

YUM BRANDS INC  
Form 10-Q  
October 18, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

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**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 September 9, 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 1-13163**

**YUM! BRANDS, INC.**

(Exact name of registrant as specified in its charter)

North Carolina

(State or other jurisdiction of incorporation or organization)

13-3951308

(I.R.S. Employer Identification No.)

1441 Gardiner Lane, Louisville, Kentucky

(Address of principal executive offices)

40213

(Zip Code)

Registrant's telephone number, including area code: (502) 874-8300

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 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

The number of shares outstanding of the Registrant's Common Stock as of October 10, 2006 was 265,076,421 shares.

**YUM! BRANDS, INC.**

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**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)**

## YUM! BRANDS, INC. AND SUBSIDIARIES

(in millions, except per share data)

	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
<b>Revenues</b>				
Company sales	\$ 1,989	\$ 1,975	\$ 5,720	\$ 5,687
Franchise and license fees	289	268	825	763
Total revenues	2,278	2,243	6,545	6,450
<b>Costs and Expenses, Net</b>				
Company restaurants				
Food and paper	606	619	1,746	1,793
Payroll and employee benefits	492	501	1,461	1,493
Occupancy and other operating expenses	570	561	1,607	1,582
	1,668	1,681	4,814	4,868
General and administrative expenses	271	264	789	784
Franchise and license expenses	7	12	24	24
Closures and impairment expenses	1	17	25	43
Refranchising (gain) loss	4	(10)	(7)	(21)
Other (income) expense	(17)	(27)	(33)	(66)
Wrench litigation (income) expense		(2)		(2)
AmeriServe and other charges (credits)				
Total costs and expenses, net	1,934	1,935	5,612	5,630
<b>Operating Profit</b>	344	308	933	820
Interest expense, net	34	28	105	86
<b>Income Before Income Taxes</b>	310	280	828	734
Income tax provision	80	75	236	198
<b>Net Income</b>	\$ 230	\$ 205	\$ 592	\$ 536
<b>Basic Earnings Per Common Share</b>	\$ 0.86	\$ 0.72	\$ 2.18	\$ 1.86
<b>Diluted Earnings Per Common Share</b>	\$ 0.83	\$ 0.69	\$ 2.10	\$ 1.78
<b>Dividends Declared Per Common Share</b>	\$	\$	\$ 0.265	\$ 0.215

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

YUM! BRANDS, INC. AND SUBSIDIARIES

(in millions)

	Year to date	
	9/09/06	9/03/05
<b>Cash Flows - Operating Activities</b>		
Net income	\$ 592	\$ 536
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	319	319
Closures and impairment expenses	25	43
Refranchising (gain) loss	(7 )	(21 )
Contributions to defined benefit pension plans	(41 )	
Other liabilities and deferred credits	71	37
Deferred income taxes	(47 )	(80 )
Equity income from investments in unconsolidated affiliates	(37 )	(39 )
Distributions of income received from unconsolidated affiliates	26	21
Excess tax benefits from share-based compensation	(40 )	(67 )
Share-based compensation expense	46	43
Other non-cash charges and credits, net	59	20
Changes in operating working capital, excluding effects of acquisitions and dispositions:		
Accounts and notes receivable	22	(22 )
Inventories	7	7
Prepaid expenses and other current assets	(10 )	70
Accounts payable and other current liabilities	(47 )	42
Income taxes payable	69	86
Net change in operating working capital	41	183
<b>Net Cash Provided by Operating Activities</b>	<b>1,007</b>	<b>995</b>
<b>Cash Flows - Investing Activities</b>		
Capital spending	(323 )	(362 )
Proceeds from refranchising of restaurants	96	79
Acquisition of restaurants from franchisees	(11 )	
Short-term investments	(79 )	(32 )
Sales of property, plant and equipment	33	25
Other, net	(16 )	20
<b>Net Cash Used in Investing Activities</b>	<b>(300 )</b>	<b>(270 )</b>
<b>Cash Flows - Financing Activities</b>		
Proceeds from Senior Unsecured Notes	300	
Revolving Credit Facility activity		
Three months or less, net	(26 )	78
Repayments of long-term debt	(207 )	(11 )
Short-term borrowings-three months or less, net	162	(32 )
Repurchase shares of common stock	(853 )	(678 )
Excess tax benefits from share-based compensation	40	67
Employee stock option proceeds	93	113
Dividends paid on common shares	(104 )	(91 )
Other, net	(2 )	
<b>Net Cash Used in Financing Activities</b>	<b>(597 )</b>	<b>(554 )</b>
<b>Effect of Exchange Rates on Cash and Cash Equivalents</b>	<b>3</b>	<b>(4 )</b>
<b>Net Increase in Cash and Cash Equivalents</b>	<b>113</b>	<b>167</b>
<b>Net Increase in Cash and Cash Equivalents of Mainland China for December 2004</b>		<b>34</b>
<b>Cash and Cash Equivalents - Beginning of Period</b>	<b>158</b>	<b>62</b>
<b>Cash and Cash Equivalents - End of Period</b>	<b>\$ 271</b>	<b>\$ 263</b>
<b>Significant Non-Cash Investing and Financing Activities:</b>		
Accrual for repurchase of shares of common stock	\$ 14	
Additional capital lease obligations	\$ 11	\$ 3
See accompanying Notes to Condensed Consolidated Financial Statements.		

## CONDENSED CONSOLIDATED BALANCE SHEETS

## YUM! BRANDS, INC. AND SUBSIDIARIES

(in millions)

	(Unaudited)	
	9/09/06	12/31/05
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 271	\$ 158
Short-term investments	123	43
Accounts and notes receivable, less allowance: \$16 in 2006 and \$23 in 2005	223	236
Inventories	80	85
Prepaid expenses and other current assets	90	75
Deferred income taxes	150	163
Advertising cooperative assets, restricted	99	77
<b>Total Current Assets</b>	<b>1,036</b>	<b>837</b>
Property, plant and equipment, net of accumulated depreciation and amortization of \$2,994 in 2006 and \$2,830 in 2005	3,276	3,356
Goodwill	546	538
Intangible assets, net	338	330
Investments in unconsolidated affiliates	190	173
Other assets	515	464
<b>Total Assets</b>	<b>\$5,901</b>	<b>\$5,698</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable and other current liabilities	\$ 1,212	\$ 1,238
Income taxes payable	103	79
Short-term borrowings	173	211
Advertising cooperative liabilities	99	77
<b>Total Current Liabilities</b>	<b>1,587</b>	<b>1,605</b>
Long-term debt	1,932	1,649
Other liabilities and deferred credits	1,054	995
<b>Total Liabilities</b>	<b>4,573</b>	<b>4,249</b>
<b>Shareholders Equity</b>		
Preferred stock, no par value, 250 shares authorized; no shares issued		
Common stock, no par value, 750 shares authorized; 265 shares and 278 shares issued in 2006 and 2005, respectively		
Retained earnings	1,462	1,619
Accumulated other comprehensive loss	(134 )	(170 )
<b>Total Shareholders Equity</b>	<b>1,328</b>	<b>1,449</b>
<b>Total Liabilities and Shareholders Equity</b>	<b>\$5,901</b>	<b>\$5,698</b>

See accompanying Notes to Condensed Consolidated Financial Statements.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

(Tabular amounts in millions, except per share data)

**1. Financial Statement Presentation**

We have prepared our accompanying unaudited Condensed Consolidated Financial Statements ( Financial Statements ) in accordance with the rules and regulations of the Securities and Exchange Commission ( SEC ) for interim financial information. Accordingly, they do not include all of the information and footnotes required by United States generally accepted accounting principles for complete financial statements. Therefore, we suggest that the accompanying Financial Statements be read in conjunction with the Consolidated Financial Statements and notes thereto included in our annual report on Form 10-K for the fiscal year ended December 31, 2005 ( 2005 Form 10-K ). Except as disclosed herein, there has been no material change in the information disclosed in the notes to our Consolidated Financial Statements included in the 2005 Form 10-K.

Our Financial Statements include YUM! Brands, Inc. and its wholly-owned subsidiaries (collectively referred to as YUM or the Company ). The Financial Statements include the worldwide operations of KFC, Pizza Hut, Taco Bell, Long John Silver s ( LJS ) and A&W All-American Food Restaurants ( A&W ) (collectively the Concepts ). References to YUM throughout these notes to our Financial Statements are made using the first person notations of we, us or our.

Our preparation of the accompanying Financial Statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the Financial Statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from the estimates.

In our opinion, the accompanying Financial Statements include all normal and recurring adjustments considered necessary to present fairly, when read in conjunction with our 2005 Form 10-K, our financial position as of September 9, 2006, the results of our operations for the quarters and years to date ended September 9, 2006 and September 3, 2005 and cash flows for the years to date ended September 9, 2006 and September 3, 2005. Our results of operations for these interim periods are not necessarily indicative of the results to be expected for the full year.

Our significant interim accounting policies include the recognition of certain advertising and marketing costs, generally in proportion to revenue, and the recognition of income taxes using an estimated annual effective tax rate.

We have reclassified certain items in the accompanying Financial Statements and Notes to the Financial Statements in order to be comparable with the current classifications. These reclassifications had no effect on previously reported net income.

**2. Share-Based Compensation**

In the fourth quarter 2005, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (Revised 2004), Share-Based Payment ( SFAS 123R ), which replaced SFAS No. 123 Accounting for Stock-Based Compensation ( SFAS 123 ), superseded APB 25, Accounting for Stock Issued to Employees and related interpretations and amended SFAS No. 95, Statement of Cash Flows. We adopted SFAS 123R using the

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modified retrospective application transition method effective September 4, 2005, the beginning of our fourth quarter in 2005. As permitted by SFAS 123R, we applied the modified retrospective application transition method to the beginning of the fiscal year of adoption (our fiscal year 2005). As such, the results for the first three quarters of 2005, including the quarter and year to date ended September 3, 2005, were adjusted to

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recognize the compensation cost previously reported in the pro forma footnote disclosures under the provisions of SFAS 123.

The following table details the impact of adopting SFAS 123R by financial statement line item.

	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
Payroll and employee benefits	\$2	\$2	\$6	\$7
General and administrative	12	12	36	33
Operating profit	14	14	42	40
Income tax benefit	(6 )	(5 )	(15 )	(14 )
Net income	\$8	\$9	\$27	\$26

During the year to date ended September 9, 2006, we have granted 4.0 million stock appreciation rights to employees to redeem shares of our Common Stock at an exercise price equal to the average market price on the date of grant. The weighted-average exercise price of these stock appreciation rights was approximately \$49.

### 3. Earnings Per Common Share ( EPS )

	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
Net income	\$230	\$205	\$592	\$536
Weighted-average common shares outstanding (for basic calculation)	268	285	272	288
Effect of dilutive share-based employee compensation	9	13	10	13
Weighted-average common and common equivalent shares outstanding (for diluted calculation)	277	298	282	301
Basic EPS	\$0.86	\$0.72	\$2.18	\$1.86
Diluted EPS	\$0.83	\$0.69	\$2.10	\$1.78
Unexercised employee stock options and stock appreciation rights (in millions) excluded from the diluted EPS computation <sup>(a)</sup>	0.8	0.8	0.8	0.4

(a) These unexercised employee stock options and stock appreciation rights were not included in the computation of diluted EPS because their exercise prices were greater than the average market price of our Common Stock during the respective quarter and year to dates ended.



