1	1		1

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Change in fair value of derivatives accounted for as hedges									
Other			44		44				44
Total other comprehensive earnings									458
Total comprehensive earnings									2,146
Exercise of stock options and issuance of other stock awards			(310)		202			127	19
Cash dividends declared (\$0.46 per share)					(765)				(765)
Class A common stock repurchased								(625)	(625)
Balances, June 30, 2006	\$	\$	23,525	\$	10,578	\$	(856)	\$	(349)
								\$	(1,205)
								\$	(2,530)
									\$ 30,368

Total comprehensive earnings were \$1,043 million and \$262 million, respectively, for the quarters ended June 30, 2006 and 2005 and \$957 million for the first six months of 2005.

See notes to condensed consolidated financial statements.

Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(in millions of dollars)

(Unaudited)

	For the Six Months Ended	
	June 30,	
	2006	2005
CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Net earnings	\$ 1,688	\$ 1,185
Adjustments to reconcile net earnings to operating cash flows:		
Depreciation and amortization	433	436
Deferred income tax benefit	(56)	(222)
Losses (gains) on sales of businesses, net	11	(115)
Loss on sale of discontinued operations		32
Asset impairment and exit costs, net of cash paid	325	92
Cash effects of changes, net of the effects from acquired and divested companies:		
Receivables, net	(59)	80
Inventories	(216)	(296)
Accounts payable	(93)	(193)
Income taxes	103	591
Amounts due to Altria Group, Inc. and affiliates	(202)	84
Other working capital items	(442)	(392)
Change in pension assets and postretirement liabilities, net	14	(101)
Other	100	111
Net cash provided by operating activities	1,606	1,292
CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES		
Capital expenditures	(450)	(441)
Proceeds from sales of businesses	91	1,640
Other	63	16
Net cash (used in) provided by investing activities	(296)	1,215

See notes to condensed consolidated financial statements.

Continued

Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Continued)

(in millions of dollars)

(Unaudited)

	For the Six Months Ended	
	June 30,	
	2006	2005
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES		
Net issuance (repayment) of short-term borrowings	\$ 294	\$ (945)
Long-term debt proceeds	32	34
Long-term debt repaid	(35)	(739)
Increase in amounts due to Altria Group, Inc. and affiliates	35	187
Repurchase of Class A common stock	(633)	(375)
Dividends paid	(769)	(700)
Other	(173)	144
Net cash used in financing activities	(1,249)	(2,394)
Effect of exchange rate changes on cash and cash equivalents	25	1
Cash and cash equivalents:		
Increase	86	114
Balance at beginning of period	316	282
Balance at end of period	\$ 402	\$ 396

See notes to condensed consolidated financial statements.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 1. Accounting Policies:

Basis of Presentation

The interim condensed consolidated financial statements of Kraft Foods Inc. (Kraft), together with its subsidiaries (collectively referred to as the Company), are unaudited. It is the opinion of the Company s management that all adjustments necessary for a fair statement of the interim results presented have been reflected therein. All such adjustments were of a normal recurring nature. Net revenues and net earnings for any interim period are not necessarily indicative of results that may be expected for the entire year.

These statements should be read in conjunction with the Company s consolidated financial statements and related notes, which are included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

In June 2005, the Company sold substantially all of its sugar confectionery business for pre-tax proceeds of approximately \$1.4 billion. The Company has reflected the results of its sugar confectionery business prior to the closing date as discontinued operations on the condensed consolidated statements of earnings.

In October 2005, the Company announced that, effective January 1, 2006, its Canadian business will be realigned to better integrate it into the Company s North American business by product category. Beginning in the first quarter of 2006, the operating results of the Canadian business are being reported throughout the North American food segments. In addition, in the first quarter of 2006, the Company s international businesses were realigned to reflect the reorganization announced within Europe in November 2005. The two revised international segments, which are reflected in these condensed consolidated financial statements and notes, are European Union; and Developing Markets, Oceania & North Asia, the latter to reflect the Company s increased management focus on developing markets. Accordingly, prior period segment results have been restated.

Stock-Based Compensation Expense

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), Share-Based Payment, (SFAS No. 123(R)) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on date of grant and recognition of compensation over the service periods for awards expected to vest. The fair value of restricted stock and rights to receive shares of stock is determined based on the number of shares granted and the market value at date of grant. The fair value of stock options is determined using a modified Black-Scholes methodology. The impact of adoption was not material.

The Company previously applied the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and provided the pro forma disclosures required by SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). No compensation expense for employee stock options was reflected in net earnings in 2005, as all stock options granted under those plans had an exercise price equal to the market value of the common stock on the date of the grant. Historical condensed consolidated statements of earnings already include the compensation expense for restricted stock and rights to receive shares of stock. The following table illustrates the effect on net earnings and earnings per share (EPS) if the Company had applied the fair value recognition provisions of SFAS No. 123 to measure stock-based compensation expense for stock option awards in 2005:

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Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

	For the Six Months Ended June 30, 2005 (in millions, except per share data)	For the Three Months Ended June 30, 2005
Net earnings, as reported	\$ 1,185	\$ 472
Deduct:		
Total stock-based employee compensation expense determined under fair value method for all stock option awards, net of related tax effects	4	2
Pro forma net earnings	\$ 1,181	\$ 470
Earnings per share:		
Basic as reported	\$ 0.70	\$ 0.28
Basic pro forma	\$ 0.70	\$ 0.28
Diluted as reported	\$ 0.70	\$ 0.28
Diluted pro forma	\$ 0.69	\$ 0.28

The adoption of SFAS No. 123(R) in the first quarter of 2006 resulted in a cumulative effect gain of \$6 million, which is net of \$3 million in taxes, in the condensed consolidated statements of earnings for the six months ended June 30, 2006. This gain resulted from the impact of estimating future forfeitures on restricted stock and rights to receive shares of stock in the determination of periodic expense for unvested awards, rather than recording forfeitures only when they occur. The gross cumulative effect was recorded in marketing, administration and research costs in the first quarter of 2006.

Under SFAS No. 123(R), tax shortfalls occur when actual tax deductible compensation expense is less than cumulative stock-based compensation expense recognized in the financial statements. Tax shortfalls of \$10 million were recognized for the six months ended June 30, 2006, and were recorded in additional paid-in capital.

Note 2. Asset Impairment, Exit and Implementation Costs:

Restructuring Program:

In January 2004, the Company announced a three-year restructuring program with the objectives of leveraging the Company's global scale, realigning and lowering its cost structure, and optimizing capacity utilization. In January 2006, the Company announced plans to expand its restructuring efforts through 2008. The entire restructuring program is expected to result in \$3.7 billion in pre-tax charges reflecting asset disposals, severance and implementation costs. As part of this program, the Company anticipates the closure of up to 40 facilities and the elimination of approximately 14,000 positions. Approximately \$2.3 billion of the \$3.7 billion in pre-tax charges are expected to require cash payments. Pre-tax restructuring program charges during 2006 are expected to be approximately \$1 billion, including \$348 million incurred for the six months ended June 30, 2006. Total pre-tax restructuring charges incurred since the inception of the program in January 2004 were \$1.3 billion.

During the second quarter of 2006, the Company announced a seven-year, \$1.7 billion agreement to receive information technology services from Electronic Data Systems (EDS). The agreement, which includes data centers, web hosting, telecommunications and IT workplace services, began on June 1, 2006. Pursuant to the agreement, approximately 670 employees, who provide certain IT support to the Company, were transitioned to EDS. As a result, in the second quarter of 2006, the Company incurred pre-tax asset impairment and exit costs of \$3 million and implementation costs of \$11 million related to the transition. These costs were included in the pre-tax restructuring program charges discussed above.

