HERSHEY CO
Form 10-Q
August 06, 2008

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

FORM 10-Q

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

For the quarterly period ended June 29, 2008

OR

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

For the transition period
from ______to_______

Commission file number 1-183

THE HERSHEY COMPANY
100 Crystal A Drive
Hershey, PA 17033

Registrant's telephone number: 717-534-4200

State of Incorporation	IRS Employer Identification No.
Delaware	23-0691590

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 x No o

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller	Smaller reporting company o

reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
Common Stock, $1 par value – 166,215,273 shares, as of July 18, 2008. Class B Common Stock, $1 par value – 60,805,727 shares, as of July 18, 2008.

THE HERSHEY COMPANY
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PART I - FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (Unaudited)

THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(in thousands except per share amounts)

	For the Three Months Ended	
	June 29, 2008	July 1, 2007
Net Sales	$ 1,105,437	$ 1,051,916
Costs and Expenses:		
Cost of sales	722,926	722,478
Selling, marketing and administrative	266,612	216,870
Business realignment and impairment charges, net	21,786	79,728
Total costs and expenses	1,011,324	1,019,076
Income before Interest and Income Taxes	94,113	32,840
Interest expense, net	23,610	29,213
Income before Income Taxes	70,503	3,627
Provision for income taxes	29,036	73
Net Income	$ 41,467	$ 3,554
Earnings Per Share - Basic - Class B Common Stock	$ .17	$ .01
Earnings Per Share - Diluted - Class B Common Stock	$ .17	$ .02
Earnings Per Share - Basic - Common Stock	$ .19	$ .02
Earnings Per Share - Diluted - Common Stock	$ .18	$ .01
Average Shares Outstanding - Basic - Common Stock	166,624	168,309
Average Shares Outstanding - Basic - Class B Common Stock	60,806	60,815
Average Shares Outstanding - Diluted	228,664	231,963
Cash Dividends Paid Per Share:		
Common Stock	$ .2975	$ .2700

Class B Common Stock	$	.2678	$	.2425

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

THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(in thousands except per share amounts)

	For the Six Months Ended June 29, 2008	July 1, 2007
Net Sales	$ 2,265,779	$ 2,205,025
Costs and Expenses:		
Cost of sales	1,506,816	1,461,556
Selling, marketing and administrative	516,561	433,303
Business realignment and impairment charges, net	25,871	107,273
Total costs and expenses	2,049,248	2,002,132
Income before Interest and Income Taxes	216,531	202,893
Interest expense, net	47,996	57,468
Income before Income Taxes	168,535	145,425
Provision for income taxes	63,823	48,398
Net Income	$ 104,712	$ 97,027
Earnings Per Share - Basic - Class B Common Stock	$ .43	$ .39
Earnings Per Share - Diluted - Class B Common Stock	$ .43	$ .39
Earnings Per Share - Basic - Common Stock	$ .47	$ .43
Earnings Per Share - Diluted - Common Stock	$ .46	$ .42
Average Shares Outstanding - Basic - Common Stock	166,701	169,078
Average Shares Outstanding - Basic - Class B Common Stock	60,806	60,815
Average Shares Outstanding - Diluted	228,798	232,841
Cash Dividends Paid Per Share:		
Common Stock	$ .5950	$ .5400
Class B Common Stock	$ .5356	$ .4850

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

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THE HERSHEY COMPANY
CONSOLIDATED BALANCE SHEETS
(in thousands of dollars)

ASSETS	June 29, 2008	December 31, 2007
Current Assets:		
Cash and cash equivalents	$ 45,427	$ 129,198
Accounts receivable - trade	302,952	487,285
Inventories	697,569	600,185
Deferred income taxes	44,913	83,668
Prepaid expenses and other	188,156	126,238
Total current assets	1,279,017	1,426,574
Property, Plant and Equipment, at cost	3,490,170	3,606,443
Less-accumulated depreciation and amortization	(1,997,476)	(2,066,728)
Net property, plant and equipment	1,492,694	1,539,715
Goodwill	578,689	584,713
Other Intangibles	168,522	155,862
Other Assets	559,770	540,249
Total assets	$ 4,078,692	$ 4,247,113
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 281,152	$ 223,019
Accrued liabilities	486,128	538,986
Accrued income taxes	1,579	373
Short-term debt	419,372	850,288
Current portion of long-term debt	16,874	6,104
Total current liabilities	1,205,105	1,618,770
Long-term Debt	1,514,029	1,279,965
Other Long-term Liabilities	527,693	544,016
Deferred Income Taxes	181,897	180,842
Total liabilities	3,428,724	3,623,593
Minority Interest	42,345	30,598
Stockholders' Equity:		
Preferred Stock, shares issued:		
none in 2008 and 2007	—	—
Common Stock, shares issued: 299,096,017 in 2008 and 299,095,417 in 2007	299,095	299,095
Class B Common Stock, shares issued: 60,805,727 in 2008 and 60,806,327 in 2007	60,806	60,806
Additional paid-in capital	336,665	335,256
Retained earnings	3,900,537	3,927,306
Treasury-Common Stock shares at cost:		
132,883,044 in 2008 and 132,851,893 in 2007	(4,008,137)	(4,001,562)
Accumulated other comprehensive income (loss)	18,657	(27,979)

Total stockholders' equity	607,623	592,922
Total liabilities, minority interest and stockholders' equity	$ 4,078,692	$ 4,247,113

The accompanying notes are an integral part of these consolidated balance sheets.

THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands of dollars)

	For the Six Months Ended	
	June 29, 2008	July 1, 2007
Cash Flows Provided from (Used by) Operating Activities		
Net Income	$ 104,712	$ 97,027
Adjustments to Reconcile Net Income to Net Cash		
Provided from Operations:		
Depreciation and amortization	125,088	144,003
Stock-based compensation expense, net of tax of $6,546 and $4,377, respectively	11,537	7,988
Excess tax benefits from exercise of stock options	(559)	(8,481)
Deferred income taxes	39,795	41,069
Business realignment initiatives, net of tax of $23,774 and $61,342, respectively	46,155	103,430
Contributions to pension plans	(3,813)	(7,836)
Changes in assets and liabilities, net of effects from business acquisitions and divestitures:		
Accounts receivable - trade	183,876	149,719
Inventories	(95,618)	(166,637)
Accounts payable	58,133	87,044
Other assets and liabilities	(149,234)	(153,821)
Net Cash Flows Provided from Operating Activities	320,072	293,505
Cash Flows Provided from (Used by) Investing Activities		
Capital additions	(138,374)	(77,905)
Capitalized software additions	(8,157)	(5,259)
Proceeds from sales of property, plant and equipment	76,860	—
Business acquisitions	—	(76,989)
Proceeds from divestiture	1,960	—
Net Cash Flows (Used by) Investing Activities	(67,711)	(160,153)
Cash Flows Provided from (Used by) Financing Activities		
Net (decrease) increase in short-term debt	(430,916)	264,231
Long-term borrowings	247,845	—
Repayment of long-term debt	(2,167)	(188,800)
Cash dividends paid	(131,481)	(120,798)
Exercise of stock options	21,114	42,234
Excess tax benefits from exercise of stock options	559	8,481
Repurchase of Common Stock	(41,086)	(197,019)
Net Cash Flows (Used by) Financing Activities	(336,132)	(191,671)
Decrease in Cash and Cash Equivalents	(83,771)	(58,319)
Cash and Cash Equivalents, beginning of period	129,198	97,141

Cash and Cash Equivalents, end of period	$	45,427	$	38,822
Interest Paid	$	47,259	$	62,495
Income Taxes Paid	$	94,988	$	105,852

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

THE HERSHEY COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Our unaudited consolidated financial statements provided in this report include the accounts of the Company and our majority-owned subsidiaries and entities in which we have a controlling financial interest after the elimination of intercompany accounts and transactions. We have a controlling financial interest if we own a majority of the outstanding voting common stock and minority shareholders do not have substantive participating rights, or we have significant control over an entity through contractual or economic interests in which we are the primary beneficiary. We prepared these statements in accordance with the instructions to Form 10-Q. These statements do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements.

We included all adjustments (consisting only of normal recurring accruals) which we believe were considered necessary for a fair presentation. Operating results for the six months ended June 29, 2008 may not be indicative of the results that may be expected for the year ending December 31, 2008, because of the seasonal effects of our business. For more information, refer to the consolidated financial statements and notes included in our 2007 Annual Report on Form 10-K.

2. BUSINESS ACQUISITIONS AND DIVESTITURES

In May 2007, we entered into an agreement with Godrej Beverages and Foods, Ltd., one of India's largest consumer goods, confectionery and food companies, to manufacture and distribute confectionery products, snacks and beverages across India. Under the agreement, we invested $61.5 million during 2007 and own a 51% controlling interest in Godrej Hershey Ltd. (formerly Godrej Hershey Foods and Beverages Company). Total liabilities assumed in 2007 were $51.6 million. Effective in May 2007, this business acquisition was included in our consolidated results, including the related minority interest.

Also in May 2007, we entered into a manufacturing agreement in China with Lotte Confectionery Co., LTD., to produce Hershey products and certain Lotte products for the market in China. We invested $39.0 million in 2007 and own a 44% interest. We are accounting for this investment using the equity method.

In January 2008, our Brazilian subsidiary, Hershey do Brasil, entered into a cooperative agreement with Pandurata Alimentos LTDA ("Bauducco"), a leading manufacturer of baked goods in Brazil whose primary brand is Bauducco. The arrangement with Bauducco will leverage Bauducco's strong sales and distribution capabilities for our products throughout Brazil. Under this agreement we will manufacture and market, and they will sell and distribute our products. In the fourth quarter of 2007, we recorded a goodwill impairment charge and approved a business realignment program associated with initiatives to improve distribution and enhance performance of our business in Brazil. In the first quarter of 2008, we received approximately $2.0 million in cash and recorded an other intangible asset of $13.7 million associated with the cooperative agreement with Bauducco in exchange for a 49% interest in Hershey do Brasil. We will maintain a 51% controlling interest in Hershey do Brasil.

3. STOCK COMPENSATION PLANS

The Hershey Company Equity and Incentive Compensation Plan ("EICP") is the plan under which grants using shares for compensation and incentive purposes are made. The following table summarizes our stock compensation costs:

	For the Three Months Ended		For the Six Months Ended	
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
	(in millions of dollars)			
Total compensation amount charged against income for stock options, performance stock units (“PSUs”) and restricted stock units	$ 9.0	$ 5.5	$17.8	$12.4
Total income tax benefit recognized in the Consolidated Statements of Income for share-based compensation	$ 3.4	$ 1.9	$ 6.4	$ 4.4

The increase in share-based compensation expense for the second quarter of 2008 resulted from the impact of lowered performance expectations for the PSUs in 2007.

The increase in share-based compensation expense for the first six months of 2008 resulted from the impact of lowered performance expectations for the PSUs in 2007 and the timing of the 2007 stock option grants. Our annual grant of stock options to management level employees, which customarily has occurred in February of each year, was delayed in 2007 pending approval by our stockholders of the EICP at the annual meeting in April 2007. In 2008, we resumed our customary February grant schedule.