**4. Shareholders' Equity**

We had dividends payable of zero and \$32 million at September 9, 2006 and December 31, 2005, respectively. Subsequent to the third quarter on September 14, 2006, we declared a cash dividend of \$0.15 per share of Common Stock to be distributed on November 4, 2006 to shareholders of record at the close of business on October 13, 2006.

We repurchased shares of our Common Stock under the following share repurchase programs during the years to date ended September 9, 2006 and September 3, 2005. All amounts exclude applicable transaction fees.

Program Authorization Date	Shares Repurchased (thousands)		Dollar Value of Shares Repurchased	
	2006	2005	2006	2005
March 2006	8,269		\$ 398	\$
November 2005	9,564		469	
May 2005		3,056		153
January 2005		9,963		500
May 2004		534		25
Total	17,833(a)	13,553	\$ 867(a)	\$ 678

(a) Amounts include effects of \$14 million in share repurchases (0.3 million shares) with trade dates prior to the third quarter end but cash settlement dates subsequent to the third quarter end.

As of September 9, 2006, we have approximately \$100 million available for future repurchases (includes the impact of shares repurchased but not yet cash settled as described above) under our March 2006 share repurchase program. On September 14, 2006, our Board of Directors authorized an additional share repurchase program allowing us to repurchase, through September 2007, up to \$500 million (excluding applicable transaction fees) of our outstanding Common Stock. Based on market conditions and other factors, repurchases may be made from time to time in the open market or through privately negotiated transactions at the discretion of the Company.

Comprehensive income was as follows:

	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
Net income	\$ 230	\$ 205	\$ 592	\$ 536
Foreign currency translation adjustment arising during the period	8	(7 )	31	(16 )
Changes in fair value of derivatives, net of tax	(1 )		9	1
Reclassification of derivative (gains) losses to net income, net of tax	2		(4 )	(1 )
Total comprehensive income	\$ 239	\$ 198	\$ 628	\$ 520

**5. New Accounting Pronouncements Not Yet Recognized**

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In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ), an interpretation of FASB Statement No. 109,

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Accounting for Income Taxes. FIN 48 requires that a position taken or expected to be taken in a tax return be recognized in the financial statements when it is more likely than not (i.e. a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. We have not yet determined the impact of the recognition and measurement requirements of FIN 48 on our existing tax positions. Upon adoption, the cumulative effect of applying the recognition and measurement provisions of FIN 48, if any, shall be reflected as an adjustment to the opening balance of retained earnings.

FIN 48 requires that subsequent to initial adoption a change in judgment that results in subsequent recognition, derecognition or change in a measurement of a tax position taken in a prior annual period (including any related interest and penalties) be recognized as a discrete item in the period in which the change occurs. Currently, we record such changes in judgment, including audit settlements, as a component of our annual effective rate. Thus, our reported quarterly income tax rate may become more volatile upon adoption of FIN 48. This change will not impact the manner in which we record income tax expense on an annual basis.

FIN 48 also requires expanded disclosures including identification of tax positions for which it is reasonably possible that total amounts of unrecognized tax benefits will significantly change in the next twelve months, a description of tax years that remain subject to examination by major tax jurisdiction, a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of each annual reporting period, the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate and the total amounts of interest and penalties recognized in the statements of operations and financial position. FIN 48 is effective for fiscal years beginning after December 15, 2006, the year beginning December 31, 2006 for the Company.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measures ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measures required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, the year beginning December 30, 2007 for the Company. We are currently reviewing the provisions of SFAS 157 to determine the impact for the Company.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans ( SFAS 158 ). SFAS 158 amends SFAS 87, Employers Accounting for Pensions ( SFAS 87 ), SFAS 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Plans and for Termination Benefits ( SFAS 88 ), SFAS 106, Employers Accounting for Postretirement Benefits Other Than Pensions ( SFAS 106 ) and SFAS 132(R), Employers Disclosures about Pensions and Other Postretirement Benefits.

Effective for fiscal years ending after December 15, 2006, SFAS 158 requires balance sheet recognition of the funded status for all pension and postretirement benefit plans. The impact of initial adjustment shall be recorded as an adjustment of the ending balance of other comprehensive income. Subsequent changes in funded status shall also be recognized as a component of other comprehensive income to the extent they have not yet been recognized as a component of net periodic benefit cost pursuant to SFAS 87, SFAS 88 or SFAS 106. As further described in Note 9, we have pension and postretirement benefit plans that will be subject to the provisions of SFAS 158. At this time we cannot yet determine what the funded status of these plans will be at December 30, 2006, the end of our fiscal year. However, we do not anticipate that any adjustment to our Consolidated Balance Sheet would significantly impact our financial condition.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ), which provides interpretive guidance on the consideration of the effects of

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prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 is effective as of the end of our 2006 fiscal year, allowing a one-time transitional cumulative effect adjustment to beginning retained earnings as of January 1, 2006 for errors that were not previously deemed material, but are material under the guidance in SAB 108. We are currently evaluating the impact of adopting SAB 108 on our financial statements.

### 6. Facility Actions

Refranchising (gain) loss, store closure costs (income) and store impairment charges by reportable segment are as follows:

	Quarter ended September 9, 2006			
	U.S.	International	China	Worldwide
Refranchising (gain) loss <sup>(a)</sup>	\$6	\$ (2 )	\$	\$4
Store closure costs (income) <sup>(b)</sup>	\$ (3 )	\$	\$ (1 )	\$ (4 )
Store impairment charges	3	1	1	5
Closure and impairment expenses	\$	\$1	\$	\$1

	Quarter ended September 3, 2005			
	U.S.	International	China	Worldwide
Refranchising (gain) loss <sup>(a)</sup>	\$ (10 )	\$	\$	\$ (10 )
Store closure costs (income)	\$4	\$1	\$	\$5
Store impairment charges <sup>(c)</sup>	9	3	1	12
Closure and impairment expenses	\$13	\$4	\$	\$17

	Year to date ended September 9, 2006			
	U.S.	International	China	Worldwide
Refranchising (gain) loss <sup>(a)</sup>	\$ (4 )	\$ (3 )	\$	\$ (7 )
Store closure costs (income) <sup>(b)</sup>	\$ (1 )	\$1	\$ (1 )	\$ (1 )
Store impairment charges	16	7	3	26
Closure and impairment expenses	\$15	\$8	\$2	\$25

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Year to date ended September 3, 2005

	International	China		
	U.S.	Division	Division	Worldwide
Refranchising (gain) loss <sup>(a)</sup>	\$(22 )	\$1	\$	\$(21 )
Store closure costs (income)	\$3	\$1	\$	\$4
Store impairment charges	32	5	2	39
Closure and impairment expenses	\$35	\$6	\$2	\$43

(a) Refranchising (gain) loss is not allocated to segments for performance reporting purposes.

(b) The income in store closures is primarily the result of gains from the sale of properties on which we formerly operated restaurants or adjustments to previously recorded lease reserves as a result of changes in settlement and/or sublease estimates.

(c) Store impairment charges in the quarter ended September 3, 2005 in the U.S. segment primarily resulted from decisions to close certain KFC and LJS restaurants.

### 7. Other (Income) Expense

	Quarter		Year to date		
	9/09/06	9/03/05	9/09/06	9/03/05	
Gain upon sale of investment in unconsolidated affiliate <sup>(a)</sup>	\$(2 )	\$	\$(2 )	\$(17 )	
Recovery from supplier <sup>(b)</sup>		(12 )		(12 )	
Equity income from investments in unconsolidated affiliates	(16 )	(16 )	(37 )	(39 )	
Contract termination charge <sup>(c)</sup>			8		
Foreign exchange (gain) loss and other	1	1	(2 )	2	
Other (income) expense	\$(17 )	\$(27 )	\$(33 )	\$(66 )	

Dividends received from unconsolidated affiliates were approximately \$26 million and \$21 million for the years to date ended September 9, 2006 and September 3, 2005, respectively.

(a) Reflects gains related to the 2005 sale of our fifty percent interest in the entity that operated almost all KFCs and Pizza Huts in Poland and the Czech Republic to our then partner in the entity. In the fourth quarter of 2005, we recorded a \$6 million reduction to correct the gain previously recorded in 2005 associated with this transaction.

(b) Relates to a financial recovery from a supplier ingredient issue in mainland China totaling \$14 million for the quarter ended September 9, 2005, \$2 million of which was recognized through equity income from investments in unconsolidated affiliates. Our KFC business in mainland China was negatively impacted by the interruption of product offerings and negative publicity associated with a supplier ingredient issue experienced in late March 2005. During the year ended December 31, 2005, we entered into agreements with the supplier for a partial recovery of our losses. In the fourth quarter of 2005, we recorded an additional \$10 million settlement from the same supplier.

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- (c) Reflects an \$8 million charge associated with the termination of a beverage agreement in the United States segment during the quarter ended March 25, 2006.

**8. Reportable Operating Segments**

The following tables summarize revenue and operating profit for each of our reportable operating segments:

<b>Revenues</b>	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
United States	\$ 1,300	\$ 1,393	\$ 3,969	\$ 4,113
International Division	518	490	1,476	1,466
China Division <sup>(a)</sup>	460	360	1,100	871
	\$2,278	\$2,243	\$6,545	\$6,450

<b>Operating Profit</b>	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
United States	\$ 183	\$ 183	\$ 565	\$ 525
International Division	105	86	288	264
China Division <sup>(b)</sup>	105	83	220	160
Unallocated and corporate expenses	(47 )	(55 )	(151 )	(167 )
Unallocated other income (expense) <sup>(c)</sup>	2	(1 )	4	15
Unallocated refranchising gain (loss) <sup>(d)</sup>	(4 )	10	7	21
Wrench litigation income (expense) <sup>(e)</sup>		2		2
AmeriServe and other charges (credits)				
Operating profit	344	308	933	820
Interest expense, net	(34 )	(28 )	(105 )	(86 )
Income before income taxes	\$ 310	\$ 280	\$ 828	\$ 734

- (a) Includes revenues of approximately \$397 million and \$294 million in mainland China for the quarters ended September 9, 2006 and September 3, 2005, respectively. Includes revenues of approximately \$933 million and \$693 million in mainland China for the years to date ended September 9, 2006 and September 3, 2005, respectively.
- (b) Includes approximately \$14 million of operating profit in the quarter and year to date ended September 3, 2005 related to an agreement with a supplier in mainland China for a partial recovery of our losses.
- (c) Includes a gain of approximately \$17 million related to the sale of our fifty percent interest in our former unconsolidated affiliate in Poland and the Czech Republic in the year to date ended September 3, 2005.
- (d) Unallocated refranchising gain (loss) is not allocated to the U.S., International Division or China Division segments for performance reporting purposes.
- (e) Income of \$2 million was recorded in the quarter ended September 3, 2005 from a settlement with an insurance carrier related to the legal judgment against Taco Bell Corp. on June 4, 2003, in Wrench versus Taco Bell Corp.