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Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Restructuring Costs:

During the six months and three months ended June 30, 2006, pre-tax charges under the restructuring program of \$318 million and \$226 million, respectively, were recorded as asset impairment and exit costs on the condensed consolidated statements of earnings. During the six months and three months ended June 30, 2005, pre-tax charges under the restructuring program of \$86 million and \$29 million, respectively, were recorded as asset impairment and exit costs on the condensed consolidated statements of earnings. The pre-tax charges for the six months ended June 30, 2006 resulted from the announcement of the closing of seven plants, for a total of 26 since January 2004, and the continuation of a number of workforce reduction programs. Approximately \$133 million of the pre-tax charges incurred during the first six months of 2006 will require cash payments.

Pre-tax restructuring liability activity for the six months ended June 30, 2006 was as follows:

	Severance (in millions)	Asset Write-downs	Other	Total
Liability balance, January 1, 2006	\$ 114	\$	\$ 1	\$ 115
Charges	123	184	11	318
Cash spent	(97)		(6)	(103)
Charges against assets	(3)	(184)	(1)	(188)
Currency	3			3
Liability balance, June 30, 2006	\$ 140	\$	\$ 5	\$ 145

Severance costs in the above schedule, which relate to the workforce reduction programs, include the cost of related benefits. Specific programs announced since 2004, as part of the overall restructuring program, will result in the elimination of approximately 8,600 positions. At June 30, 2006, approximately 7,200 of these positions have been eliminated. Asset write-downs relate to the impairment of assets caused by the plant closings and related activity. Other costs incurred relate primarily to contract termination costs associated with the plant closings and the termination of leasing agreements.

Implementation Costs:

The Company recorded pre-tax implementation costs associated with the restructuring program. These costs include the discontinuance of certain product lines and incremental costs related to the integration and streamlining of functions and closure of facilities. Substantially all implementation costs incurred in 2006 will require cash payments. These costs were recorded on the condensed consolidated statements of earnings as follows:

	For the Six Months Ended		For the Three Months Ended	
	June 30, 2006 (in millions)	2005	June 30, 2006	2005
Net revenues	\$	\$ 1	\$	\$ 1
Cost of sales	11	26	5	11
Marketing, administration and research costs	19	18	12	14
Implementation Costs	\$ 30	\$ 45	\$ 17	\$ 26

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Asset Impairment Charges:

In July 2006, the Company completed the sale of its pet snacks brand and assets for \$580 million and recorded additional taxes of approximately \$60 million related to the sale. This sale and the additional taxes were recorded in the third quarter of 2006. The Company incurred a pre-tax asset impairment charge of \$86 million in the first quarter of 2006 in recognition of this sale. The charge, which included the write-off of a portion of the associated goodwill, and intangible and fixed assets, was recorded as asset impairment and exit costs on the condensed consolidated statement of earnings.

During the second quarter of 2005, the Company completed the sale of its fruit snacks assets for approximately \$30 million. The Company incurred a pre-tax asset impairment charge of \$93 million in the first quarter of 2005 in recognition of the sale. The charge, which included the write-off of all associated intangible assets, was recorded as asset impairment and exit costs on the condensed consolidated statement of earnings.

During the first quarter of 2006, the Company completed its annual review of goodwill and intangible assets and recorded non-cash pre-tax charges of \$24 million related to an intangible asset impairment for biscuits assets in Egypt and hot cereal assets in the United States. These charges were recorded as asset impairment and exit costs on the condensed consolidated statement of earnings. During the first quarter of 2005, the Company completed its annual review of goodwill and intangible assets and no charges resulted from this review.

Total:

The pre-tax asset impairment, exit and implementation costs discussed above, for the six months and three months ended June 30, 2006 and 2005, were included in the operating companies income of the following segments:

	For the Six Months Ended June 30, 2006				
	Restructuring Costs (in millions)	Asset Impairment	Total Asset Impairment and Exit Costs	Implementation Costs	Total
North America Beverages	\$ 9	\$	\$ 9	\$ 4	\$ 13
North America Cheese & Foodservice	66		66	1	67
North America Convenient Meals	52		52	4	56
North America Grocery	13		13	4	17
North America Snacks & Cereals	15	99	114	4	118
European Union	99		99	9	108
Developing Markets, Oceania & North Asia	64	11	75	4	79
Total	\$ 318	\$ 110	\$ 428	\$ 30	\$ 458

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Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

For the Six Months Ended June 30, 2005

	Restructuring Costs (in millions)	Asset Impairment	Total Asset Impairment and Exit Costs	Implementation Costs	Total
North America Beverages	\$ 4	\$	\$ 4	\$ 3	\$ 7
North America Cheese & Foodservice	8		8	4	12
North America Convenient Meals	2		2	2	4
North America Grocery	11	93	104		104
North America Snacks & Cereals	4		4	23	27
European Union	47		47	10	57
Developing Markets, Oceania & North Asia	10		10	3	13
Total	\$ 86	\$ 93	\$ 179	\$ 45	\$ 224

For the Three Months Ended June 30, 2006

	Restructuring Costs (in millions)	Asset Impairment	Total Asset Impairment and Exit Costs	Implementation Costs	Total
North America Beverages	\$ 7	\$	\$ 7	\$ 3	\$ 10
North America Cheese & Foodservice	60		60	(3)	57
North America Convenient Meals	35		35	4	39
North America Grocery	8		8	3	11
North America Snacks & Cereals	10		10	3	13
European Union	81		81	6	87
Developing Markets, Oceania & North Asia	25		25	1	26
Total	\$ 226	\$	\$ 226	\$ 17	\$ 243

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

For the Three Months Ended June 30, 2005

	Restructuring Costs (in millions)	Asset Impairment	Total Asset Impairment and Exit Costs	Implementation Costs	Total
North America Beverages	\$ 1	\$	\$ 1	\$ 2	\$ 3
North America Cheese & Foodservice	1		1	1	2
North America Convenient Meals				1	1
North America Grocery	3		3		3
North America Snacks & Cereals				14	14
European Union	17		17	6	23
Developing Markets, Oceania & North Asia	7		7	2	9
Total	\$ 29	\$	\$ 29	\$ 26	\$ 55

Note 3. Related Party Transactions:

At June 30, 2006, Altria Group, Inc. owned 88.1% of the Company's outstanding shares of capital stock. Altria Group, Inc.'s subsidiary, Altria Corporate Services, Inc., provides the Company with various services, including planning, legal, treasury, auditing, insurance, human resources, office of the secretary, corporate affairs, information technology, aviation and tax services. Billings for these services, which were based on the cost to Altria Corporate Services, Inc. to provide such services and a 5% management fee based on wages and benefits, were \$102 million and \$126 million for the six months ended June 30, 2006 and 2005, respectively, and \$50 million and \$63 million for the three months ended June 30, 2006 and 2005, respectively.

At June 30, 2006, the Company had short-term amounts payable to Altria Group, Inc. of \$485 million. The amounts payable to Altria Group, Inc. generally include accrued dividends, taxes and service fees. Interest on intercompany borrowings is based on the applicable London Interbank Offered Rate.

In the second quarter of 2006, the Company purchased certain real estate and certain personal property located in Wilkes Barre, Pennsylvania, from Altria Corporate Services, Inc., for an aggregate purchase price of \$9.3 million. In addition, during the second quarter of 2006, the Company assumed all of Altria Corporate Services, Inc.'s rights under a lease for certain real property located in San Antonio, Texas. The Company also purchased certain personal property located in San Antonio, Texas from Altria Corporate Services, Inc., for an aggregate purchase price of \$6.0 million.