We estimated the fair value of each stock option grant on the date of the grant using a Black-Scholes option-pricing model and the weighted-average assumptions set forth in the following table:

	For the Six Months Ended	
	June 29, 2008	July 1, 2007
Dividend yield	2.4%	2.0%
Expected volatility	18.1%	19.5%
Risk-free interest rates	3.1%	4.6%
Expected lives in years	6.6	6.6

Stock Options

A summary of the status of our stock options as of June 29, 2008, and the change during 2008 is presented below:

	For the Six Months Ended June 29, 2008		
Stock Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term
Outstanding at beginning of year	13,889,116	$43.26	6.2 years
Granted	4,343,989	$35.96	
Exercised	(673,176)	$31.37	
Forfeited	(292,739)	$46.86	
Outstanding as of June 29, 2008	17,267,190	$41.82	6.8 years
Options exercisable as of June 29, 2008	9,241,390	$40.22	5.1 years

	For the Six Months Ended	
	June 29, 2008	July 1, 2007
Weighted-average fair value of options granted (per share)	$ 6.21	$ 12.95
Intrinsic value of options exercised (in millions of dollars)	$ 4.9	$ 31.3

- As of June 29, 2008, the aggregate intrinsic value of options outstanding and the aggregate intrinsic value of options exercisable was $9.3 million.

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As of June 29, 2008, there was $48.9 million of total unrecognized compensation cost related to non-vested stock option compensation arrangements granted under our stock option plans. That cost is expected to be recognized over a weighted-average period of 2.7 years.

Performance Stock Units and Restricted Stock Units

A summary of the status of our performance stock units and restricted stock units as of June 29, 2008, and the change during 2008 is presented below:

Performance Stock Units and Restricted Stock Units	For the Six Months Ended June 29, 2008	Weighted-average grant date fair value for equity awards or market value for liability awards
Outstanding at beginning of year	691,032	$38.14
Granted	372,578	$39.01
Vested	(304,179)	$33.15
Forfeited	(17,200)	$41.42
Outstanding as of June 29, 2008	742,231	$36.73

As of June 29, 2008, there was $14.8 million of unrecognized compensation cost relating to non-vested performance stock units and restricted stock units. We expect to recognize that cost over a weighted-average period of 2.9 years.

	For the Six Months Ended	
	June 29, 2008	July 1, 2007
Intrinsic value of share-based liabilities paid, combined with the fair value of shares vested (in millions of dollars)	$ 8.9	$ 21.0

The higher 2007 amount was due to the payment of awards earned for the 2004-2006 performance stock unit cycle. In 2008, no payment was made for the 2005-2007 performance stock unit cycle based on the Company's performance against the two financial objectives which fell below the threshold levels required to earn an award.

Deferred performance stock units, deferred restricted stock units, and directors' fees and accumulated dividend amounts representing deferred stock units totaled 430,811 units as of June 29, 2008. Each unit is equivalent to one share of the Company's Common Stock.

No stock appreciation rights were outstanding as of June 29, 2008.

For more information on our stock compensation plans, refer to the consolidated financial statements and notes included in our 2007 Annual Report on Form 10-K and our proxy statement for the 2008 annual meeting of stockholders.

4. INTEREST EXPENSE

Net interest expense consisted of the following:

	For the Six Months Ended	
	June 29, 2008	July 1, 2007
	(in thousands of dollars)	
Interest expense	$ 51,943	$ 58,860
Interest income	(1,047)	(1,327)
Capitalized interest	(2,900)	(65)
Interest expense, net	$ 47,996	$ 57,468

5. BUSINESS REALIGNMENT INITIATIVES

In February 2007, we announced a comprehensive, three-year supply chain transformation program (the “global supply chain transformation program”) and, in December 2007, we initiated a business realignment program associated with our business in Brazil (together, “the 2007 business realignment initiatives”).

When completed, the global supply chain transformation program will greatly enhance our manufacturing, sourcing and customer service capabilities, reduce inventories resulting in improvements in working capital and generate significant resources to invest in our growth initiatives. This program will provide for accelerated marketplace momentum within our core U.S. business, creation of innovative new product platforms to meet customer needs and disciplined global expansion.

Under the program, which is being implemented in stages over three years, we will significantly increase manufacturing capacity utilization by reducing the number of production lines by more than one-third, outsource production of low value-added items and construct a flexible, cost-effective production facility in Monterrey, Mexico to meet current and emerging marketplace needs. The program will result in a total net reduction of 1,500 positions across our supply chain over the three-year implementation period.

The estimated pre-tax cost of the program announced in February 2007 was from $525 million to $575 million over three years. The total included from $475 million to $525 million in business realignment costs and approximately $50 million in project implementation costs. The costs will be incurred primarily in 2007 and 2008. Total costs of $400.0 million were recorded in 2007 and total costs of $66.0 million were recorded during the first six months of 2008 for this program.

In 2001, we acquired a small business in Brazil, Hershey do Brasil, which has not gained profitable scale or adequate market distribution. In an effort to improve the performance of this business, in January 2008 Hershey do Brasil entered into a cooperative agreement with Bauducco. In the fourth quarter of 2007 we recorded a goodwill impairment charge of $12.3 million associated with Hershey do Brasil, along with a business realignment charge of $.3 million primarily related to employee separation costs. Business realignment charges of $3.9 million were recorded in the first six months of 2008.