**9. Pension and Postretirement Medical Benefits**

We sponsor defined benefit pension plans covering substantially all full-time U.S. salaried employees, certain U.S. hourly employees and certain international employees. The most significant of these plans, the YUM Retirement Plan (the Plan), covers U.S. employees. Our postretirement plan provides health care benefits, principally to U.S. salaried retirees and their dependents, and includes retiree cost sharing provisions. The defined benefit pension plans covering U.S. employees and our postretirement plan were amended during 2001 such that any salaried employee that was hired or rehired after September 30, 2001 is not eligible to participate.

The components of net periodic benefit cost for our defined benefit pension plans covering U.S. employees and our postretirement plan are as follows:

	Pension Benefits		Other Postretirement	
	Quarter		Benefits	
	9/09/06	9/03/05	9/09/06	9/03/05
Service cost	\$8	\$8	\$	\$1
Interest cost	11	9	1	1
Expected return on plan assets	(11 )	(10 )		
Amortization of prior service cost		1		
Recognized actuarial loss	7	5		
Net periodic benefit cost	\$15	\$13	\$ 1	\$2

	Pension Benefits		Other Postretirement	
	Year to date		Benefits	
	9/09/06	9/03/05	9/09/06	9/03/05
Service cost	\$24	\$23	\$ 1	\$2
Interest cost	32	29	3	3
Expected return on plan assets	(33 )	(31 )		
Amortization of prior service cost	2	3		
Recognized actuarial loss	21	15		1
Net periodic benefit cost	\$46	\$39	\$ 4	\$6

As disclosed in our 2005 Form 10-K, based on current funding rules, we are not required to make contributions to the Plan in 2006. However, in the quarter ended September 9, 2006, we elected to make a discretionary contribution to the Plan in the amount of \$23 million. No further contributions are expected to the Plan in 2006. In the quarter ended June 17, 2006 we made a contribution of approximately \$18 million to one of our International plans.

**10. Debt**

In April 2006, we issued \$300 million aggregate principal amount of 6.25% Senior Unsecured Notes due April 15, 2016 (the Notes). The Notes represent senior, unsecured obligations and rank equally in right of payment with all of our existing and future unsecured unsubordinated indebtedness. We used \$200 million of the proceeds from these Notes to repay our 8.5% Senior Unsecured Notes that matured in April 2006 and the remainder for general corporate purposes.





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In anticipation of issuing the Notes, we entered into treasury locks during the quarter ended March 25, 2006 with aggregate notional amounts of \$250 million to hedge the risk of changes in future interest payments attributable to changes in United States Treasury rates prior to issuance of the Notes. As these treasury locks were designated and effective in offsetting this variability in cash flows associated with the future interest payments, the resulting gain from settlement of these treasury locks of approximately \$8 million is being amortized over the ten year life of the Notes as a reduction in interest expense.

In July 2006, we executed a \$165 million short-term credit facility (the International Term Facility or ITF) on behalf of the International Division which is due in the first quarter of 2007. We used the proceeds from the facility for general corporate purposes. There were borrowings of \$164 million and available credit of \$1 million outstanding at September 9, 2006. The interest rate for borrowings under the ITF is 0.35% over the London Interbank Offered Rate (LIBOR). The ITF is unconditionally guaranteed by YUM and contains covenants substantially identical to those of our \$1.0 billion senior unsecured Revolving Credit Facility. We were in compliance with all debt covenants at September 9, 2006.

During July 2006, we also executed an \$80 million short-term facility agreement (the Term Loan) on behalf of the International Division. There were zero borrowings outstanding at September 9, 2006.

The fair values of our interest rate swaps with notional amounts of \$850 million changed from a liability position of \$5 million at December 31, 2005 to a liability position of \$20 million at September 9, 2006 due to increases in interest rates.

### 11. Acquisitions

#### Rostik s Acquisition

On March 24, 2006, we finalized an agreement with Rostik s Restaurant Ltd. (RRL), a franchisor and operator of a chicken chain in Russia known as Rostik s, under which we acquired the Rostik s brand and associated intellectual property for \$15 million (\$10 million of which has been paid as of September 9, 2006). We will provide financial support, including loans and guarantees, up to \$30 million to support future development by RRL in Russia. This agreement also includes a put/call option that may be exercised, subject to certain conditions, between the fifth and seventh year whereby ownership of then existing restaurants would be transferred to YRI.

The co-branding as Rostik s/KFC of the 94 Rostik s units and the 18 KFC franchise restaurants in Russia that existed at the purchase date is underway. At the end of this quarter, 19 Rostik s units have been co-branded with 75 units to be completed.

#### United Kingdom Pizza Hut Acquisition

On September 12, 2006, we completed the acquisition of the remaining fifty percent ownership interest of our Pizza Hut United Kingdom (U.K.) unconsolidated affiliate from our partner, for \$184 million in cash plus the assumption of \$25 million in certain debt and liabilities, excluding capital lease obligations. We financed the purchase with additional debt under our November 2005, \$350 million, five-year revolving credit facility. This unconsolidated affiliate owned over 500 restaurants in the U.K.



## 12. Guarantees, Commitments and Contingencies

### Guarantees and Contingencies

As a result of (a) assigning our interest in obligations under real estate leases as a condition to the refranchising of certain Company restaurants; (b) contributing certain Company restaurants to unconsolidated affiliates; and (c) guaranteeing certain other leases, we are frequently contingently liable on lease agreements. These leases have varying terms, the latest of which expires in 2031. As of September 9, 2006 and December 31, 2005, the potential amount of undiscounted payments we could be required to make in the event of non-payment by the primary lessee was \$388 million and \$374 million, respectively. The present value of these potential payments discounted at our pre-tax cost of debt at September 9, 2006 was \$308 million. Our franchisees are the primary lessees under the vast majority of these leases. We generally have cross-default provisions with these franchisees that would put them in default of their franchise agreement in the event of non-payment under the lease. We believe these cross-default provisions significantly reduce the risk that we will be required to make payments under these leases. Accordingly, the liability recorded for our probable exposure under such leases at September 9, 2006 and December 31, 2005 was not material.

We had provided approximately \$16 million of partial guarantees of two franchisee loan pools related primarily to the Company's historical refranchising programs and, to a lesser extent, franchisee development of new restaurants, at September 9, 2006 and December 31, 2005. In support of these guarantees, we posted letters of credit of \$4 million. We also provide a standby letter of credit of \$18 million under which we could potentially be required to fund a portion of one of the franchisee loan pools. The total loans outstanding under these loan pools were approximately \$75 million and \$77 million at September 9, 2006 and December 31, 2005, respectively. Any funding under the guarantees or letters of credit would be secured by the franchisee loans and any related collateral. We believe that we have appropriately provided for our estimated probable exposures under these contingent liabilities. These provisions were primarily charged to refranchising (gain) loss.

### Insurance Programs

We are self-insured for a substantial portion of our current and prior years' coverage including workers' compensation, employment practices liability, general liability, automobile liability and property losses (collectively, "property and casualty losses"). To mitigate the cost of our exposures for certain property and casualty losses, we make annual decisions to self-insure the risks of loss up to defined maximum per occurrence retentions on a line by line basis or to combine certain lines of coverage into one loss pool with a single self-insured aggregate retention. The Company then purchases insurance coverage, up to a certain limit, for losses that exceed the self-insurance per occurrence or aggregate retention. The insurers' maximum aggregate loss limits are significantly above our actuarially determined probable losses; therefore, we believe the likelihood of losses exceeding the insurers' maximum aggregate loss limits is remote.

In the U.S. and in certain other countries, we are also self-insured for healthcare claims and long-term disability for eligible participating employees subject to certain deductibles and limitations. We have accounted for our retained liabilities for self-insured property and casualty losses, healthcare and long-term disability claims, including reported and incurred but not reported claims, based on information provided by independent actuaries.

Due to the inherent volatility of actuarially determined property and casualty loss estimates, it is reasonably possible that we could experience changes in estimated losses which could be material to our growth in quarterly and annual net income. We believe that we have recorded reserves for property and casualty losses at a level which has substantially mitigated the potential negative impact of adverse developments and/or volatility.

Change of Control Severance Agreements

The Company has severance agreements with certain key executives (the Agreements) that are renewable on an annual basis. These Agreements are triggered by a termination, under certain conditions, of the executive's employment following a change in control of the Company, as defined in the Agreements. If triggered, the affected executives would generally receive twice the amount of both their annual base salary and their annual incentive, at the higher of target or actual for the preceding year, a proportionate bonus at the higher of target or actual performance earned through the date of termination, outplacement services and a tax gross-up for any excise taxes. These Agreements have a three-year term and automatically renew each January 1 for another three-year term unless the Company elects not to renew the Agreements. If these Agreements had been triggered as of September 9, 2006, payments of approximately \$38 million would have been made. In the event of a change of control, rabbi trusts would be established and used to provide payouts under existing deferred and incentive compensation plans.

Litigation

We are subject to various claims and contingencies related to lawsuits, taxes, environmental and other matters arising out of the normal course of business. We provide reserves for such claims and contingencies when payment is probable and estimable in accordance with SFAS No. 5 Accounting for Contingencies.

On August 13, 2003, a class action lawsuit against Pizza Hut, Inc., styled Coldiron v. Pizza Hut, Inc., was filed in the United States District Court, Central District of California. Plaintiff alleges that she and other current and former Pizza Hut Restaurant General Managers ( RGMs ) were improperly classified as exempt employees under the U.S. Fair Labor Standards Act ( FLSA ). There is also a pendent state law claim, alleging that current and former RGMs in California were misclassified under that state's law. Plaintiff seeks unpaid overtime wages and penalties. On May 5, 2004, the District Court granted conditional certification of a nationwide class of RGMs under the FLSA claim, providing notice to prospective class members and an opportunity to join the class. Approximately 12 percent of the eligible class members have elected to join the litigation. However, on June 30, 2005, the District Court granted Pizza Hut's motion to strike all FLSA class members who joined the litigation after July 15, 2004. The effect of this order is to reduce the number of FLSA class members to only approximately 88 (or approximately 2.5% of the eligible class members).

In November 2005, the parties agreed to a settlement. The Court granted preliminary approval of the settlement on June 28, 2006. Final approval of the settlement was granted on October 5, 2006 with payment anticipated to occur in the fourth quarter of 2006. We have provided for the settlement amount in our Consolidated Financial Statements.