Also, see Note 12. *Income Taxes* regarding the impact to the Company of the closure of an Internal Revenue Service review of Altria Group, Inc.'s consolidated federal income tax return recorded during the first quarter of 2006.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 4. Divestitures:*Discontinued Operations:*

In June 2005, the Company sold substantially all of its sugar confectionery business for pre-tax proceeds of approximately \$1.4 billion. The sale included the *Life Savers*, *Creme Savers*, *Altoids*, *Trolli* and *Sugus* brands. The Company has reflected the results of its sugar confectionery business prior to the closing date as discontinued operations on the condensed consolidated statements of earnings.

Summary results of operations for the sugar confectionery business were as follows:

	For the Six Months Ended June 30, 2005 (in millions)	For the Three Months Ended June 30, 2005
Net revenues	\$ 228	\$ 112
Earnings before income taxes	\$ 41	\$ 19
Provision for income taxes	(16)	(8)
Loss on sale of discontinued operations	(297)	(297)
Loss from discontinued operations, net of income taxes	\$ (272)	\$ (286)

The loss on sale of discontinued operations, above, for the six months and three months ended June 30, 2005, related largely to taxes on the transaction.

Other:

During the second quarter of 2006, the Company sold its industrial coconut assets. During the first quarter of 2006, the Company sold certain Canadian assets and a small U.S. biscuit brand, and incurred pre-tax asset impairment charges of \$176 million in the fourth quarter of 2005 in recognition of these sales. During the second quarter of 2005, the Company sold its fruit snacks assets and incurred a pre-tax asset impairment charge of \$93 million in the first quarter of 2005 in recognition of this sale. During the first quarter of 2005, the Company sold its U.K. desserts assets, its U.S. yogurt assets and a minor trademark in Mexico. The aggregate proceeds received from these sales during the first six months of 2006 and 2005 were \$91 million and \$221 million, respectively. The Company recorded pre-tax losses from sales of businesses of \$11 million during the first six months of 2006, and recorded pre-tax gains from sales of businesses of \$115 million during the first six months of 2005.

In July 2006, the Company completed the sale of its pet snacks brand and assets for \$580 million and recorded additional taxes of approximately \$60 million related to the sale. This sale and the additional taxes were recorded in the third quarter of 2006. The Company incurred a pre-tax asset impairment charge of \$86 million in the first quarter of 2006 in recognition of this sale.

The operating results of the other divestitures, discussed above, in the aggregate, were not material to the Company's consolidated financial position, results of operations or cash flows in any of the periods presented.

Note 5. Stock Plans:

Under the Kraft 2005 Performance Incentive Plan (the 2005 Plan), the Company may grant to eligible employees awards of stock options, stock appreciation rights, restricted stock, restricted and deferred stock units, and other awards based on the Company's Class A common stock, as well

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as performance-based annual and long-term incentive awards. A maximum of 150 million shares of the Company's Class A common stock may be issued under the 2005 Plan, of which no more than 45 million shares may be awarded as restricted stock. In addition, under the Kraft 2006 Stock Compensation Plan for Non-Employee Directors (the 2006 Directors Plan), the Company may grant up to 500,000 shares of Class A common stock to members of the Board of Directors who are not full-time employees of the Company or Altria Group, Inc., or their subsidiaries, over a five-year period. Shares available to be granted under the 2005 Plan and the 2006 Directors Plan at June 30, 2006, were 143,326,485 and 481,555, respectively. Restricted shares available for grant under the 2005 Plan at June 30, 2006, were 38,326,485.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Generally, stock options are granted at an exercise price equal to the fair value of the underlying stock on the date of the grant, become exercisable on the first anniversary of the grant date and have a maximum term of ten years. However, the Company has not granted stock options to its employees since 2002. Restricted stock generally vests on the third anniversary of the grant date.

Stock Option Plan

Stock option activity was as follows for the six months ended June 30, 2006:

	Shares Subject to Option	Weighted Average Exercise Price	Average Remaining Contractual Term	Aggregate Intrinsic Value
Balance at January 1, 2006	15,145,840	\$ 31.00		
Options exercised	(133,750)	31.00		
Options cancelled	(324,910)	31.00		
Balance at June 30, 2006	14,687,180	31.00	5 years	\$
Exercisable at June 30, 2006	14,687,180	31.00	5	

The total intrinsic value of options exercised was \$0.1 million and \$0.6 million during the six months ended June 30, 2006 and 2005, respectively, and \$0.1 million and \$0.2 million, during the three months ended June 30, 2006 and 2005, respectively.

Prior to the initial public offering (IPO), certain employees of the Company participated in Altria Group, Inc. s stock compensation plans. Altria Group, Inc. does not intend to issue additional Altria Group, Inc. stock compensation to the Company s employees, except for reloads of previously issued options.

Pre-tax compensation cost and the related tax benefit for Altria stock option awards for reloads totaled \$2.0 million and \$0.7 million, respectively, for the six months ended June 30, 2006 and \$0.6 million and \$0.2 million, respectively, for the three months ended June 30, 2006. The fair value of the awards was determined using a modified Black-Scholes methodology using the following assumptions for Altria Group, Inc. common stock:

	Risk-Free Interest Rate	Weighted Average Expected Life	Expected Volatility	Expected Dividend Yield	Fair Value at Grant Date
2006 Altria Group, Inc.	4.88	% 4 years	26.54	% 4.44	% \$ 12.56
2005 Altria Group, Inc.	3.73	4	33.79	4.43	13.98

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Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

The Company's employees held options to purchase the following number of shares of Altria Group, Inc. stock at June 30, 2006:

	Shares Subject to Option	Weighted Average Exercise Price	Average Remaining Contractual Term	Aggregate Intrinsic Value
Balance at June 30, 2006	18,313,200	\$ 40.25	3 years	\$608 million
Exercisable at June 30, 2006	18,205,817	40.06	3	608

Restricted Stock Plans

The Company may grant shares of restricted stock and rights to receive shares of stock to eligible employees, giving them in most instances all of the rights of stockholders, except that they may not sell, assign, pledge or otherwise encumber such shares and rights. Such shares and rights are subject to forfeiture if certain employment conditions are not met.

The fair value of the restricted shares and rights at the date of grant is amortized to expense ratably over the restriction period. The Company recorded pre-tax compensation expense related to restricted stock and rights of \$61 million (including the pre-tax cumulative effect gain of \$9 million from the adoption of SFAS No. 123(R)) and \$76 million for the six months ended June 30, 2006 and 2005, respectively, and \$38 million for the three months ended June 30, 2006 and 2005. The deferred tax benefit recorded related to this compensation expense was \$22 million and \$28 million for the six months ended June 30, 2006 and 2005, respectively, and \$14 million, for the three months ended June 30, 2006 and 2005. The unamortized compensation expense related to the Company's restricted stock and rights was \$292 million at June 30, 2006 and is expected to be recognized over a weighted average period of two years.

The Company's restricted stock and rights activity was as follows for the six months ended June 30, 2006:

	Number of Shares	Weighted-Average Grant Date Fair Value Per Share
Balance at January 1, 2006	15,085,116	\$ 33.80
Granted	6,776,035	29.12
Vested	(4,007,117)	36.50
Forfeited	(1,400,728)	32.62
Balance at June 30, 2006	16,453,306	31.32

The weighted average grant date fair value of restricted stock and rights granted during the six months ended June 30, 2006 and 2005 was \$197 million and \$196 million, respectively, or \$29.12 and \$33.31 per restricted share or right, respectively. The total fair value of restricted stock and rights vested during the six months ended June 30, 2006 and 2005 was \$117 million and \$1 million, respectively.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 6. Earnings Per Share:

Basic and diluted EPS from continuing and discontinued operations were calculated using the following:

	For the Six Months Ended	
	June 30, 2006 (in millions)	2005
Earnings from continuing operations	\$ 1,688	\$ 1,457
Loss from discontinued operations		(272)
Net earnings	\$ 1,688	\$ 1,185
Weighted average shares for basic EPS	1,652	1,694
Plus incremental shares from assumed conversions of stock options, restricted stock and stock rights	9	7
Weighted average shares for diluted EPS	1,661	1,701

	For the Three Months Ended	
	June 30, 2006 (in millions)	2005
Earnings from continuing operations	\$ 682	\$ 758
Loss from discontinued operations		(286)
Net earnings	\$ 682	\$ 472
Weighted average shares for basic EPS	1,647	1,691
Plus incremental shares from assumed conversions of stock options, restricted stock and stock rights	9	7
Weighted average shares for diluted EPS	1,656	1,698

For the three months ended June 30, 2006 and 2005, the number of stock options excluded from the calculation of weighted average shares for diluted EPS because their effects were antidilutive (i.e. the cash that would be received upon exercise is greater than the average market price of the stock during the period) was immaterial.