Charges (credits) associated with business realignment initiatives recorded during the three-month and six-month periods ended June 29, 2008 and July 1, 2007 were as follows:

	For the Three Months Ended		For the Six Months Ended	
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
	(in thousands of dollars)			
Cost of sales – 2007 business realignment initiatives	$ 15,027	$ 41,307	$ 40,181	$ 51,166
Selling, marketing and administrative – 2007 business realignment initiatives	2,443	3,347	3,877	6,333
Business realignment and impairment charges, net:				
Global supply chain transformation program				
Losses (gains) on sale of fixed assets	7,110	—	(6,790)	—
Fixed asset impairments and plant closure expenses	5,488	13,878	15,265	40,098
Employee separation costs	7,985	51,534	11,874	52,859
Contract termination costs	1,591	14,316	1,591	14,316
Brazilian business realignment				
Employee separation (credits) costs	(334)	—	1,526	—
Fixed asset impairment (credits) charges	(5)	—	717	—

Contract termination costs and other exit (credits) costs	(49)	—	1,688	—
Total business realignment and impairment charges, net	21,786	79,728	25,871	107,273
Total net charges associated with 2007 business realignment initiatives	$ 39,256	$ 124,382	$ 69,929	$ 164,772

The charge of $15.0 million recorded in cost of sales during the second quarter of 2008 related primarily to the accelerated depreciation of fixed assets over a reduced estimated remaining useful life and start-up costs associated with the global supply chain transformation program. The $2.4 million recorded in selling, marketing and administrative expenses related primarily to project administration for the global supply chain transformation program. In determining the costs related to fixed asset impairments, fair value was estimated based on the expected sales proceeds. The $7.1 million of losses on sale of fixed assets resulted from the write-off of machinery and equipment at a plant which was sold during the quarter. The $5.5 million of fixed asset impairments and plant closure expenses for 2008 related primarily to the preparation of plants for sale and line removal costs. Certain real estate with a carrying value of $12.9 million was being held for sale as of June 29, 2008. The decrease from the prior quarter was due to asset sales during the second quarter. The

global supply chain transformation program employee separation costs included $3.1 million related to involuntary terminations at the North American manufacturing facilities which are being closed and $4.9 million primarily related to pension settlements. The global supply chain transformation program had identified six manufacturing facilities which would be closed. As of June 29, 2008, the facilities located in Dartmouth, Nova Scotia; Montreal, Quebec and Oakdale, California have been closed and sold. The facility located in Naugatuck, Connecticut has been closed and is being held for sale. The facilities in Reading, Pennsylvania and Smiths Falls, Ontario are being held and used pending closure, following which they will be offered for sale.

The charge of $40.2 million recorded in cost of sales during the first six months of 2008 related primarily to the accelerated depreciation of fixed assets over a reduced estimated remaining useful life and start-up costs associated with the global supply chain transformation program. The $3.9 million recorded in selling, marketing and administrative expenses related primarily to project administration for the global supply chain transformation program. In determining the costs related to fixed asset impairments, fair value was estimated based on the expected sales proceeds. The $6.8 million of gains on sale of fixed assets resulted from the receipt of proceeds in excess of the carrying value primarily from the sale of a warehousing and distribution facility. The $15.3 million of fixed asset impairments and plant closure expenses for 2008 related primarily to the preparation of plants for sale and line removal costs. The global supply chain transformation program employee separation costs included $7.0 million related to involuntary terminations at the North American manufacturing facilities which are being closed and $4.9 million primarily related to pension settlements.

The charges (credits) for the Brazilian business realignment were related to costs for involuntary terminations and costs associated with office consolidation related to the cooperative agreement with Bauducco.

The charge of $41.3 million recorded in cost of sales during the second quarter of 2007 related to the accelerated depreciation of fixed assets over a reduced estimated remaining useful life and costs related to inventory reductions. The $3.3 million recorded in selling, marketing and administrative expenses related primarily to project administration. In determining the costs related to fixed asset impairments, fair value was estimated based on the expected sales proceeds. The employee separation costs included $22.3 million for involuntary terminations at the North American manufacturing facilities which have been closed or are being closed. The employee separation costs also included $29.2 million for charges relating to pension and other post-retirement benefits curtailments and special termination benefits.

The charge of $51.2 million recorded in cost of sales during the first six months of 2007 related to the accelerated depreciation of fixed assets over a reduced estimated remaining useful life and costs related to inventory reductions. The $6.3 million recorded in selling, marketing and administrative expenses related primarily to project administration. In determining the costs related to fixed asset impairments, fair value was estimated based on the expected sales proceeds. The employee separation costs included $23.7 million for involuntary terminations and $29.2 million for charges relating to pension and other post-retirement benefits curtailments and special termination benefits.

The June 29, 2008 liability balance relating to the 2007 business realignment initiatives was $46.6 million for employee separation costs. During the first six months of 2008, we made payments against the liabilities recorded for the 2007 business realignment initiatives of $30.3 million principally related to employee separation costs.