On November 26, 2001, a lawsuit against Long John Silver's, Inc. ( LJS ) styled Kevin Johnson, on behalf of himself and all others similarly situated v. Long John Silver's, Inc. ( Johnson ) was filed in the United States District Court for the Middle District of Tennessee, Nashville Division. Johnson's suit alleged that LJS's former Security/Restitution for Losses policy (the Policy) provided for deductions from RGMs and Assistant Restaurant General Managers ( ARGMs ) salaries that violate the salary basis test for exempt personnel under regulations issued pursuant to the FLSA. Johnson alleged that all RGMs and ARGMs who were employed by LJS for the three year period prior to the lawsuit i.e., since November 26, 1998 should be treated as the equivalent of hourly employees and thus were eligible under the FLSA for overtime for any hours worked over 40 during all weeks in the recovery period. In addition, Johnson claimed that the potential members of the class are entitled to certain liquidated damages and attorneys' fees under the FLSA.

LJS believed that Johnson's claims, as well as the claims of all other similarly situated parties, should be resolved in individual arbitrations pursuant to LJS's Dispute Resolution Program ( DRP ), and that a collective action to resolve these claims in court was clearly inappropriate under the current state of the law. Accordingly,



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LJS moved to compel arbitration in the Johnson case. LJS and Johnson also agreed to stay the action effective December 17, 2001, pending mediation, and entered into a tolling agreement for that purpose. After mediation did not resolve the case, and after limited discovery and a hearing, the Court determined on June 7, 2004, that Johnson's individual claims should be referred to arbitration. Johnson appealed, and the decision of the District Court was affirmed in all respects by the United States Court of Appeals for the Sixth Circuit on July 5, 2005.

On December 19, 2003, counsel for plaintiff in the above referenced Johnson lawsuit, filed a separate demand for arbitration with the American Arbitration Association (AAA) on behalf of former LJS managers Erin Cole and Nick Kaufman (the Cole Arbitration). Claimants in the Cole Arbitration demand a class arbitration on behalf of the same putative class - and the same underlying FLSA claims - as were alleged in the Johnson lawsuit. The complaint in the Cole Arbitration subsequently was amended to allege a practice of deductions (distinct from the allegations as to the Policy) in violation of the FLSA salary basis test, and to add Victoria McWhorter, another LJS former manager, as an additional claimant. LJS has denied the claims and the putative class alleged in the Cole Arbitration, and it is LJS's position that the claims of Cole, Kaufman, and McWhorter should be individually arbitrated.

Arbitrations under LJS's DRP, including the Cole Arbitration, are governed by the rules of the AAA. In October 2003, the AAA adopted its Supplementary Rules for Class Arbitrations (AAA Class Rules). The AAA appointed an arbitrator for the Cole Arbitration. On June 15, 2004, the arbitrator issued a clause construction award, ruling that the DRP does not preclude class arbitration. LJS moved to vacate the clause construction award in the United States District Court for the District of South Carolina. On September 15, 2005, the federal court in South Carolina ruled that it did not have jurisdiction to hear LJS's motion to vacate. LJS has appealed the U.S. District Court's ruling to the United States Court of Appeals for the Fourth Circuit. LJS has also filed a motion to vacate the clause construction award in South Carolina state court. While judicial review of the clause construction award was pending in the U.S. District Court, the arbitrator permitted claimants to move for a class determination award, which was opposed by LJS. On September 19, 2005, the arbitrator issued a class determination award, certifying a class of LJS's RGMs and ARGMs employed between December 17, 1998, and August 22, 2004, on FLSA claims, to proceed on an opt-out basis under the AAA Class Rules. That class determination award was upheld on appeal by the United States District Court for the District of South Carolina on January 20, 2006, and the arbitrator declined to reconsider the award. LJS has appealed the ruling of the U.S. District Court to the United States Court of Appeals for the Fourth Circuit. LJS has also filed a motion to vacate the class determination award in South Carolina state court.

LJS believes that the DRP provides for individual arbitrations. LJS also believes that if the Cole Arbitration must proceed on a class basis, (i) the proceedings should be governed by the opt-in collective action structure of the FLSA, and (ii) a class should not be certified under the applicable provisions of the FLSA. LJS also believes that each individual should not be able to recover for more than two years (and a maximum three years) prior to the date they file a consent to join the arbitration. We have provided for the estimated costs of the Cole Arbitration, based on a projection of eligible claims, the amount of each eligible claim, the estimated legal fees incurred by the claimants and the results of settlement negotiations in this and other wage and hour litigation matters. But in view of the novelties of proceeding under the AAA Class Rules and the inherent uncertainties of litigation, there can be no assurance that the outcome of the arbitration will not result in losses in excess of those currently provided for in our Consolidated Financial Statements.

On September 2, 2005, a collective action lawsuit against the Company and KFC Corporation, originally styled Parler v. Yum Brands, Inc., d/b/a KFC, and KFC Corporation, was filed in the United States District Court for the District of Minnesota. Plaintiff alleges that he and other current and former KFC Assistant Unit Managers (AUMs) were improperly classified as exempt employees under the FLSA. Plaintiff seeks overtime wages and liquidated damages. On January 17, 2006, the District Court dismissed the claims against the Company with prejudice, leaving KFC Corporation as the sole defendant. Notice was mailed to current and former AUMs advising them of the litigation and providing an opportunity to join the case if they choose to do so. Plaintiff

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amended the complaint on September 8, 2006, to add related state law claims on behalf of a putative class of KFC AUMs employed in Illinois, Minnesota, Nevada, New Jersey, New York, Ohio, and Pennsylvania.

We believe that KFC has properly classified its AUMs as exempt under the FLSA and applicable state law, and accordingly intend to vigorously defend against all claims in this lawsuit. However, in view of the inherent uncertainties of litigation, the outcome of this case cannot be predicted at this time. Likewise, the amount of any potential loss cannot be reasonably estimated.

On December 17, 2002, Taco Bell was named as the defendant in a class action lawsuit filed in the United States District Court for the Northern District of California styled Moeller, et al. v. Taco Bell Corp. On August 4, 2003, plaintiffs filed an amended complaint that alleges, among other things, that Taco Bell has discriminated against the class of people who use wheelchairs or scooters for mobility by failing to make its approximately 220 company-owned restaurants in California (the California Restaurants) accessible to the class. Plaintiffs contend that queue rails and other architectural and structural elements of the Taco Bell restaurants relating to the path of travel and use of the facilities by persons with mobility-related disabilities (including parking spaces, ramps, counters, restroom facilities and seating) do not comply with the U.S. Americans with Disabilities Act (the ADA), the Unruh Civil Rights Act (the Unruh Act), and the California Disabled Persons Act (the CDPA). Plaintiffs have requested: (a) an injunction from the District Court ordering Taco Bell to comply with the ADA and its implementing regulations; (b) that the District Court declare Taco Bell in violation of the ADA, the Unruh Act, and the CDPA; and (c) monetary relief under the Unruh Act or CDPA. Plaintiffs, on behalf of the class, are seeking the minimum statutory damages per offense of either \$4,000 under the Unruh Act or \$2,000 under the CDPA for each aggrieved member of the class. Plaintiffs contend that there may be in excess of 100,000 individuals in the class. For themselves, the four named plaintiffs have claimed aggregate minimum statutory damages of no less than \$16,000, but are expected to claim greater amounts based on the number of Taco Bell outlets they visited at which they claim to have suffered discrimination.

On February 23, 2004, the District Court granted Plaintiffs' motion for class certification. The District Court certified a Rule 23(b)(2) mandatory injunctive relief class of all individuals with disabilities who use wheelchairs or electric scooters for mobility who, at any time on or after December 17, 2001, were denied, or are currently being denied, on the basis of disability, the full and equal enjoyment of the California Restaurants. The class includes claims for injunctive relief and minimum statutory damages.

Pursuant to the parties' agreement, on or about August 31, 2004, the District Court ordered that the trial of this action be bifurcated so that stage one will resolve Plaintiffs' claims for equitable relief and stage two will resolve Plaintiffs' claims for damages. The parties are currently proceeding with the equitable relief stage of this action. During this stage, Taco Bell filed a motion to partially decertify the class to exclude from the Rule 23(b)(2) class claims for monetary damages. The District Court denied the motion. Plaintiffs filed their own motion for partial summary judgment as to liability relating to a subset of the California Restaurants. The District Court denied that motion as well. Discovery is ongoing as of the date of this report.

Taco Bell has denied liability and intends to vigorously defend against all claims in this lawsuit. Although this lawsuit is at a relatively early stage in the proceedings, it is likely that certain of the California Restaurants will be determined to be not fully compliant with accessibility laws, and Taco Bell has begun to take certain steps to make those restaurants compliant. However, at this time, it is not possible to estimate with reasonable certainty the potential costs to bring non-compliant California Restaurants into compliance with applicable state and federal disability access laws. Nor is it possible at this time to reasonably estimate the probability or amount of liability for monetary damages on a class wide basis to Taco Bell.

On August 4, 2006, a putative class action lawsuit against Taco Bell Corp. styled Rajeev Chhibber vs. Taco Bell Corp. was filed in Orange County Superior Court. On August 7, 2006, another putative class action lawsuit styled Marina Puchalski v. Taco Bell Corp. was filed in San Diego County Superior Court. Both lawsuits were





filed by a Taco Bell RGM purporting to represent all current and former RGMs who worked at corporate-owned restaurants in California from August 2002 to the present. The lawsuits allege violations of California's wage and hour laws involving unpaid overtime and meal and rest period violations and seek unspecified amounts in damages and penalties. As of September 7, 2006, the Orange County case was voluntarily dismissed by the plaintiff and both cases have been consolidated in San Diego County.

Taco Bell denies liability and intends to vigorously defend against all claims in this lawsuit. However, in view of the inherent uncertainties of litigation, the outcome of this case cannot be predicted at this time. Likewise, the amount of any potential loss cannot be reasonably estimated.

Obligations to PepsiCo, Inc. After Spin-off

In connection with our October 6, 1997 spin-off from PepsiCo, Inc. ( "PepsiCo" ) (the "Spin-off" ), we entered into separation and other related agreements (the "Separation Agreements" ) governing the Spin-off and our subsequent relationship with PepsiCo. These agreements provide certain indemnities to PepsiCo.

Under the terms of these agreements, we have indemnified PepsiCo for any costs or losses it incurs with respect to all letters of credit, guarantees and contingent liabilities relating to our businesses under which PepsiCo remains liable. As of September 9, 2006, PepsiCo remains liable for approximately \$24 million on a nominal basis related to these contingencies. This obligation ends at the time PepsiCo is released, terminated or replaced by a qualified letter of credit. We have not been required to make any payments under this indemnity.

Under the Separation Agreements, PepsiCo maintains full control and absolute discretion with regard to any combined or consolidated tax filings for periods through October 6, 1997. PepsiCo also maintains full control and absolute discretion regarding any common tax audit issues. Although PepsiCo has contractually agreed to, in good faith, use its best efforts to settle all joint interests in any common tax audit issue on a basis consistent with prior practice, there can be no assurance that determinations made by PepsiCo would be the same as we would reach, acting on our own behalf. Through September 9, 2006, there have not been any determinations made by PepsiCo where we would have reached a different determination.