Note 7. Contingencies:

Kraft and its subsidiaries are parties to a variety of legal proceedings arising out of the normal course of business, including a few cases in which substantial amounts of damages are sought. While the results of litigation cannot be predicted with certainty, management believes that the final outcome of these proceedings will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Third-Party Guarantees: At June 30, 2006, the Company's third-party guarantees, which are primarily derived from acquisition and divestiture activities, approximated \$24 million. Substantially all of these guarantees expire through 2013, with \$12 million expiring through June 30, 2007. The Company is required to perform under these guarantees in the event that a third party fails to make contractual payments or achieve performance measures. The Company has a liability of \$16 million on its condensed consolidated balance sheet at June 30, 2006, relating to these guarantees.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 8. Goodwill and Other Intangible Assets, Net:

Goodwill by reportable segment was as follows:

	June 30, 2006 (in millions)	December 31, 2005
North America Beverages	\$ 1,372	\$ 1,372
North America Cheese & Foodservice	4,227	4,216
North America Convenient Meals	2,167	2,167
North America Grocery	3,058	3,058
North America Snacks & Cereals	8,965	8,990
European Union	4,178	3,858
Developing Markets, Oceania & North Asia	1,018	987
Total goodwill	\$ 24,985	\$ 24,648

Intangible assets were as follows:

	June 30, 2006 Gross Carrying Amount (in millions)	Accumulated Amortization	December 31, 2005 Gross Carrying Amount	Accumulated Amortization
Non-amortizable intangible assets	\$ 10,399		\$ 10,482	
Amortizable intangible assets	94	\$ 65	95	\$ 61
Total intangible assets	\$ 10,493	\$ 65	\$ 10,577	\$ 61

Non-amortizable intangible assets consist substantially of brand names purchased through the Nabisco acquisition. Amortizable intangible assets consist primarily of certain trademark licenses and non-compete agreements. Amortization expense for intangible assets was \$5 million for the six months ended June 30, 2006 and 2005, and \$3 million and \$2 million for the three months ended June 30, 2006 and 2005, respectively. Amortization expense for each of the next five years is currently estimated to be approximately \$10 million or less.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

The movement in goodwill and gross carrying amount of intangible assets from December 31, 2005, is as follows:

	Goodwill (in millions)	Intangible Assets
Balance at December 31, 2005	\$ 24,648	\$ 10,577
Changes due to:		
Currency	348	(3)
Asset impairment	(25)	(79)
Other	14	(2)
Balance at June 30, 2006	\$ 24,985	\$ 10,493

Note 9. Segment Reporting:

The Company manufactures and markets packaged food products, consisting principally of beverages, cheese, snacks, convenient meals and various packaged grocery products. Kraft manages and reports operating results through two units, Kraft North America Commercial and Kraft International Commercial. Reportable segments for Kraft North America Commercial are organized and managed principally by product category. Kraft International Commercial's operations are organized and managed by geographic location.

In October 2005, the Company announced that, effective January 1, 2006, its Canadian business will be realigned to better integrate it into the Company's North American business by product category. Beginning in the first quarter of 2006, the operating results of the Canadian business are being reported throughout the North American food segments. In addition, in the first quarter of 2006, the Company's international businesses were realigned to reflect the reorganization announced within Europe in November 2005. The two revised international segments are European Union; and Developing Markets, Oceania & North Asia, the latter to reflect the Company's increased management focus on developing markets. Accordingly, prior period segment results have been restated.

The Company's management uses operating companies income, which is defined as operating income before general corporate expenses and amortization of intangibles, to evaluate segment performance and allocate resources. Management believes it is appropriate to disclose this measure to help investors analyze the business performance and trends of the various business segments. Interest and other debt expense, net, and provision for income taxes are centrally managed and, accordingly, such items are not presented by segment since they are not included in the measure of segment profitability reviewed by management.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Segment data were as follows:

	For the Six Months Ended	
	June 30, 2006	2005
	(in millions)	
Net revenues:		
North America Beverages	\$ 1,614	\$ 1,543
North America Cheese & Foodservice	2,964	2,977
North America Convenient Meals	2,444	2,286
North America Grocery	1,422	1,549
North America Snacks & Cereals	3,144	2,949
European Union	3,006	3,203
Developing Markets, Oceania & North Asia	2,148	1,886
Net revenues	\$ 16,742	\$ 16,393
Earnings from continuing operations before income taxes and minority interest:		
Operating companies income:		
North America Beverages	\$ 262	\$ 288
North America Cheese & Foodservice	382	450
North America Convenient Meals	385	382
North America Grocery	498	411
North America Snacks & Cereals	411	437
European Union	215	387
Developing Markets, Oceania & North Asia	133	153
Amortization of intangibles	(5)	(5)
General corporate expenses	(86)	(96)
Operating income	2,195	2,407
Interest and other debt expense, net	(243)	(350)
Earnings from continuing operations before income taxes and minority interest	\$ 1,952	\$ 2,057
For the Three Months Ended		
	June 30,	
	2006	2005
	(in millions)	
Net revenues:		
North America Beverages	\$ 819	\$ 771
North America Cheese & Foodservice	1,495	1,487
North America Convenient Meals	1,230	1,146
North America Grocery	790	830
North America Snacks & Cereals	1,611	1,517
European Union	1,539	1,589
Developing Markets, Oceania & North Asia	1,135	994
Net revenues	\$ 8,619	\$ 8,334

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

	For the Three Months Ended	
	June 30,	
	2006	2005
	(in millions)	
Earnings from continuing operations before income taxes and minority interest:		
Operating companies income:		
North America Beverages	\$ 115	\$ 126
North America Cheese & Foodservice	179	231
North America Convenient Meals	185	184
North America Grocery	294	279
North America Snacks & Cereals	269	238
European Union	86	142
Developing Markets, Oceania & North Asia	98	105
Amortization of intangibles	(3)	(2)
General corporate expenses	(46)	(53)
Operating income	1,177	1,250
Interest and other debt expense, net	(147)	(174)
Earnings from continuing operations before income taxes and minority interest	\$ 1,030	\$ 1,076

As discussed in Note 2. *Asset Impairment, Exit and Implementation Costs*, the Company recorded asset impairment, exit and implementation costs of \$458 million and \$243 million, respectively, during the six months and three months ended June 30, 2006, and \$224 million and \$55 million, respectively, during the six months and three months ended June 30, 2005. See Note 2 for a breakdown of these pre-tax charges by segment.

During the second quarter of 2006, the Company sold its industrial coconut assets and recorded a pre-tax loss of \$8 million. This loss is included in the operating companies income of the North America Cheese & Foodservice segment. During the first quarter of 2006, the Company sold certain Canadian assets and recorded a pre-tax loss of \$1 million. This loss is included in the operating companies income of the North America Grocery segment. In addition, during the first quarter of 2006, the Company sold a small U.S. biscuit brand, resulting in a pre-tax loss of \$2 million. This loss is included in the operating companies income of the North America Snacks & Cereals segment.