6. EARNINGS PER SHARE

In accordance with Statement of Financial Accounting Standards No. 128, Earnings Per Share, we compute Basic and Diluted Earnings Per Share based on the weighted-average number of shares of the Common Stock and the Class B Common Stock outstanding as follows:

	For the Three Months Ended		For the Six Months Ended	
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
	(in thousands except per share amounts)			
Net income	$ 41,467	$ 3,554	$ 104,712	$ 97,027
Weighted-average shares - Basic				
Common Stock	166,624	168,309	166,701	169,078
Class B Common Stock	60,806	60,815	60,806	60,815
Total weighted-average shares - Basic	227,430	229,124	227,507	229,893
Effect of dilutive securities:				
Employee stock options	937	2,330	956	2,367
Performance and restricted stock units	297	509	335	581
Weighted-average shares - Diluted	228,664	231,963	228,798	232,841
Earnings Per Share - Basic				
Class B Common Stock	$ .17	$ .01	$ .43	$ .39
Common Stock	$ .19	$ .02	$ .47	$ .43
Earnings Per Share - Diluted				
Class B Common Stock	$ .17	$ .02	$ .43	$ .39
Common Stock	$ .18	$ .01	$ .46	$ .42

The Class B Common Stock is convertible into Common Stock on a share for share basis at any time. In accordance with proposed Financial Accounting Standards Board (“FASB”) Staff Position No. FAS 128-a, Computational Guidance for Computing Diluted EPS under the Two-Class Method, the calculation of earnings per share-diluted for the Class B Common Stock was performed using the two-class method and the calculation of earnings per share-diluted for the Common Stock was performed using the if-converted method.

For the three-month and six-month periods ended June 29, 2008, 12.8 million stock options were not included in the diluted earnings per share calculation because the effect would have been antidilutive. For the three-month and six-month periods ended July 1, 2007, 5.6 million stock options were not included in the diluted earnings per share calculation because the effect would have been antidilutive.

7. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We account for derivative instruments in accordance with Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (“SFAS No. 133”). SFAS No. 133 requires us to recognize all derivative instruments at fair value. We classify the derivatives as assets or liabilities on the balance sheet. As of June 29, 2008 and July 1, 2007, all of our derivative instruments were designated as cash flow hedges.

Summary of Activity

Our cash flow hedging derivative activity during the three months and six months ended June 29, 2008 and July 1, 2007 was as follows:

	For the Three Months Ended		For the Six Months Ended	
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
	(in millions of dollars)			
Net after-tax gains (losses) on cash flow hedging derivatives	$40.7	$(1.0)	$62.3	$4.9
Reclassification adjustment of gains (losses) from accumulated other comprehensive income to income, net of tax	12.0	(1.2)	18.5	(1.1)
Hedge ineffectiveness gains recognized in cost of sales, before tax	.7	–	.5	–

- Net gains and losses on cash flow hedging derivatives were primarily associated with commodities futures contracts.

- Reclassification adjustments from accumulated other comprehensive income (loss) to income related to gains or losses on commodities futures contracts were reflected in cost of sales. Reclassification adjustments for gains on interest rate swaps were reflected as an adjustment to interest expense.

- We recognized no components of gains or losses on cash flow hedging derivatives in income due to excluding such components from the hedge effectiveness assessment.

The amount of net gains on cash flow hedging derivatives, including foreign exchange forward contracts, interest rate swap agreements and commodities futures contracts, expected to be reclassified into earnings in the next twelve months was approximately $26.8 million after tax as of June 29, 2008. This amount was primarily associated with commodities futures contracts.

For more information, refer to the consolidated financial statements and notes included in our 2007 Annual Report on Form 10-K.

8. COMPREHENSIVE INCOME

A summary of the components of comprehensive income (loss) is as follows:

	For the Three Months Ended June 29, 2008		
	Pre-Tax Amount	Tax (Expense) Benefit	After-Tax Amount
		(in thousands of dollars)	
Net income			$ 41,467

Other comprehensive income (loss):					
Foreign currency translation adjustments	$	3,787	$	—	3,787
Pension and post-retirement benefit plans		4,830		(1,918)	2,912
Cash flow hedges:					
Gains on cash flow hedging derivatives		63,561		(22,877)	40,684
Reclassification adjustments		(18,767)		6,761	(12,006)
Total other comprehensive income	$	53,411	$	(18,034)	35,377
Comprehensive income					$ 76,844

	For the Three Months Ended July 1, 2007		
	Pre-Tax Amount	Tax (Expense) Benefit	After-Tax Amount
		(in thousands of dollars)	
Net income			$ 3,554
Other comprehensive income (loss):			
Foreign currency translation adjustments	$ 24,714	$ —	24,714
Pension and post-retirement benefit plans	2,425	(1,073)	1,352
Cash flow hedges:			
Losses on cash flow hedging derivatives	(1,649)	600	(1,049)
Reclassification adjustments	1,819	(644)	1,175
Total other comprehensive income	$ 27,309	$ (1,117)	26,192
Comprehensive income			$ 29,746

	For the Six Months Ended June 29, 2008		
	Pre-Tax Amount	Tax (Expense) Benefit	After-Tax Amount
		(in thousands of dollars)	
Net income			$ 104,712
Other comprehensive income (loss):			
Foreign currency translation adjustments	$ (95)	$ —	(95)
Pension and post-retirement benefit plans	4,924	(1,961)	2,963
Cash flow hedges:			
Gains on cash flow hedging derivatives	97,300	(35,020)	62,280
Reclassification adjustments	(28,964)	10,452	(18,512)
Total other comprehensive income	$ 73,165	$ (26,529)	46,636
Comprehensive income			$ 151,348

	For the Six Months Ended July 1, 2007		
	Pre-Tax Amount	Tax (Expense) Benefit	After-Tax Amount
		(in thousands of dollars)	
Net income			$ 97,027
Other comprehensive income (loss):			
Foreign currency translation adjustments	$ 27,318	$ —	27,318
Pension and post-retirement benefit plans	3,720	(1,592)	2,128
Cash flow hedges:			
Gains on cash flow hedging derivatives	7,647	(2,768)	4,879
Reclassification adjustments	1,626	(570)	1,056
Total other comprehensive income	$ 40,311	$ (4,930)	35,381
Comprehensive income			$ 132,408