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

**Introduction and Overview**

YUM! Brands, Inc. and Subsidiaries (collectively referred to as "YUM" or the "Company") comprises the worldwide operations of KFC, Pizza Hut, Taco Bell, Long John Silver's ("LJS") and A&W All-American Food Restaurants ("A&W") (collectively "the Concepts") and is the world's largest quick service restaurant ("QSR") company based on the number of system units. YUM is the second largest QSR company outside the U.S. with 14,222 units.

Through its Concepts, YUM develops, operates, franchises and licenses a system of both traditional and non-traditional QSR restaurants. Traditional units feature dine-in, carryout and, in some instances, drive-thru or delivery services. Non-traditional units, which are typically licensed outlets, include express units and kiosks which have a more limited menu and operate in non-traditional locations like malls, airports, gasoline service stations, convenience stores, stadiums, amusement parks and colleges, where a full-scale traditional outlet would not be practical or efficient.

The retail food industry, in which the Company competes, is made up of supermarkets, supercenters, warehouse stores, convenience stores, coffee shops, snack bars, delicatessens and restaurants (including the QSR segment), and is intensely competitive with respect to food quality, price, service, convenience, location and concept. The industry is often affected by changes in consumer tastes; national, regional or local economic conditions; currency fluctuations; demographic trends; traffic patterns; the type, number and location of competing food retailers and products; and disposable purchasing power. Each of the Concepts compete with international, national and regional restaurant chains as well as locally-owned restaurants, not only for customers, but also for management and hourly personnel, suitable real estate sites and qualified franchisees.

Our business consists of three reporting segments: United States, the International Division and the China Division. The China Division includes mainland China ("China"), Thailand and KFC Taiwan and the International Division includes the remainder of our international operations.

The Company's key strategies are:

- Building dominant restaurant brands in China
- Driving profitable international expansion
- Improving restaurant operations
- Multibranding category-leading brands

The Company is focused on five long-term measures identified as essential to our growth and progress. These five measures and related key performance indicators are as follows:

- China Division and International Division expansion
- China Division and International Division system-sales growth (local currency)

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Number of new China Division and International Division restaurant openings  
Net China Division and International Division unit growth

Multibrand innovation and expansion

Number of multibrand restaurant locations  
Number of multibrand units added  
Number of franchise multibrand units added

Portfolio of category-leading U.S. brands

U.S. blended same store sales growth

Global franchise fees

New restaurant openings by franchisees

Franchise fee growth

Strong cash generation and returns

Cash generated from all sources

Cash generated from all sources after capital spending

Restaurant margins

U.S. and International Division operating margins

Our progress against these measures is discussed throughout the Management's Discussion and Analysis ( MD&A ).

Throughout the MD&A, the Company provides the percentage change excluding the impact of foreign currency translation. These amounts are derived by translating current year results at prior year average exchange rates. We believe the elimination of the foreign currency translation impact provides better year-to-year comparability without the distortion of foreign currency fluctuations.

The following MD&A should be read in conjunction with the unaudited Condensed Consolidated Financial Statements ( Financial Statements ), the Cautionary Statements and our annual report on Form 10-K for the fiscal year ended December 31, 2005 ( 2005 Form 10-K ).

All Note references herein refer to the accompanying Notes to the Financial Statements. Tabular amounts are displayed in millions except per share and unit count amounts, or as otherwise specifically identified.

#### **Significant Known Events, Trends or Uncertainties Impacting or Expected to Impact 2006 Comparisons with 2005**

The following factors impacted comparability of operating performance for the quarter and/or year to date ended September 9, 2006 or could impact comparisons for the remainder of 2006. Certain of these factors were previously discussed in our 2005 Form 10-K.

##### Mainland China Issues

Our KFC business in mainland China was negatively impacted by the interruption of product offerings and negative publicity associated with a supplier ingredient issue experienced in late March 2005 as well as consumer concerns related to Avian Flu in the fourth quarter of 2005. As a result of the aforementioned issues, the China Division experienced system sales growth in the full year 2005 of 11% excluding foreign currency translation which was below our ongoing target of at least 22%. For the quarter and year to date ended September 9, 2006, we achieved China Division growth rates of 25% and 23%, respectively, for system sales and 25% and 24%, respectively, for Company sales, both excluding foreign currency translation. Given these positive trends, we believe KFC sales in mainland China have rebounded from the negative impact of

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the supplier ingredient issue and Avian Flu. During 2005 we entered into agreements with the supplier of the aforementioned ingredient. As a result, we recognized recoveries in other income of \$14 million in the quarter ended September 3, 2005 and \$10 million in the quarter ended December 31, 2005.

United States Commodity Costs

Restaurant profits in the United States were positively impacted by a decline in commodity costs (principally meats and cheese) in the quarter and year to date ended September 9, 2006 versus the quarter and year to date ended September 3, 2005. Commodity costs declined by approximately \$10 million and \$35 million in the quarter and year to date ended September 9, 2006, respectively. We do not expect commodity costs in the fourth quarter of 2006 to be significantly different than commodity costs were in the fourth quarter of 2005.

Beverage Agreement Contract Termination

During the first quarter of 2006, we entered into an agreement with a beverage supplier to certain of our Concepts to terminate a long-term supply contract. As a result of the cash payment we made to the supplier in connection with this termination, we recorded a charge of \$8 million in the quarter ended March 25, 2006. We anticipate entering into an agreement with an alternative beverage supplier for these Concepts in the near future that will provide for more favorable beverage pricing than the agreement being terminated. The contract termination charge we recorded in the quarter ended March 25, 2006 will largely be offset by more favorable beverage pricing for our Concepts such that the net impact on 2006 net income will not be significant. We expect to continue to benefit from the more favorable pricing in 2007 and beyond.

United Kingdom Pizza Hut Acquisition

On September 12, 2006, we completed the acquisition of the remaining fifty percent ownership interest of our Pizza Hut United Kingdom ( U.K. ) unconsolidated affiliate from our partner. This unconsolidated affiliate owned over 500 restaurants in the U.K. Over the next several years, we expect to substantially reduce our company ownership of the restaurants acquired through refranchising to new and existing franchisees.

Prior to the acquisition, we accounted for our fifty percent ownership interest using the equity method of accounting. Thus, we reported our fifty percent share of the net income of the unconsolidated affiliate (after interest expense and income taxes) as Other (income) expense in the Consolidated Statements of Income. We also recorded a franchise fee for the royalty received from the stores owned by the unconsolidated affiliate. Subsequent to the acquisition, we will report Company sales and the associated restaurant costs, general and administrative expense, interest expense and income taxes associated with the restaurants previously owned by the unconsolidated affiliate in the appropriate line items of our Consolidated Statements of Income. Such restaurants had sales of approximately \$450 million in the first three quarters of 2006. We will no longer record franchise fee income for these restaurants.

The impact of this acquisition on operating profit in the fourth quarter of 2006 is expected to be minimal.

Pension Plan Funded Status

Certain of our employees are covered under noncontributory defined benefit pension plans. The most significant of these plans ( the Plans ) were amended in 2001 such that salaried employees hired or rehired after September 30, 2001 are not eligible to participate. As disclosed in our 2005 Form 10-K, as of our September 30, 2005 measurement date the Plans had a projected benefit obligation ( PBO ) of \$815 million and a fair value of plan assets of \$610 million. We currently estimate that the expected increase in PBO due to current year s benefits earned by covered employees and interest on benefits previously earned will exceed the increases to plan assets as a result of stock market gains and the \$33 million in pension plan contributions we made during the plan year (October 1, 2005 through September 30, 2006) by about \$40 million.

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Any remaining change in the Plans funded status at September 30, 2006 versus September 30, 2005 will primarily be the result of any change in the discount rate we use to measure our PBO. Due to the relatively long



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time frame over which benefits are expected to be paid, our PBO is highly sensitive to changes in discount rates. A 10 basis point increase in the discount rate from the 5.75% used at September 30, 2005 would decrease our PBO at September 30, 2006, holding all other variables and assumptions constant, by approximately \$15 million. While we have not yet determined the discount rate we will use to measure our PBO as of our September 30, 2006 measurement date, we believe that it will increase. The resulting decrease in our PBO is expected to largely offset the impact on our funded status described in the previous paragraph.

We do not believe the underfunded status of our pension plans will materially affect our results of operations, financial position or cash flows and have incorporated the estimated future impact into our financial projections and plans.

### Store Portfolio Strategy

From time to time we sell Company restaurants to existing and new franchisees where geographic synergies can be obtained or where their expertise can generally be leveraged to improve our overall operating performance, while retaining Company ownership of key U.S. and international markets. In the U.S., we are in the process of increasing franchise ownership of restaurants from 75% currently to 80%. This two-year plan calls for selling approximately 1,000 Company restaurants to franchisees in 2006 and 2007. Through September 9, 2006, 191 company restaurants in the U.S. have been sold to franchisees as part of this plan. Refranchisings reduce our reported revenues and restaurant profits and increase the importance of system sales growth as a key performance measure.

The following table summarizes our worldwide refranchising activities:

	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
Number of units refranchised	157	64	289	205
Refranchising proceeds, pre-tax	\$48	\$38	\$96	\$79
Refranchising (gain) loss, pre-tax	\$4	\$(10)	\$(7)	\$(21)

In addition to our refranchising program, from time to time we close restaurants that are poor performing, we relocate restaurants to a new site within the same trade area or we consolidate two or more of our existing units into a single unit (collectively store closures). Store closure costs (income) includes the net of gains or losses on sales of real estate on which we are not currently operating a Company restaurant, lease reserves established when we cease using a property under an operating lease and subsequent adjustments to those reserves, and other facility-related expenses from previously closed stores.

The following table summarizes worldwide Company store closure activities:

	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
Number of units closed	47	80	122	167
Store closure costs (income)	\$(4)	\$5	\$(1)	\$4

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The impact on operating profit arising from refranchising and Company store closures is the net of (a) the estimated reductions in restaurant profit, which reflects the decrease in Company sales, and general and administrative expenses and (b) the estimated increase in franchise fees from the stores refranchised. The amounts presented below reflect the estimated impact from stores that were operated by us for all or some portion of the comparable period in 2005 and were no longer operated by us as of September 9, 2006. The

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amounts do not include results from new restaurants that we opened in connection with a relocation of an existing unit or any incremental impact upon consolidation of two or more of our existing units into a single unit.