During the second quarter of 2005, the Company sold its fruit snacks assets and recorded a pre-tax loss of \$2 million. This loss is included in the operating companies income of the North America Grocery segment. Also in the second quarter of 2005, the Company recorded a pre-tax gain of \$1 million from the sale of its U.S. yogurt assets. This gain is included in the operating companies income of the North America Cheese & Foodservice segment. During the first quarter of 2005, the Company sold its U.K. desserts assets and recorded a pre-tax gain of \$115 million. This gain is included in the operating companies income of the European Union segment. In addition, the Company sold a minor trademark in Mexico, resulting in a pre-tax gain of \$1 million. This gain is included in the operating companies income of the Developing Markets, Oceania & North Asia segment.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Net revenues by consumer sector, which include the separation of Foodservice into sector components, were as follows (in millions):

	For the Six Months Ended June 30, 2006			For the Six Months Ended June 30, 2005		
	Kraft North America Commercial	Kraft International Commercial	Total	Kraft North America Commercial	Kraft International Commercial	Total
Consumer Sector:						
Snacks	\$ 2,622	\$ 1,994	\$ 4,616	\$ 2,502	\$ 1,883	\$ 4,385
Beverages	1,744	1,868	3,612	1,671	1,829	3,500
Cheese & Dairy	2,343	744	3,087	2,341	765	3,106
Grocery	2,295	369	2,664	2,345	420	2,765
Convenient Meals	2,584	179	2,763	2,445	192	2,637
Net revenues	\$ 11,588	\$ 5,154	\$ 16,742	\$ 11,304	\$ 5,089	\$ 16,393

	For the Three Months Ended June 30, 2006			For the Three Months Ended June 30, 2005		
	Kraft North America Commercial	Kraft International Commercial	Total	Kraft North America Commercial	Kraft International Commercial	Total
Consumer Sector:						
Snacks	\$ 1,358	\$ 986	\$ 2,344	\$ 1,295	\$ 886	\$ 2,181
Beverages	890	994	1,884	840	964	1,804
Cheese & Dairy	1,171	386	1,557	1,147	396	1,543
Grocery	1,222	204	1,426	1,240	227	1,467
Convenient Meals	1,304	104	1,408	1,229	110	1,339
Net revenues	\$ 5,945	\$ 2,674	\$ 8,619	\$ 5,751	\$ 2,583	\$ 8,334

Note 10. Financial Instruments:

During the six months and three months ended June 30, 2006 and 2005, ineffectiveness related to cash flow hedges was not material. At June 30, 2006, the Company was hedging forecasted transactions for periods not exceeding the next eighteen months and expects substantially all amounts reported in accumulated other comprehensive earnings (losses) to be reclassified to the consolidated statement of earnings within the next twelve months.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Hedging activities affected accumulated other comprehensive earnings (losses), net of income taxes, as follows:

	For the Six Months Ended June 30, 2006 (in millions)		For the Three Months Ended June 30, 2006	
	2006	2005	2006	2005
(Loss) gain at beginning of period	\$ (4)	\$ 6	\$	\$ 27
Derivative losses (gains) transferred to earnings	10	(12)	1	(15)
Change in fair value	(9)	20	(4)	2
(Loss) gain as of June 30	\$ (3)	\$ 14	\$ (3)	\$ 14

Note 11. Benefit Plans:

The Company sponsors noncontributory defined benefit pension plans covering substantially all U.S. employees. Pension coverage for employees of the Company's non-U.S. subsidiaries is provided, to the extent deemed appropriate, through separate plans, many of which are governed by local statutory requirements. In addition, the Company's U.S. and Canadian subsidiaries provide health care and other benefits to substantially all retired employees. Health care benefits for retirees outside the United States and Canada are generally covered through local government plans.

*Pension Plans***Components of Net Periodic Benefit Cost**

Net periodic pension cost consisted of the following for the six months and three months ended June 30, 2006 and 2005:

	U.S. Plans For the Six Months Ended June 30, 2006 (in millions)		Non-U.S. Plans For the Six Months Ended June 30, 2006	
	2006	2005	2006	2005
Service cost	\$ 85	\$ 82	\$ 46	\$ 41
Interest cost	177	173	83	86
Expected return on plan assets	(252)	(254)	(99)	(97)
Amortization:				
Unrecognized net loss from experience differences	99	83	34	24
Prior service cost	3	2	4	4
Other expense	11	4		
Net periodic pension cost	\$ 112	\$ 97	\$ 68	\$ 62

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

	U.S. Plans For the Three Months Ended June 30, 2006 (in millions)		Non-U.S. Plans For the Three Months Ended June 30, 2006	
	2006	2005	2006	2005
Service cost	\$ 41	\$ 40	\$ 23	\$ 21
Interest cost	88	85	42	43
Expected return on plan assets	(127)	(128)	(50)	(49)
Amortization:				
Unrecognized net loss from experience differences	51	42	17	12
Prior service cost	2	1	2	2
Other expense				3
Net periodic pension cost	\$ 55	\$ 40	\$ 34	\$ 32

Other expense, above, is due primarily to additional pension benefits related to workforce reduction programs under the Company's restructuring program and is included as part of asset impairment and exit costs.

Employer Contributions

The Company presently makes, and plans to make, contributions, to the extent that they are tax deductible and do not generate an excise tax liability, in order to maintain plan assets in excess of the accumulated benefit obligation of its funded U.S. and non-U.S. plans. During the six months ended June 30, 2006, approximately \$135 million and approximately \$50 million of employer contributions were made to U.S. plans and non-U.S. plans, respectively. Currently, the Company anticipates making additional contributions of approximately \$15 million during the remainder of 2006 to its U.S. plans and approximately \$60 million during the remainder of 2006 to its non-U.S. plans, based on current tax law. However, these estimates are subject to change as a result of many factors, including changes in tax and other benefit laws, as well as asset performance significantly above or below the assumed long-term rate of return on pension assets, or significant changes in interest rates. During the six months ended June 30, 2005, approximately \$200 million and approximately \$50 million of employer contributions were made to U.S. plans and non-U.S. plans, respectively.

Postretirement Benefit Plans

Net postretirement health care costs consisted of the following for the six months and three months ended June 30, 2006 and 2005:

	For the Six Months Ended June 30, 2006 (in millions)		For the Three Months Ended June 30, 2006	
	2006	2005	2006	2005
Service cost	\$ 25	\$ 24	\$ 12	\$ 12
Interest cost	87	85	42	42
Amortization:				

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Unrecognized net loss from experience differences	41	29	16	15
Unrecognized prior service cost	(13)	(12)	(7)	(6)
Net postretirement health care costs	\$ 140	\$ 126	\$ 63	\$ 63

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Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 12. Income Taxes:

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. The U.S. accounts of the Company are included in the consolidated federal income tax return of Altria Group, Inc. Income taxes are generally computed on a separate company basis. To the extent that foreign tax credits, capital losses and other credits generated by the Company, which cannot currently be utilized on a separate company basis, are utilized in Altria Group, Inc.'s consolidated federal income tax return, the benefit is recognized in the calculation of the Company's provision for income taxes. The Company makes payments to, or is reimbursed by, Altria Group, Inc. for the tax effects resulting from its inclusion in Altria Group, Inc.'s consolidated federal income tax return, including current taxes payable and net changes in tax provisions. Significant judgment is required in determining income tax provisions and in evaluating tax positions. The Company establishes additional provisions for income taxes when, despite the belief that existing tax positions are fully supportable, there remain certain positions that are likely to be challenged and that may not be sustained on review by tax authorities. The Company evaluates and potentially adjusts these provisions in light of changing facts and circumstances. The consolidated tax provision includes the impact of changes to accruals deemed necessary. Upon the closure of current and future tax audits in various jurisdictions, significant income tax accrual reversals could continue to occur, which could trigger cash reimbursements from Altria Group, Inc.