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The components of accumulated other comprehensive income (loss) as shown on the Consolidated Balance Sheets are as follows:

	June 29, 2008	December 31, 2007
	(in thousands of dollars)	
Foreign currency translation adjustments	$ 44,715	$ 44,810
Pension and post-retirement benefit plans, net of tax	(76,602)	(79,565)
Cash flow hedges, net of tax	50,544	6,776
Total accumulated other comprehensive income (loss)	$ 18,657	$ (27,979)

9. INVENTORIES

We value the majority of our inventories under the last-in, first-out ("LIFO") method and the remaining inventories at the lower of first-in, first-out ("FIFO") cost or market. Inventories were as follows:

	June 29, 2008	December 31, 2007
	(in thousands of dollars)	
Raw materials	$ 265,344	$ 199,460
Goods in process	111,892	80,282
Finished goods	451,233	407,058
Inventories at FIFO	828,469	686,800
Adjustment to LIFO	(130,900)	(86,615)
Total inventories	$ 697,569	$ 600,185

The increase in raw material inventories as of June 29, 2008 resulted from the timing of deliveries to support manufacturing requirements and higher prices in 2008. The increase in finished goods inventories was primarily associated with seasonal sales patterns and the introduction of new products.

10. SHORT-TERM DEBT

As a source of short-term financing, we utilize commercial paper or bank loans with an original maturity of three months or less. In December 2006, we entered into a five-year unsecured revolving credit agreement. The credit limit is $1.1 billion with an option to borrow an additional $400 million with the concurrence of the lenders. During the fourth quarter of 2007, the lenders approved a one-year extension to the term of this agreement in accordance with our option under the agreement. These funds may be used for general corporate purposes. The unsecured revolving credit agreement contains certain financial and other covenants, customary representations, warranties, and events of default. As of June 29, 2008, we complied with all covenants pertaining to the credit agreement. There were no significant compensating balance agreements that legally restricted these funds. For more information, refer to the consolidated financial statements and notes included in our 2007 Annual Report on Form 10-K.

In August 2007, we entered into an unsecured revolving short-term credit agreement to borrow up to an additional $300 million because we believed at the time that seasonal working capital needs, share repurchases and other business activities would cause our borrowings to exceed the $1.1 billion borrowing limit available under our five-year credit agreement. We used the funds borrowed under this new agreement for general corporate purposes, including commercial paper backstop. Although the new agreement was scheduled to expire in August 2008, we elected to terminate it in June 2008 because we determined that we no longer needed the additional borrowing capacity provided by the agreement.

11. LONG-TERM DEBT

In May 2006, we filed a shelf registration statement on Form S-3 that registered an indeterminate amount of debt securities. This registration statement was effective immediately upon filing under Securities and Exchange Commission regulations governing “well-known seasoned issuers” (the “WKSI Registration Statement”). In March 2008, the Company issued $250 million of 5.0% Notes due April 1, 2013 under the WKSI Registration Statement. The net proceeds of this debt issuance were used to repay a portion of the Company’s outstanding indebtedness under its short-term commercial paper program.

12. FINANCIAL INSTRUMENTS

The carrying amounts of financial instruments including cash and cash equivalents, accounts receivable, accounts payable and short-term debt approximated fair value as of June 29, 2008 and December 31, 2007, because of the relatively short maturity of these instruments.

The carrying value of long-term debt, including the current portion, was $1,530.9 million as of June 29, 2008, compared with a fair value of $1,556.6 million, an increase of $25.7 million over the carrying value, based on quoted market prices for the same or similar debt issues.

Foreign Exchange Forward Contracts

The following table summarizes our foreign exchange activity:

	June 29, 2008	
	Contract Amount	Primary Currencies
	(in millions of dollars)	
Foreign exchange forward contracts to purchase foreign currencies	$ 14.2	British pounds Australian dollars
Foreign exchange forward contracts to sell foreign currencies	$ 164.1	Canadian dollars Mexican pesos

Our foreign exchange forward contracts mature in 2008 and 2009.

We define the fair value of foreign exchange forward contracts as the amount of the difference between contracted and current market foreign currency exchange rates at the end of the period. On a quarterly basis, we estimate the fair value of foreign exchange forward contracts by obtaining market quotes for future contracts with similar terms, adjusted where necessary for maturity differences. We do not hold or issue financial instruments for trading purposes.

The total fair value of our foreign exchange forward contracts included in prepaid expenses and other current assets, accrued liabilities and non-current assets (liabilities), as appropriate, on the Consolidated Balance Sheets were as follows:

	June 29, 2008	December 31, 2007
	(in millions of dollars)	
Fair value of foreign exchange forward contracts – asset (liability)	$ 0.8	$ (2.1)

13. FAIR VALUE ACCOUNTING

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (“SFAS No. 157”). SFAS No. 157 applies a consistent definition to fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles (“GAAP”), and expands disclosures about fair value measurements.

SFAS No. 157 establishes a fair value measurement hierarchy to price a particular asset or liability. The fair value of the asset or liability is determined based on inputs or assumptions that market participants would use in pricing the asset or liability. These assumptions consist of (1) observable inputs - market data obtained from independent sources,

or (2) unobservable inputs - market data determined using the company's own assumptions about valuation.

SFAS No. 157 establishes a fair value hierarchy to prioritize the inputs to valuation techniques, with the highest priority being given to Level 1 inputs and the lowest priority to Level 3 inputs, as defined below:

- Level 1 Inputs – quoted prices in active markets for identical assets or liabilities;
- Level 2 Inputs – quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; inputs other than quoted prices that are observable; and inputs that are derived from or corroborated by observable market data by correlation; and
- Level 3 Inputs – unobservable inputs used to the extent that observable inputs are not available. These reflect the entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

In addition, SFAS No. 157 requires disclosures about the use of fair value to measure assets and liabilities to enable the assessment of inputs used to develop fair value measures, and for unobservable inputs, to determine the effects of the measurements on earnings.