The following table summarizes the estimated impact on revenue of refranchising and Company store closures:

	Quarter ended 9/09/06			
	International		China	
	U.S.	Division	Division	Worldwide
Decreased Company sales	\$ (89 )	\$ (30 )	\$ (6 )	\$ (125 )
Increased franchise fees	3	3		6
Decrease in total revenues	\$ (86 )	\$ (27 )	\$ (6 )	\$ (119 )

	Year to date ended 9/09/06			
	International		China	
	U.S.	Division	Division	Worldwide
Decreased Company sales	\$ (258 )	\$ (88 )	\$ (13 )	\$ (359 )
Increased franchise fees	9	4		13
Decrease in total revenues	\$ (249 )	\$ (84 )	\$ (13 )	\$ (346 )

The following table summarizes the estimated impact on operating profit of refranchising and Company store closures:

	Quarter ended 9/09/06			
	International		China	
	U.S.	Division	Division	Worldwide
Decreased restaurant profit	\$ (9 )	\$ (1 )	\$	\$ (10 )
Increased franchise fees	3	3		6
Decreased general and administrative expenses	1			1
Increase (decrease) in operating profit	\$ (5 )	\$ 2	\$	\$ (3 )

	Year to date ended 9/09/06			
	International		China	
	U.S.	Division	Division	Worldwide
Decreased restaurant profit	\$ (27 )	\$ (3 )	\$	\$ (30 )
Increased franchise fees	9	4		13
Decreased general and administrative expenses	1			1
Increase (decrease) in operating profit	\$ (17 )	\$ 1	\$	\$ (16 )

**Results of Operations**

	Quarter 9/09/06	9/03/05	% B/(W)	Year to date 9/09/06	9/03/05	% B/(W)	
Company sales	\$ 1,989	\$ 1,975	1	\$ 5,720	\$ 5,687	1	
Franchise and license fees	289	268	8	825	763	8	
Revenues	\$ 2,278	\$ 2,243	2	\$ 6,545	\$ 6,450	1	
Company restaurant profit	\$ 321	\$ 294	9	\$ 906	\$ 819	11	
% of Company sales	16.1%	14.8%	1.3 ppts.	15.8%	14.4%	1.4	ppts.
Operating profit	344	308	11	933	820	14	
Interest expense, net	34	28	(17)	105	86	(21)	)
Income tax provision	80	75	(7)	236	198	(19)	)
Net income	\$ 230	\$ 205	12	\$ 592	\$ 536	10	
Diluted earnings per share <sup>(a)</sup>	\$ 0.83	\$ 0.69	20	\$ 2.10	\$ 1.78	18	

(a) See Note 3 for the number of shares used in this calculation.

**Restaurant Unit Activity**

	Company	Unconsolidated Affiliates	Franchisees	Total Excluding Licensees
<u>Worldwide</u> Beginning of year	7,587	1,648	22,666	31,901
New Builds	215	78	550	843
Acquisitions	10	1	(11)	)
Refranchising	(289)	)	291	2
Closures	(122)	)	(412)	)
Other	3	(3)	(38)	)
End of quarter	7,404	1,696	23,046	32,146
% of Total	23%	5%	72%	100%

The above totals exclude 2,128 and 2,376 licensed units at September 9, 2006 and December 31, 2005, respectively. The worldwide total excludes 75 units from the acquisition of the Rostik s brand (see Note 11). These units will be presented as franchisee new builds as the co-branding into Rostik s/KFC restaurants occurs.



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<u>United States</u>	Company	Unconsolidated Affiliates	Franchisees	Total Excluding Licensees
Beginning of year	4,686		13,605	18,291
New Builds	39		139	178
Acquisitions				
Refranchising	(191 )		193	2
Closures	(79 )		(251 )	(330 )
Other	3		(24 )	(21 )
End of quarter	4,458		13,662	18,120
% of Total	25%		75%	100%

The above totals exclude 1,932 and 2,181 licensed units at September 9, 2006 and December 31, 2005, respectively.

<u>International Division</u>	Company	Unconsolidated Affiliates	Franchisees	Total Excluding Licensees
Beginning of year	1,375	1,096	8,848	11,319
New Builds	25	23	404	452
Acquisitions	9	1	(10 )	
Refranchising	(97 )		97	
Closures	(23 )	(22 )	(159 )	(204 )
Other		(3 )	(13 )	(16 )
End of quarter	1,289	1,095	9,167	11,551
% of Total	11%	10%	79%	100%

The above totals exclude 196 and 195 licensed units at September 9, 2006 and December 31, 2005, respectively. The International Division total excludes 75 units from the acquisition of the Rostik s brand. These units will be presented as franchisee new builds as the co-branding into Rostik s/KFC restaurants occurs.

<u>China Division</u>	Company	Unconsolidated Affiliates	Franchisees	Total Excluding Licensees
Beginning of year	1,526	552	213	2,291
New Builds	151	55	7	213
Acquisitions	1		(1 )	
Refranchising	(1 )		1	
Closures	(20 )	(6 )	(2 )	(28 )
Other			(1 )	(1 )
End of quarter	1,657	601	217	2,475
% of Total	67%	24%	9%	100%

There are no licensed units in the China Division.

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Multibrand restaurants are included in the totals above. Multibrand conversions increase the sales and points of distribution for the second brand added to a restaurant but do not result in an additional unit count. Similarly, a new multibrand restaurant, while increasing sales and points of distribution for two brands, results in just one additional unit count. Franchise unit counts below include both franchisee and unconsolidated affiliate multibrand units. Following are multibrand restaurant totals at September 9, 2006 and December 31, 2005:

<u>9/09/06</u>	Company	Franchise	Total
United States	1,758	1,519	3,277
International Division	15	186	201
Worldwide	1,773	1,705	3,478

<u>12/31/05</u>	Company	Franchise	Total
United States	1,696	1,400	3,096
International Division	17	176	193
Worldwide	1,713	1,576	3,289

For the year to date ended September 9, 2006, Company and franchise multibrand unit gross additions were 123 and 115, respectively. There are no multibrand units in the China Division.

### System Sales Growth

<u>Quarter</u>	Increase/(Decrease)		Increase excluding currency translation	
	9/09/06	9/03/05	9/09/06	9/03/05
United States	(1)%	4%	N/A	N/A
International Division	10%	7%	9%	4%
China Division	28%	18%	25%	17%
Worldwide	5%	6%	4%	5%

System sales growth includes the results of all restaurants regardless of ownership, including Company-owned, franchise, unconsolidated affiliate and license restaurants. Sales of franchise, unconsolidated affiliate and license restaurants generate franchise and license fees for the Company (typically at a rate of 4% to 6% of sales). Franchise, unconsolidated affiliate and license restaurants sales are not included in Company sales on the Condensed Consolidated Statements of Income; however, the franchise and license fees are included in the Company's revenues. We believe system sales growth is useful to investors as a significant indicator of the overall strength of our business as it incorporates all of our revenue drivers, Company and franchise same store sales as well as net unit development.

The increases in Worldwide, International Division and China Division system sales were all driven by new unit development and same store sales growth, partially offset by store closures.

The decrease in U.S. system sales was driven by store closures and same store sales declines, partially offset by new unit development.

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<u>Year to date</u>	Increase	9/03/05	Increase excluding	
			currency translation	
	9/09/06		9/09/06	9/03/05
United States	2%	4%	N/A	N/A
International Division	6%	10%	7%	6%
China Division	26%	17%	23%	16%
Worldwide	5%	7%	5%	5%

The increases in Worldwide, U.S., International Division and China Division system sales were all driven by new unit development and same store sales growth, partially offset by store closures.

**Revenues**

<u>Quarter</u>	Amount	9/03/05	% Increase/(Decrease)	% Increase/(Decrease)
				excluding currency translation
	9/09/06			
Company sales				
United States	\$ 1,145	\$ 1,239	(8 )	N/A
International Division	399	387	3	1
China Division	445	349	28	25
Worldwide	1,989	1,975	1	
Franchise and license fees				
United States	155	154	1	N/A
International Division	119	103	15	13
China Division	15	11	27	23
Worldwide	289	268	8	7
Total revenues				
United States	1,300	1,393	(7 )	N/A
International Division	518	490	6	4
China Division	460	360	28	25
Worldwide	\$ 2,278	\$ 2,243	2	1

The increase in Worldwide Company sales was driven by new unit development partially offset by refranchising and store closures.

The increase in Worldwide franchise and license fees was driven by new unit development, refranchising and same store sales growth, partially offset by store closures.

The decrease in U.S. Company sales was driven by refranchising, same store sales declines and store closures, partially offset by new unit development.



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U.S. same store sales include only Company restaurants that have been open one year or more. U.S. blended same store sales include KFC, Pizza Hut and Taco Bell Company-owned restaurants only. U.S. same store sales

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for Long John Silver's and A&W restaurants are not included. Following are the same store sales results by brand:

	Quarter ended 9/09/06 Same Store		Average Guest	
	Sales	Transactions	Check	
KFC	(5) %	(4) %	4	%
Pizza Hut	(5) %	(6) %	1	%
Taco Bell	(2) %	(5) %	3	%

U.S. blended Company same store sales decreased 2% due to a decline in transactions, partially offset by an increase in average guest check.

The increase in U.S. franchise and license fees was driven by new unit development and refranchising, partially offset by store closures and same store sales declines.

The increase in International Division Company sales was driven by new unit development and same store sales growth, partially offset by refranchising and store closures.

The increase in International Division franchise and license fees was driven by new unit development, same store sales growth and refranchising, partially offset by store closures.

The increases in China Division Company sales and franchise and license fees were driven by new unit development and same store sales growth.

<u>Year to date</u>	Amount 9/09/06	9/03/05	% Increase/(Decrease)	% Increase/(Decrease)
				excluding currency translation
<b>Company sales</b>				
United States	\$3,515	\$3,678	(4 )	N/A
International Division	1,139	1,165	(2 )	(2 )
China Division	1,066	844	26	24
Worldwide	5,720	5,687	1	
<b>Franchise and license fees</b>				
United States	454	435	4	N/A
International Division	337	301	12	13
China Division	34	27	24	20
Worldwide	825	763	8	8
<b>Total revenues</b>				
United States	3,969	4,113	(4 )	N/A
International Division	1,476	1,466	1	1
China Division	1,100	871	26	23

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Worldwide	\$6,545	\$6,450	1	1
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The increase in Worldwide Company sales was driven by new unit development and same store sales growth, partially offset by refranchising and store closures.

The increase in Worldwide franchise and license fees was driven by new unit development, same store sales growth and refranchising, partially offset by store closures.

The decrease in U.S. Company sales was driven by refranchising and store closures, partially offset by new unit development.

Following are the same store sales results by brand:

	Year to date ended 9/09/06		Average Guest	
	Same Store		Check	
	Sales	Transactions		
KFC	2 %	(2 ) %	4	%
Pizza Hut	(4 ) %	(8 ) %	4	%
Taco Bell	4 %	1 %	3	%

U.S. blended Company same store sales were flat as an increase in average guest check was offset by a decrease in transactions.

The increase in U.S. franchise and license fees was driven by new unit development, same store sales growth (primarily Taco Bell) and refranchising, partially offset by store closures.

The decrease in International Division Company sales was driven by refranchising and store closures, partially offset by new unit development and same store sales growth.

The increase in International Division franchise and license fees was driven by new unit development, same store sales growth, royalty rate changes and refranchising, partially offset by store closures.

The increases in China Division Company sales and franchise and license fees were driven by new unit development and same store sales growth.