The Company is regularly audited by federal, state and foreign tax authorities, and these audits are at various stages at any given time. Any tax contingency reserves in excess of additional assessed liabilities will be reversed at the time the audits close.

In the first quarter of 2006, the United States Internal Revenue Service concluded its examination of Altria Group, Inc.'s consolidated tax returns for the years 1996 through 1999 and issued a final Revenue Agents Report on March 15, 2006. Consequently, Altria Group, Inc. reimbursed the Company in cash for unrequired federal tax reserves of \$337 million and pre-tax interest of \$46 million (\$29 million after-tax). The Company also recognized net state tax reversals of \$39 million, resulting in a total net earnings benefit of \$405 million or \$0.24 per diluted share, for the six months ended June 30, 2006.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for the Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109, which will become effective for the Company on January 1, 2007. The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. The Company and Altria Group, Inc. are presently evaluating the impact of FASB Interpretation No. 48 and currently believe that its adoption will result in an increase to shareholders' equity on January 1, 2007, which might be significant.

Note 13. Subsequent Events:

United Biscuits Agreement

In July 2006, the Company announced an agreement with United Biscuits (UB) to acquire the Spanish and Portuguese operations of UB, and rights to all Nabisco trademarks in the European Union, Eastern Europe, the Middle East and Africa, which UB has held since 2000, for a total cost of approximately \$1.07 billion.

The Spanish and Portuguese operations of UB include its biscuits, dry desserts, canned meats, tomato and fruit juice businesses as well as seven UB manufacturing facilities and 1,300 employees. Together, these businesses generated net revenues of approximately \$400 million in 2005.

The acquisition will be financed by the Company's assumption of approximately \$548 million of debt issued by the acquired business immediately prior to the acquisition, as well as \$522 million of value for the redemption of the Company's outstanding investment in UB, primarily deep-discount securities. The redemption of the Company's interest in UB is expected to result in a gain on closing of approximately \$0.13 per diluted share, subject to currency movements and the finalization of income tax effects.

The transaction is expected to close in the third quarter of 2006, pending regulatory approval.

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Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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Rice Sale

On July 27, 2006, the Company announced that it had agreed to sell its rice brand and assets for approximately \$280 million. The transaction, which is subject to regulatory review, is expected to result in an after-tax gain of approximately \$160 million.

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Item 2.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Description of the Company

Kraft Foods Inc. (Kraft), together with its subsidiaries (collectively referred to as the Company), manufactures and markets packaged food products, consisting principally of beverages, cheese, snacks, convenient meals and various packaged grocery products. Kraft manages and reports operating results through two units, Kraft North America Commercial and Kraft International Commercial. Reportable segments for Kraft North America Commercial are organized and managed principally by product category. Kraft International Commercial's operations are organized and managed by geographic location. At June 30, 2006, Altria Group, Inc. held 98.4% of the combined voting power of Kraft's outstanding capital stock and owned 88.1% of the outstanding shares of Kraft's capital stock.

In October 2005, the Company announced that, effective January 1, 2006, its Canadian business will be realigned to better integrate it into the Company's North American business by product category. Beginning in the first quarter of 2006, the operating results of the Canadian business are being reported throughout the North American food segments. In addition, in the first quarter of 2006, the Company's international businesses were realigned to reflect the reorganization announced within Europe in November 2005. The two revised international segments, which are reflected in this report, are European Union and Developing Markets, Oceania & North Asia, the latter to reflect the Company's increased management focus on developing markets. Accordingly, prior period segment results have been restated.

In June 2005, the Company sold substantially all of its sugar confectionery business for pre-tax proceeds of approximately \$1.4 billion. The Company has reflected the results of its sugar confectionery business prior to the closing date as discontinued operations on the condensed consolidated statements of earnings. The Company recorded a loss on sale of discontinued operations of \$297 million in the second quarter of 2005, related largely to taxes on the transaction.

On June 26, 2006, it was announced that Irene B. Rosenfeld became Chief Executive Officer of the Company.

As previously communicated, for significant business reasons, the Altria Group, Inc. Board of Directors is looking at a number of restructuring alternatives, including the possibility of separating Kraft from the balance of Altria Group, Inc. Altria Group, Inc. has indicated that continuing improvements in its litigation environment are a prerequisite to such action by its Board of Directors, and the timing and chronology of events are uncertain.

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Executive Summary

The following executive summary is intended to provide significant highlights of the Discussion and Analysis that follows.

Consolidated Operating Results for the Six Months ended June 30, 2006 — The changes in the Company's earnings and diluted earnings per share (EPS) from continuing operations for the six months ended June 30, 2006 from the six months ended June 30, 2005 were due primarily to the following (in millions, except per share data):

	Earnings from Continuing Operations	Diluted EPS from Continuing Operations
For the six months ended June 30, 2005	\$ 1,457	\$ 0.86
2006 Asset impairment, exit and implementation costs - restructuring	(236)	(0.14)
2005 Asset impairment, exit and implementation costs - restructuring	89	0.05
2006 Asset impairments non-restructuring	(78)	(0.05)
2005 Asset impairments non-restructuring	60	0.04
2005 Gains on sales of businesses	(67)	(0.04)
Change in tax rate	(71)	(0.04)
Favorable resolution of the Altria Group, Inc. 1996-1999 IRS Tax Audit	405	0.24
Shares outstanding		0.02
Operations	129	0.08
For the six months ended June 30, 2006	\$ 1,688	\$ 1.02

See discussion of events affecting the comparability of statement of earnings amounts in the Consolidated Operating Results section of the following Discussion and Analysis.

The unfavorable net impact of asset impairment, exit and implementation costs on earnings and diluted EPS from continuing operations is due primarily to the following:

Restructuring Program – The Company announced a three-year restructuring program in January 2004. In January 2006, the Company announced plans to expand its restructuring efforts through 2008. During the six months ended June 30, 2006 and 2005, the Company recorded pre-tax charges of \$348 million (\$236 million after-tax) and \$131 million (\$89 million after-tax), respectively, for the restructuring plan, including pre-tax implementation costs of \$30 million and \$45 million, respectively.

Asset Impairment Charges – The Company incurred a pre-tax asset impairment charge of \$86 million (\$63 million after-tax) in the first quarter of 2006 in recognition of the sale of its pet snacks brand and assets, which was completed in the third quarter of 2006. The charge, which includes the write-off of a portion of the associated goodwill, and intangible and fixed assets, was recorded as asset impairment and exit costs on the condensed consolidated statement of earnings.

In addition, during the first quarter of 2006, the Company completed its annual review of goodwill and intangible assets and recorded non-cash pre-tax charges of \$24 million (\$15 million after-tax) related to an intangible asset impairment for biscuits assets in Egypt and hot cereal assets in the United States. These charges were recorded as asset impairment and exit costs on the condensed consolidated statement of earnings.

During the second quarter of 2005, the Company sold its fruit snacks assets for approximately \$30 million. The Company incurred a pre-tax asset impairment charge of \$93 million (\$60 million after-tax) in the first quarter of 2005 in recognition of the sale. The charge, which includes the write-off of all associated intangible assets, was recorded as asset impairment and exit costs on the condensed consolidated statement of earnings.

For further details on the restructuring program or asset impairment and implementation costs, see Note 2 to the Condensed Consolidated Financial Statements and the Business Environment section of the following Discussion and Analysis.