Effective January 1, 2008, we partially adopted SFAS No. 157 and have applied its provisions to financial assets and liabilities that are recognized or disclosed at fair value on a recurring basis (at least annually). We have not yet adopted SFAS No. 157 for nonfinancial assets and liabilities, in accordance with FASB Staff Position 157-2, Effective Date of FASB Statement No. 157 ("FSP 157-2"). FSP 157-2 defers the effective date of SFAS No. 157 to January 1, 2009, for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed on a recurring basis.

We use certain derivative instruments from time to time to manage interest rate, foreign currency exchange rate and commodity market price risk exposures, all of which are recorded at fair value based on quoted market prices or rates.

A summary of our cash flow hedging derivative assets and liabilities measured at fair value on a recurring basis as of June 29, 2008, is as follows:

Description	Fair Value as of June 29, 2008	Quoted Prices in Active Markets of Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands of dollars)			
Assets				
Cash flow hedging derivatives	$ 1,499	$ 689	$ 810	$ —

As of June 29, 2008, cash flow hedging derivative Level 1 assets were related to cash transfers receivable on commodities futures contracts reflecting the change in quoted market prices on the last trading day for the period. We account for commodities futures contracts in accordance with SFAS No. 133. We make or receive cash transfers to or from commodity futures brokers on a daily basis reflecting changes in the value of futures contracts on the IntercontinentalExchange or various other exchanges. These changes in value represent unrealized gains and losses.

As of June 29, 2008, cash flow hedging derivative Level 2 assets were principally related to the fair value of foreign exchange forward contracts. We define the fair value of foreign exchange forward contracts as the amount of the difference between the contracted and current market foreign currency exchange rates at the end of the period. We estimate the fair value of foreign exchange forward contracts on a quarterly basis by obtaining market quotes for future contracts with similar terms, adjusted where necessary for maturity differences.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115 ("SFAS No. 159"). SFAS No. 159 permits entities to choose to measure many financial instruments and other items at fair value. The objective of SFAS No. 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions.

As of January 1, 2008, we elected not to adopt the fair value option under SFAS No. 159 for any financial instruments or other items.

14. INCOME TAXES

During the first quarter of 2008, the U.S. Internal Revenue Service commenced its audit of our U.S. income tax returns for 2005 and 2006. It is reasonably possible that this audit will be completed in 2009, but it is not possible at this time to estimate the resolution and any possible refunds or payments.

15. PENSION AND OTHER POST-RETIREMENT BENEFIT PLANS

Components of net periodic benefits (income) cost consisted of the following:

	Pension Benefits		Other Benefits	
	For the Three Months Ended			
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
	(in thousands of dollars)			
Service cost	$ 6,739	$ 10,809	$ 390	$ 1,177
Interest cost	14,886	14,551	4,748	4,714
Expected return on plan assets	(26,575)	(28,554)	—	—
Amortization of prior service cost	324	748	(114)	(35)
Recognized net actuarial (gain) loss	(240)	154	(55)	433
Administrative expenses	91	128	—	—
Net periodic benefits (income) cost	(4,775)	(2,164)	4,969	6,289
Special termination benefits	147	6,166	—	—
Settlement	4,843	—	—	—
Curtailment	—	4,215	—	18,862
Total amount reflected in earnings	$ 215	$ 8,217	$ 4,969	$ 25,151

We made contributions of $.5 million and $6.0 million to the pension plans and other benefits plans, respectively, during the second quarter of 2008. In the second quarter of 2007, we made contributions of $2.7 million and $5.9 million to our pension and other benefits plans, respectively. The contributions in 2008 and 2007 primarily reflected benefit payments from our non-qualified pension plans and post-retirement benefit plans.

In the second quarter of 2008, there was net periodic pension benefits income of $4.8 million, compared with net periodic benefits income of $2.2 million in the second quarter of 2007. The higher net periodic pension benefits income primarily reflected the lower service cost resulting from a reduction in employment levels under the global supply chain transformation program. The Special termination benefits, Settlement and Curtailment losses recorded in the second quarter of 2008 and 2007 primarily related to the 2007 business realignment initiatives.

	Pension Benefits		Other Benefits	
	For the Six Months Ended			
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
	(in thousands of dollars)			
Service cost	$ 14,764	$ 21,966	$ 877	$ 2,349
Interest cost	29,899	29,219	10,170	9,461
Expected return on plan assets	(53,908)	(57,142)	—	—
Amortization of prior service cost	643	1,127	(228)	(74)
Recognized net actuarial (gain) loss	(287)	910	(2)	975
Administrative expenses	179	301	—	—
Net periodic benefits (income) cost	(8,710)	(3,619)	10,817	12,711
Special termination benefits	147	6,166	—	—
Settlement	4,843	—	—	—
Curtailment	—	4,215	—	18,862
Total amount reflected in earnings	$ (3,720)	$ 6,762	$ 10,817	$ 31,573

We made contributions of $3.8 million and $11.9 million to the pension plans and other benefits plans, respectively, during the first six months of 2008. In the first six months of 2007, we made contributions of $7.8 million and $10.4 million to our pension and other benefits plans, respectively. The contributions in 2008 and 2007 primarily reflected benefit payments from our non-qualified pension plans and post-retirement benefit plans.