### **Company Restaurant Margin**

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<u>Quarter ended 9/09/06</u>	United States		International Division		China Division		Worldwide	
Company sales	100.0	%	100.0	%	100.0	%	100.0	%
Food and paper	27.8		33.0		35.0		30.5	
Payroll and employee benefits	30.2		23.8		11.4		24.7	
Occupancy and other operating expenses	27.9		29.8		29.9		28.7	
Company restaurant margin	14.1	%	13.4	%	23.7	%	16.1	%

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<u>Quarter ended 9/03/05</u>	United States		International Division		China Division		Worldwide	
Company sales	100.0	%	100.0	%	100.0	%	100.0	%
Food and paper	29.6		33.1		35.4		31.3	
Payroll and employee benefits	29.7		23.8		12.0		25.5	
Occupancy and other operating expenses	26.8		30.5		32.0		28.4	
Company restaurant margin	13.9	%	12.6	%	20.6	%	14.8	%

The increase in U.S. restaurant margin as a percentage of sales was driven by lower commodity costs (primarily meats and cheese) and the favorable impact of lower casualty insurance expense driven by the improved loss trends on our insurance reserves and lower property related losses (including the lapping of the unfavorable impact of Hurricane Katrina). These increases were partially offset by higher occupancy and other costs (primarily higher utility costs) and higher labor costs, primarily driven by wage rates and benefits.

The increase in International Division restaurant margin as a percentage of sales was driven by the impact of same store sales growth on restaurant margin and the favorable impact on restaurant margins of closing and refranchising certain restaurants. These increases were partially offset by higher labor costs and higher food and paper costs.

The increase in China Division restaurant margin as a percentage of sales was driven by the impact of same store sales growth on restaurant margin. The increase was partially offset by the lower margins associated with new units during the initial periods of operations.

<u>Year to date ended 9/09/06</u>	United States		International Division		China Division		Worldwide	
Company sales	100.0	%	100.0	%	100.0	%	100.0	%
Food and paper	28.2		33.2		35.4		30.5	
Payroll and employee benefits	30.0		24.0		12.5		25.6	
Occupancy and other operating expenses	26.7		30.0		30.5		28.1	
Company restaurant margin	15.1	%	12.8	%	21.6	%	15.8	%

<u>Year to date ended 9/03/05</u>	United States		International Division		China Division		Worldwide	
Company sales	100.0	%	100.0	%	100.0	%	100.0	%
Food and paper	30.0		33.0		36.0		31.5	
Payroll and employee benefits	30.1		24.0		12.9		26.3	
Occupancy and other operating expenses	26.1		30.2		32.0		27.8	
Company restaurant margin	13.8	%	12.8	%	19.1	%	14.4	%

The increase in U.S. restaurant margin as a percentage of sales was driven by lower commodity costs (primarily meats and cheese), the impact of same store sales on margin (due to higher average guest check) and the favorable impact of lower casualty insurance expense driven by

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improved loss trends on our insurance reserves and lower property related losses. These increases were partially offset by higher occupancy and other costs (primarily higher utility costs) and higher labor costs, primarily driven by wages and benefits.

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International Division restaurant margin as a percentage of sales was flat. Restaurant margin increased as a result of the impact of same store sales on restaurant margin and the favorable impact on restaurant margin of refranchising and closing certain restaurants. These increases were offset by higher food and paper costs, higher labor costs and the impact of lower margins associated with new units during the initial periods of operations.

The increase in China Division restaurant margin as a percentage of sales was driven by the impact of same store sales growth on restaurant margin. The increase was partially offset by the lower margins associated with new units during the initial periods of operations.

### Worldwide General and Administrative Expenses

General and administrative expenses increased \$7 million or 3% in the quarter and \$5 million or 1% year to date. The increase in general and administrative expenses in the quarter and year to date was driven by higher compensation related costs, including amounts associated with investments in strategic initiatives in China and other international growth markets. Such increases were offset by the lapping of the unfavorable impact of higher prior year litigation related costs.

### Worldwide Other (Income) Expense

	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
Gain upon sale of investment in unconsolidated affiliate <sup>(a)</sup>	\$(2 )	\$	\$(2 )	\$(17 )
Recovery from supplier <sup>(b)</sup>		(12 )		(12 )
Equity income from investments in unconsolidated affiliates	(16 )	(16 )	(37 )	(39 )
Contract termination charge <sup>(c)</sup>			8	
Foreign exchange (gain) loss and other	1	1	(2 )	2
Other (income) expense	\$(17 )	\$(27 )	\$(33 )	\$(66 )

- (a) Reflects gains related to the 2005 sale of our fifty percent interest in the entity that operated almost all KFCs and Pizza Huts in Poland and the Czech Republic to our then partner in the entity. In the fourth quarter of 2005, we recorded a \$6 million reduction to correct the gain previously recorded in 2005 associated with this transaction.
- (b) Relates to a financial recovery from a supplier ingredient issue in mainland China totaling \$14 million for the quarter ended September 9, 2005, \$2 million of which was recognized through equity income from investments in unconsolidated affiliates. Our KFC business in mainland China was negatively impacted by the interruption of product offerings and negative publicity associated with a supplier ingredient issue experienced in late March 2005. During the year ended December 31, 2005, we entered into agreements with the supplier for a partial recovery of our losses. In the fourth quarter of 2005, we recorded an additional \$10 million settlement from the same supplier.
- (c) Reflects an \$8 million charge associated with the termination of a beverage agreement in the United States segment during the quarter ended March 25, 2006.



**Worldwide Closure and Impairment Expense and Refranchising (Gain) Loss**

See the Store Portfolio Strategy section for more detail of our refranchising and closure activities and Note 6 for a summary of closures and impairment expenses and refranchising (gain) loss by reportable operating segment.

**Operating Profit**

	Quarter			Year to date		
	9/09/06	9/03/05	% B/(W)	9/09/06	9/03/05	% B/(W)
United States	\$ 183	\$ 183	1	\$ 565	525	8
International Division	105	86	22	288	264	9
China Division	105	83	26	220	160	38
Unallocated and corporate expenses	(47 )	(55 )	17	(151 )	(167 )	10
Unallocated other income (expense)	2	(1 )	NM	4	15	NM
Unallocated refranchising gain (loss)	(4 )	10	NM	7	21	NM
Wrench litigation income (expense)		2	NM		2	NM
Operating profit	\$ 344	\$ 308	11	\$ 933	\$ 820	14
United States operating margin	14.2%	13.2%	1.0 ppts.	14.2%	12.8%	1.4 ppts.
International Division operating margin	20.2%	17.5%	2.7 ppts.	19.5%	18.0%	1.5 ppts.

Neither unallocated and corporate expenses, which comprise general and administrative expenses, or unallocated refranchising gain (loss), are allocated to the U.S., International Division or China Division segments for performance reporting purposes. The decrease in unallocated and corporate expenses in both the quarter and year to date was driven by the lapping of the unfavorable impact of higher prior year litigation related costs. Lower charitable contributions also contributed to the year to date decrease. Unallocated other income (expense) primarily reflects gains related to the 2005 sale of our fifty percent interest in an entity as discussed in the Worldwide Other (Income) Expense section.

The slight increase in U.S. operating profit for the quarter was driven by the impact of lower closure and impairment expenses and lower commodity costs. These increases were almost fully offset by higher restaurant operating costs, higher G&A expenses and the impact of same store sales declines on restaurant profit and franchise fees.

The increase in U.S. operating profit for the year to date was driven by the impact of same store sales on restaurant profit (due to higher average guest check) and franchise fees, lower commodity costs and the impact of lower closure and impairment expenses. These increases were partially offset by higher restaurant operating costs, the unfavorable impact of refranchising, higher G&A expenses and a charge associated with the termination of a beverage agreement in the quarter ended March 25, 2006.

Excluding the favorable impact from foreign currency translation, International Division operating profit increased 20% in the third quarter. The increase was driven by the impact of same store sales growth on restaurant profit and franchise and license fees and new unit development, partially offset by higher restaurant operating costs.

Excluding the unfavorable impact from foreign currency translation, International Division operating profit increased 10% year to date. The increase was driven by the impact of new unit development and same store



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sales growth on restaurant profit and franchise and license fees. These increases were partially offset by higher restaurant operating costs and lower equity income from unconsolidated affiliates.

Excluding the favorable impact from foreign currency translation, China Division operating profit increased 23% in the third quarter and 34% year to date. The increases were driven by the impact of same store sales growth on restaurant profit and new unit development, partially offset in the quarter by lapping the impact of a prior year financial recovery from a supplier.

### Interest Expense, Net

	Quarter			Year to date		
	9/09/06	9/03/05	% B/(W)	9/09/06	9/03/05	% B/(W)
Interest expense	\$40	\$34	(15 )	\$116	\$100	(15 )
Interest income	(6 )	(6 )	6	(11 )	(14 )	(22 )
Interest expense, net	\$34	\$28	(17 )	\$105	\$86	(21 )

Interest expense increased \$6 million or 15% in the quarter and \$16 million or 15% year to date. The increases were driven by both an increase in interest rates on the variable rate portion of our debt and increased International borrowings as compared to prior year.

### Income Taxes

	Quarter		Year to date	
	9/09/06	9/03/05	9/09/06	9/03/05
Income taxes	\$80	\$75	\$236	\$198
Effective tax rate	25.8%	26.8%	28.5%	27.0%

Our effective tax rate for the quarter decreased primarily due to the recognition of benefit resulting from the reconciliation of previously recorded tax expense to amounts reflected on our tax returns.

Our year to date effective tax rate increased due to the lapping of prior year items that on a net basis benefited our prior year tax rate. In the year to date ended September 3, 2005 our tax rate benefited from the reversal of certain tax reserves associated with audits that were settled. This prior year benefit was partially offset by the negative impact of tax provided on foreign earnings we repatriated in 2005. The impact of lapping prior year net tax benefits was partially offset by the current year recognition of benefit resulting from the reconciliation of previously recorded tax expense to amounts reflected on our tax returns.

Our effective tax rates for the quarters and years to date in 2006 and 2005 benefited from the recognition of certain foreign tax credits that was driven by events that are not recurring in nature.

### Consolidated Cash Flows

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**Net cash provided by operating activities** was \$1,007 million compared to \$995 million in 2005. The increase was driven by higher net income in the current year. This increase was offset by higher income tax payments and the pension contributions made in 2006.

**Net cash used in investing activities** was \$300 million versus \$270 million in 2005. The increase was driven by the impact of the timing of purchases and sales of short-term investments, the lapping of proceeds related to the 2005 sale of our fifty percent interest in our former unconsolidated affiliate in Poland and the current year

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acquisition of the Rostiks brand in Russia. These factors were partially offset by lower capital spending in the current year and an increase in proceeds received from refranchising.

**Net cash used in financing activities** was \$597 million versus \$554 million in 2005. The increase was driven by higher share repurchases and lower stock option exercises in 2006 compared to 2005, partially offset by an increase in net borrowings.