Gains on Sales of Businesses The unfavorable impact on earnings and diluted EPS from continuing operations is due primarily to the gain on the sale of the U.K. desserts assets in the first quarter of 2005.

Income Tax Benefit - The 2006 tax benefit reflects a reimbursement from Altria Group, Inc. in cash for unrequired federal tax reserves of \$337 million and pre-tax interest of \$46 million (\$29 million after-tax), as well as net state tax reversals of \$39 million, due to the conclusion of an audit of Altria Group, Inc.'s consolidated federal income tax returns for the years 1996 through 1999. Income taxes also include a benefit of \$48 million in 2006 and \$56 million in 2005 from the resolution of outstanding items in the Company's international operations, and \$24 million in 2005 from the settlement of an outstanding U.S. tax claim. The 2005 income tax rate also includes benefits from the dividend repatriation provision of the American Jobs Creation Act.

Operations - The \$129 million increase in results from operations was due primarily to the following:

- Higher income in North America Snacks & Cereals, reflecting higher volume/mix, higher pricing and lower marketing costs, partially offset by higher commodity costs and increased promotional spending.
- Higher income in North America Convenient Meals, reflecting higher pricing, lower commodity costs and higher volume/mix.
- Higher income in Developing Markets, Oceania & North Asia, reflecting favorable volume/mix and higher pricing, partially offset by increased marketing spending.
- Higher income in the European Union, reflecting lower general and administrative costs and favorable volume/mix.
- Lower interest and other debt expense, reflecting lower debt levels and the redemption of higher coupon Nabisco bonds, partially offset by higher short-term interest rates.

Partially offset by:

- Lower income in North America Beverages, reflecting higher commodity and fixed manufacturing costs, partially offset by favorable volume/mix and higher pricing.

For further details, see the Consolidated Operating Results and Operating Results by Business Segment sections of the following Discussion and Analysis.

Consolidated Operating Results for the Three Months ended June 30, 2006 — The changes in the Company's earnings and diluted earnings per share (EPS) from continuing operations for the three months ended June 30, 2006 from the three months ended June 30, 2005 were due primarily to the following (in millions, except per share data):

	Earnings from Continuing Operations	Diluted EPS from Continuing Operations
For the three months ended June 30, 2005	\$ 758	\$ 0.45
2006 Asset impairment, exit and implementation costs - restructuring	(162)	(0.10)
2005 Asset impairment, exit and implementation costs - restructuring	37	0.02
Change in tax rate	(44)	(0.03)
Shares outstanding		0.01
Operations	93	0.06
For the three months ended June 30, 2006	\$ 682	\$ 0.41

See discussion of events affecting the comparability of statement of earnings amounts in the Consolidated Operating Results section of the following Discussion and Analysis.

The unfavorable net impact of asset impairment, exit and implementation costs on earnings and diluted EPS from continuing operations is due primarily to the following:

Restructuring Program – During the three months ended June 30, 2006 and 2005, the Company recorded pre-tax charges of \$243 million (\$162 million after-tax) and \$55 million (\$37 million after-tax), respectively, for the restructuring plan, including pre-tax implementation costs of \$17 million and \$26 million, respectively.

For further details on the restructuring program or asset impairment and implementation costs, see Note 2 to the Condensed Consolidated Financial Statements and the Business Environment section of the following Discussion and Analysis.

Higher Income Tax Rate The Company's income tax rate increased by 4.3 percentage points to 33.7%, due primarily to the settlement of an outstanding U.S. tax claim of \$24 million in 2005 and benefits in 2005 from the dividend repatriation provision of the American Jobs Creation Act.

Operations - The \$93 million increase in results from operations was due primarily to the following:

- Higher income in North America Convenient Meals, reflecting higher pricing, lower commodity costs and higher volume/mix.
- Higher income in North America Snacks & Cereals, reflecting higher volume/mix, lower marketing costs and higher pricing, partially offset by higher commodity costs and increased promotional spending.
- Higher income in European Union, reflecting higher pricing and higher volume/mix, partially offset by increased promotional spending.
- Higher income in North America Grocery, reflecting favorable volume/mix and higher pricing, partially offset by higher commodity costs.

- Higher income in North America Cheese & Foodservice, reflecting favorable volume/mix and lower commodity costs, partially offset by higher marketing costs and increased promotional spending, net of higher pricing.
- Lower interest and other debt expense, reflecting lower debt levels and the redemption of higher coupon Nabisco bonds, partially offset by higher short-term interest rates.

For further details, see the Consolidated Operating Results and Operating Results by Business Segment sections of the following Discussion and Analysis.

2006 Forecasted Results In July 2006, the Company increased its full-year diluted EPS guidance for 2006 to \$1.78 to \$1.83, or by \$0.23 per diluted share, to reflect an anticipated third quarter \$0.13 one-time gain related to Kraft's redemption of its interest in United Biscuits, subject to currency movements and the finalization of income tax effects, and \$0.10 in lower asset impairment, exit and implementation costs.

Guidance now includes \$0.40 per diluted share of charges attributable to the Company's restructuring program and other impairment charges (versus \$0.50 previously) and a loss of \$0.07 per diluted share for divestiture of the pet snacks business, partially offset by the anticipated \$0.13 per diluted share one-time gain on the redemption of the Company's interest in United Biscuits, subject to currency movements and the finalization of income tax effects, and \$0.24 per diluted share for the favorable resolution of the Altria Group, Inc. 1996-1999 IRS Tax Audit.

On July 27, 2006, the Company announced that it had agreed to sell its rice brand and assets for approximately \$280 million. The transaction, which is subject to regulatory review, is expected to result in an after-tax gain of approximately \$160 million (\$0.10 per diluted share). The gain has not been included in the guidance amounts above since the sale is subject to regulatory review, the timing of which cannot currently be estimated.

The Company expects charges attributable to the restructuring program and other impairment charges to total approximately \$1 billion in 2006 (versus the \$1.3 billion estimated previously) due to the timing of program announcements. There is no change to the full program. In addition, there is no change to the Company's expectation that cumulative savings will reach approximately \$560 million by the end of 2006.

The Company currently forecasts its 2006 effective income tax rate to average 33%, excluding charges for asset impairment, exit and implementation costs; and the impacts of the IRS tax audit resolution. The factors described in the Risk Factors section of the Company's Annual Report on Form 10-K for the year ended December 31, 2005 and the Business Environment section below represent continuing risks to these forecasts.

Discussion and Analysis

Business Environment

The Company is subject to a number of challenges that may adversely affect its businesses. These challenges, which are discussed below and under the Risk Factors section of the Company's Annual Report on Form 10-K for the year ended December 31, 2005, include:

- fluctuations in commodity prices;
- movements of foreign currencies;
- competitive challenges in various products and markets, including price gaps with competitor products and the increasing price-consciousness of consumers;

- a rising cost environment and the limited ability to increase prices;
- a trend toward increasing consolidation in the retail trade and consequent pricing pressure and inventory reductions;
- a growing presence of discount retailers, primarily in Europe, with an emphasis on own-label products;
- changing consumer preferences, including diet and health/wellness trends;
- competitors with different profit objectives and less susceptibility to currency exchange rates; and
- concerns and/or regulations regarding food safety, quality and health, including genetically modified organisms, trans-fatty acids and obesity. Increased government regulation of the food industry could result in increased costs to the Company.

In the ordinary course of business, the Company is subject to many influences that can impact the timing of sales to customers, including the timing of holidays and other annual or special events, seasonality of certain products, significant weather conditions, timing of Company or customer incentive programs and pricing actions, customer inventory programs, Company initiatives to improve supply chain efficiency, financial condition of customers and general economic conditions. For instance, changes in the timing of the Easter holiday will often affect first and second quarter comparisons with the prior year.

Fluctuations in commodity costs can lead to retail price volatility and intense price competition, and can influence consumer and trade buying patterns. During the first six months of 2006, the Company's commodity costs on average have been higher than those incurred during the first six months of 2005 (most notably higher coffee, energy and packaging costs, partially offset by lower cheese and meat costs), and have adversely affected earnings. For the first six months of 2006, the Company's commodity costs were approximately \$170 million higher than the first six months of 2005.

Restructuring

In January 2004, the Company announced a three-year restructuring program (which is discussed further in Note 2. *Asset Impairment, Exit and Implementation Costs*) with the objectives of leveraging the Company's global scale, realigning and lowering its cost structure, and optimizing capacity utilization. In January 2006, the Company announced plans to expand its restructuring efforts through 2008. The entire restructuring program is expected to result in \$3.7 billion in pre-tax charges, the closure of up to 40 facilities, the elimination of approximately 14,000 positions and annualized cost savings at the completion of the program of approximately \$1.15 billion. Approximately \$2.3 billion of the \$3.7 billion in pre-tax charges are expected to require cash payments. Pre-tax restructuring program charges during 2006 are expected to be approximately \$1 billion. Total pre-tax restructuring program charges incurred were \$348 million and \$131 million in the six months ended June 30, 2006 and 2005, respectively, and \$243 million and \$55 million in the three months ended June 30, 2006 and 2005, respectively. Total pre-tax restructuring charges for the program incurred from January 2004 through June 30, 2006 were \$1.3 billion and specific programs announced will result in the elimination of approximately 8,600 positions. Approximately 60% of the pre-tax charges to date are expected to require cash payments. In July 2006, the Company announced that full-year 2006 charges attributable to the restructuring program and other impairment charges is estimated to be approximately \$1 billion, down from the previous estimate of \$1.3 billion due to the timing of program announcements. There is no change to the full program. In addition, there is no change to the Company's expectation that cumulative savings will reach approximately \$560 million by the end of 2006.

In addition, the Company expects to incur approximately \$575 million in capital expenditures to implement the restructuring program. From January 2004 through June 30, 2006, the Company spent approximately \$166 million in capital, including \$22 million spent in the first six

months of 2006, to implement the restructuring program. Cumulative annualized cost savings as a result of the restructuring program were approximately \$260 million through 2005, and are anticipated to reach approximately \$560 million by the end of 2006, all of which are expected to be used in support of brand-building initiatives. Through June 30, 2006, cumulative annualized cost savings for the program to date totaled approximately \$385 million.

Acquisitions and Dispositions:

One element of the Company's growth strategy is to strengthen its brand portfolios and/or expand its geographic reach through a disciplined program of selective acquisitions and divestitures. The Company is constantly reviewing potential acquisition candidates and from time to time sells businesses to accelerate the shift in its portfolio toward businesses—whether global, regional or local—that offer the Company a sustainable competitive advantage. The impact of any future acquisition or divestiture could have a material impact on the Company's consolidated financial position, results of operations or cash flows, and future sales of businesses could in some cases result in losses on sale.

In July 2006, the Company announced an agreement with United Biscuits (UB) to acquire the Spanish and Portuguese operations of UB and rights to all Nabisco trademarks in the European Union, Eastern Europe, the Middle East and Africa, which UB has held since 2000, for a total cost of approximately \$1.07 billion. The Spanish and Portuguese operations of UB include its biscuits, dry desserts, canned meats, tomato and fruit juice businesses as well as seven UB manufacturing facilities and 1,300 employees. Together, these businesses generated net revenues of approximately \$400 million in 2005. The acquisition will be financed by the Company's assumption of approximately \$548 million of debt issued by the acquired business immediately prior to the acquisition, as well as \$522 million of value for the redemption of the Company's outstanding investment in UB, primarily deep-discount securities. The redemption of the Company's interest in UB is expected to result in a gain on closing of approximately \$0.13 per diluted share, subject to currency movements and the finalization of income tax effects. The transaction is expected to close in the third quarter of 2006, pending regulatory approval.

As previously discussed, the Company sold substantially all of its sugar confectionery business in June 2005 for pre-tax proceeds of approximately \$1.4 billion. The sale included the *Life Savers*, *Creme Savers*, *Altoids*, *Trolli* and *Sugus* brands. The Company has reflected the results of its sugar confectionery business prior to the closing date as discontinued operations on the condensed consolidated statements of earnings. The Company recorded a loss on sale of discontinued operations of \$297 million in the second quarter of 2005, related largely to taxes on the transaction.

During the second quarter of 2006, the Company sold its industrial coconut assets. During the first quarter of 2006, the Company sold certain Canadian assets and a small U.S. biscuit brand and incurred pre-tax asset impairment charges of \$176 million in the fourth quarter of 2005 in recognition of these sales. During the second quarter of 2005, the Company sold its fruit snacks assets, and incurred a pre-tax asset impairment charge of \$93 million in the first quarter of 2005 in recognition of this sale. During the first quarter of 2005, the Company sold its U.K. desserts assets, its U.S. yogurt assets and a minor trademark in Mexico. The aggregate proceeds received from these sales during the first six months of 2006 and 2005 were \$91 million and \$221 million, respectively, on which pre-tax losses of \$11 million and pre-tax gains of \$115 million, respectively, were recorded.

In July 2006, the Company completed the sale of its pet snacks brand and assets for \$580 million and recorded additional taxes of approximately \$60 million related to the sale. This sale and the additional taxes were recorded in the third quarter of 2006. In the first quarter of 2006, the Company incurred a pre-tax asset impairment charge of \$86 million in recognition of this sale.

The operating results of the businesses sold, excluding the sugar confectionery business, in the aggregate, were not material to the Company's consolidated financial position, results of operations or cash flows in any of the periods presented.

Consolidated Operating Results

	For the Six Months Ended June 30,	
	2006	2005
	(in millions, except per share data)	
Volume (in pounds)	9,179	9,467
Net revenues	\$ 16,742	\$ 16,393
Operating income:		
Operating companies income:		
North America Beverages	\$ 262	\$ 288
North America Cheese & Foodservice	382	450
North America Convenient Meals	385	382
North America Grocery	498	411
North America Snacks & Cereals	411	437
European Union	215	387
Developing Markets, Oceania & North Asia	133	153
Amortization of intangibles	(5)	(5)
General corporate expenses	(86)	(96)
Operating income	\$ 2,195	\$ 2,407
Net earnings:		
Earnings from continuing operations	\$ 1,688	\$ 1,457
Loss from discontinued operations, net of income taxes		(272)
Net earnings	\$ 1,688	\$ 1,185
Weighted average shares for diluted earnings per share	1,661	1,701
Diluted earnings per share:		
Continuing operations	\$ 1.02	\$ 0.86
Discontinued operations		(0.16)
Net earnings	\$ 1.02	\$ 0.70

Consolidated Operating Results

	For the Three Months Ended June 30,	
	2006	2005
	(in millions, except per share data)	
Volume (in pounds)	4,837	4,921
Net revenues	\$ 8,619	\$ 8,334
Operating income:		
Operating companies income:		
North America Beverages	\$ 115	\$ 126
North America Cheese & Foodservice	179	231
North America Convenient Meals	185	184
North America Grocery	294	279
North America Snacks & Cereals	269	238
European Union	86	142
Developing Markets, Oceania & North Asia	98	105
Amortization of intangibles	(3)	(2)
General corporate expenses	(46)	(53)
Operating income	\$ 1,177	\$ 1,250
Net earnings:		
Earnings from continuing operations	\$ 682	\$ 758
Loss from discontinued operations, net of income taxes		(286)
Net earnings	\$ 682	\$ 472
Weighted average shares for diluted earnings per share	1,656	1,698