### Liquidity and Capital Resources

Operating in the QSR industry allows us to generate substantial cash flows from the operations of our company stores and from our franchise operations, which require a limited YUM investment. In each of the last four fiscal years, net cash provided by operating activities has exceeded \$1 billion. We expect these levels of net cash provided by operating activities to continue in the foreseeable future. Our discretionary spending includes capital spending for new restaurants, acquisitions of restaurants from franchisees, repurchases of shares of our common stock and dividends paid to our shareholders. Though a decline in revenues could adversely impact our cash flows from operations, we believe our operating cash flows, our ability to reduce discretionary spending, and our borrowing capacity will allow us to meet our cash requirements in 2006 and beyond.

During the year to date ended September 9, 2006, we paid cash dividends of \$104 million. Additionally, subsequent to the third quarter on September 14, 2006, our Board of Directors declared a cash dividend of \$0.15 per share of Common Stock to be distributed on November 4, 2006 to shareholders of record at the close of business on October 13, 2006. The Company is targeting an annual payout ratio of 15% to 20% of net income.

Our primary bank credit agreement comprises a \$1.0 billion senior unsecured Revolving Credit Facility (the **Credit Facility**) which matures in September 2009. At September 9, 2006, our unused Credit Facility totaled \$779 million, net of outstanding letters of credit of \$221 million. There were no borrowings outstanding under the Credit Facility at September 9, 2006. We were in compliance with all debt covenants under this facility at September 9, 2006.

On November 8, 2005, we executed a \$350 million, five-year revolving credit facility (the **International Credit Facility** or **ICF**) on behalf of three of our wholly owned international subsidiaries. There were borrowings of \$164 million and available credit of \$186 million outstanding under the ICF at September 9, 2006. We were in compliance with all debt covenants under the ICF at September 9, 2006.

In April 2006, we issued \$300 million aggregate principal amount of 6.25% Senior Unsecured Notes due April 15, 2016. We used \$200 million of the proceeds to repay our 8.5% Senior Unsecured Notes due in April 2006 and the remainder for general corporate purposes. At September 9, 2006 we had \$1.6 billion in Senior Notes outstanding. See Note 10 for further details.

In July 2006, we executed a \$165 million short-term credit facility (the **International Term Facility** or **ITF**) on behalf of the International Division which is due in the first quarter of 2007. We used the proceeds from the facility for general corporate purposes. There were borrowings of \$164 million and available credit of \$1 million outstanding at September 9, 2006. The interest rate for borrowings under the ITF is 0.35% over the London Interbank Offered Rate ( **LIBOR** ). The ITF is unconditionally guaranteed by YUM and contains covenants substantially identical to those of our \$1.0 billion senior unsecured Revolving Credit Facility. We were in compliance with all debt covenants at September 9, 2006.

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During July 2006, we also executed an \$80 million short-term facility agreement (the Term Loan ) on behalf of the International Division. There were zero borrowings outstanding at September 9, 2006.

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We estimate that in 2006 capital spending will be approximately \$625 million. We also estimate that in 2006 franchising proceeds, prior to taxes, will total approximately \$250 million, employee stock options proceeds, prior to taxes, will be approximately \$150 million and proceeds from sales of property, plant and equipment will be in excess of \$40 million.

At September 9, 2006, we had remaining capacity to repurchase up to approximately \$100 million of our outstanding Common Stock (excluding applicable transaction fees) under the program authorized in March 2006. On September 14, 2006, our Board of Directors authorized an additional share repurchase program allowing us to repurchase, through September 2007, up to \$500 million (excluding applicable transaction fees) of our outstanding Common Stock.

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

There were no material changes during the quarter ended September 9, 2006 to the disclosures made in Item 7A of the Company's 2005 Form 10-K.

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

#### Evaluation of Disclosure Controls and Procedures

The Company has evaluated the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as of the end of the period covered by this report. Based on the evaluation, performed under the supervision and with the participation of the Company's management, including the Chairman, Chief Executive Officer and President (the CEO) and the Chief Financial Officer (the CFO), the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by the report.

#### Changes in Internal Control

There were no significant changes with respect to the Company's internal control over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, internal control over financial reporting during the quarter ended September 9, 2006.

### **Cautionary Note Regarding Forward-Looking Statements**

This report may contain forward-looking statements within the meaning of the U.S. federal securities laws. These forward-looking statements are intended to be covered by the safe harbor provisions for forward-looking statements in the federal securities laws. The statements include those identified by such words as may, will, expect, project, anticipate, believe, plan and other similar terminology. These forward-looking statements reflect our current expectations regarding future events and operating and financial performance and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to us and those specific to the industry, and could differ materially from expectations. These risks and uncertainties include, but are not limited to those described in Part II, Item 1A

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Risk Factors in this report, those described under Risk Factors in Part I, Item 1A of our Form 10-K for the year ended December 31, 2005, and those described from time to time in our reports filed with the Securities and Exchange Commission. We do not undertake any obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise. You are cautioned not to place undue reliance on forward-looking statements.



Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

YUM! Brands, Inc.:

We have reviewed the accompanying Condensed Consolidated Balance Sheet of YUM! Brands, Inc. and Subsidiaries ( YUM ) as of September 9, 2006, the related Condensed Consolidated Statements of Income for the twelve and thirty-six weeks ended September 9, 2006 and September 3, 2005, and the related Condensed Consolidated Statements of Cash Flows for the thirty-six weeks ended September 9, 2006 and September 3, 2005. These condensed consolidated financial statements are the responsibility of YUM s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Consolidated Balance Sheet of YUM as of December 31, 2005, and the related Consolidated Statements of Income, Cash Flows and Shareholders Equity and Comprehensive Income for the year then ended not presented herein; and in our report dated March 2, 2006, we expressed an unqualified opinion on those consolidated financial statements. Our report refers to the adoption of the provisions of the Financial Accounting Standards Boards Statement of Financial Accounting Standards No. 123R (Revised 2004), Share-Based Payment, and the change in method of accounting for share-based payments. In our opinion, the information set forth in the accompanying Condensed Consolidated Balance Sheet as of December 31, 2005 is fairly presented, in all material respects, in relation to the Consolidated Balance Sheet from which it has been derived.

KPMG LLP

Louisville, Kentucky

October 17, 2006

**PART II Other Information and Signatures**

Item 1. Legal Proceedings

Information regarding legal proceedings is incorporated by reference from Note 12 to the Company's Condensed Consolidated Financial Statements set forth in Part I of this report.

Item 1A. Risk Factors

We face a variety of risks that are inherent in our business and our industry, including operational, legal, regulatory and product risks. The following are some of the more significant factors that could affect our business and our results of operations:

Health concerns arising from outbreaks of Avian Flu and food safety and food-borne illness concerns may have an adverse effect on our business;

Our foreign operations, which are significant, subject us to risks that could negatively affect our business such as fluctuations in foreign currency exchange rates and changes in economic conditions, tax systems, consumer preferences, social conditions and political conditions inherent in foreign operations;

Changes in commodity and other operating costs or supply chain and business disruptions could adversely affect our results of operations;

Our operating results are closely tied to the success of our franchisees, and any significant inability of our franchisees to operate successfully could adversely affect our operating results;

We could be party to litigation that could adversely affect us by increasing our expenses or subjecting us to material money damages and other remedies;

Changes in governmental regulations may adversely affect our business operations;

We may not attain our target development goals which are dependent upon our ability and the ability of our franchisees to upgrade existing restaurants and open new restaurants and to operate these restaurants on a profitable basis; and

The restaurant industry in which we operate is highly competitive.

These risks are described in more detail under "Risk Factors" in Item 1A of our Form 10-K for the year ended December 31, 2005. We encourage you to read these risk factors in their entirety. Other factors may also exist that we cannot anticipate or that we currently do not consider to be significant based on information that is currently available.



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

The following table provides information as of September 9, 2006 with respect to shares of Common Stock repurchased by the Company during the quarter then ended:

		Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or programs
Fiscal Periods					
Period 7					
6/18/06	7/15/06	1,383,700	49.80	1,383,700	370,963,118
Period 8					
7/16/06	8/12/06	3,706,300	46.28	3,706,300	199,453,330
Period 9					
8/13/06	9/09/06	2,000,800	48.27	2,000,800	102,883,578
Total		7,090,800	47.52	7,090,800	102,883,578

In March 2006, our Board of Directors authorized a share repurchase program to repurchase, through March 2007, up to \$500 million (excluding applicable transaction fees) of our outstanding Common Stock. For the quarter ended September 9, 2006, approximately 7.1 million shares were repurchased under this program.

On September 14, 2006, our Board of Directors authorized an additional share repurchase program allowing us to repurchase, through September 2007, up to \$500 million (excluding applicable transaction fees) of our outstanding Common Stock. Shares to be purchased under this program are not included in the table above.

### Item 6. Exhibits

(a) Exhibit Index

EXHIBITS

Exhibit 15	Letter from KPMG LLP regarding Unaudited Interim Financial Information (Accountants Acknowledgement).
Exhibit 31.1	Certification of the Chairman, Chief Executive Officer and President pursuant to Rule 13a-14(a) of Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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- Exhibit 32.1 Certification of the Chairman, Chief Executive Officer and President pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- Exhibit 32.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

Pursuant to the requirement of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, duly authorized officer of the registrant.

YUM! BRANDS, INC.  
(Registrant)

Date: October 17, 2006

/s/ Ted F. Knopf  
Senior Vice President of Finance  
  
and Corporate Controller  
(Principal Accounting Officer)

Exhibit 31.1

**CERTIFICATION**

I, David C. Novak, certify that:

1. I have reviewed this report on Form 10-Q of YUM! Brands, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant, as of, and for, the periods presented in this report.
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
  - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 17, 2006

/s/ David C. Novak  
Chairman, Chief Executive Officer and President

Exhibit 31.2

**CERTIFICATION**

I, Richard T. Carucci, certify that:

1. I have reviewed this report on Form 10-Q of YUM! Brands, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant, as of, and for, the periods presented in this report.
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
  - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 17, 2006

/s/ Richard T. Carucci  
Chief Financial Officer



Exhibit 32.1

CERTIFICATION OF CHAIRMAN AND CHIEF EXECUTIVE OFFICER

PURSUANT TO

18 U.S.C. SECTION 1350,

AS ADOPTED PURSUANT TO

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of YUM! Brands, Inc. (the Company) on Form 10-Q for the quarter ended September 9, 2006, as filed with the Securities and Exchange Commission on the date hereof (the Periodic Report), I, David C. Novak, Chairman, Chief Executive Officer and President of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Periodic Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. the information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 17, 2006

/s/ David C. Novak  
Chairman, Chief Executive Officer and President

A signed original of this written statement required by Section 906 has been provided to YUM! Brands, Inc. and will be retained by YUM! Brands, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

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Exhibit 32.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER

PURSUANT TO

18 U.S.C. SECTION 1350,

AS ADOPTED PURSUANT TO

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of YUM! Brands, Inc. (the Company) on Form 10-Q for the quarter ended September 9, 2006, as filed with the Securities and Exchange Commission on the date hereof (the Periodic Report), I, Richard T. Carucci, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Periodic Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. the information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 17, 2006

/s/ Richard T. Carucci  
Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to YUM! Brands, Inc. and will be retained by YUM! Brands, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.