In the first six months of 2008, there was net periodic pension benefits income of $8.7 million, compared with net periodic benefits income of $3.6 million in the first six months of 2007. The increased net periodic pension benefits

income primarily reflected lower service cost resulting from a reduction in employment levels under the global supply chain transformation program. The Special termination benefits, Settlement and Curtailments losses recorded during the first six months of 2008 and 2007 primarily related to the 2007 business realignment initiatives.

For 2008, there are no minimum funding requirements for the domestic plans and minimum funding requirements for the non-domestic plans are not material. During the remainder of 2008, we anticipate contributions to our pension plans of $25.0 million to $30.0 million which includes benefit payments from our non-qualified plans.

For more information, refer to the consolidated financial statements and notes included in our 2007 Annual Report on Form 10-K.

16. SHARE REPURCHASES

Repurchases and Issuances of Common Stock

A summary of cumulative share repurchases and issuances is as follows:

	For the Six Months Ended June 29, 2008	
	Shares	Dollars
	(in thousands)	
Shares repurchased in the open market under pre-approved share repurchase programs	—	$ —
Shares repurchased to replace Treasury Stock issued for stock options and incentive compensation	1,090	41,086
Total share repurchases	1,090	41,086
Shares issued for stock options and incentive compensation	(1,059)	(34,511)
Net change	31	$ 6,575

- In December 2006, our Board of Directors approved a $250 million share repurchase program. As of June 29, 2008, $100.0 million remained available for repurchases of Common Stock under this program.

17. PENDING ACCOUNTING PRONOUNCEMENTS

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations (“SFAS No. 141R”), and Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51 (“SFAS No. 160”). Both of these new standards are effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. These standards significantly change the accounting for and reporting of future business combinations and noncontrolling interests (minority interests) in consolidated financial statements. We are required to adopt these standards on January 1, 2009 and are currently evaluating their impact on our consolidated financial statements upon adoption.

SFAS No. 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired business. SFAS No. 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to

evaluate the nature and financial effects of the business combination.

SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary and requires the noncontrolling interest to be reported as a component of equity. In addition, changes in a parent's ownership interest while the parent retains its controlling interest will be accounted for as equity transactions, and any retained noncontrolling equity investment upon the deconsolidation of a subsidiary will be initially measured at fair value. Disclosures that clearly identify and distinguish between the interests of the parent and the interests of noncontrolling owners will be required.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133 ("SFAS No. 161"). SFAS No. 161 requires enhanced disclosures about an entity's derivative and hedging activities. Entities will be required to provide enhanced disclosures about how and why an entity uses derivative instruments, how these instruments are accounted for, and how they affect the entity's financial position, financial performance and cash flows. This new standard is effective for

our Company as of January 1, 2009 and we are currently evaluating the impact on disclosures associated with our derivative and hedging activities.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, The Hierarchy of Generally Accepted Accounting Principles ("SFAS No. 162"). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. We do not expect any significant changes to our financial accounting and reporting as a result of the issuance of SFAS No. 162.

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

SUMMARY OF OPERATING RESULTS

Analysis of Selected Items from Our Income Statement

	For the Three Months Ended			For the Six Months Ended		
	June 29, 2008	July 1, 2007	Percent Change Increase (Decrease)	June 29, 2008	July 1, 2007	Percent Change Increase (Decrease)
	(in thousands except per share amounts)					
Net Sales	$ 1,105.4	$ 1,051.9	5.1%	$ 2,265.8	$ 2,205.0	2.8%
Cost of Sales	722.9	722.5	0.1%	1,506.8	1,461.5	3.1%
Gross Profit	382.5	329.4	16.1%	759.0	743.5	2.1%
Gross Margin	34.6%	31.3%		33.5%	33.7%	
SM&A Expense	266.6	216.9	22.9%	516.6	433.3	19.2%
SM&A Expense as a percent of sales	24.1%	20.6%		22.8%	19.7%	
Business Realignment Charge, net	21.8	79.7	(72.7)%	25.9	107.3	(75.9)%
EBIT	94.1	32.8	186.6%	216.5	202.9	6.7%
EBIT Margin	8.5%	3.1%		9.6%	9.2%	
Interest Expense, net	23.6	29.2	(19.2)%	48.0	57.5	(16.5)%
Provision for Income Taxes	29.0	—	N/A	63.8	48.4	31.9%
Effective Income Tax Rate	41.2%	—		37.9%	33.3%	
Net Income	$ 41.5	$ 3.6	N/A	$ 104.7	$ 97.0	7.9%
Net Income Per Share-Diluted	$ 0.18	$ 0.01	N/A	$ 0.46	$ 0.42	9.5%

Results of Operations - Second Quarter 2008 vs. Second Quarter 2007

U.S. Price Increases

In April 2007, we announced an increase of approximately four percent to five percent in the wholesale prices of our domestic confectionery line, effective immediately. The price increase applied to our standard bar, king-size bar, 6-pack and vending lines. These products represent approximately one-third of our U.S. confectionery portfolio.

In January 2008, we announced another increase in the wholesale prices of our domestic confectionery line, effective immediately. This price increase also applied to our standard bar, king-size bar, 6-pack and vending lines and represented a weighted average increase of approximately thirteen percent on these items. These price changes approximated a three percent price increase over our entire domestic product line. We implemented both pricing actions to help partially offset increases in input costs, including raw materials, fuel, utilities and transportation.

Usually there is a time lag between the effective date of list price increases and the impact of the price increases on net sales. The impact of price increases is often delayed because the Company honors previous commitments to planned

consumer and customer promotions and merchandising events subsequent to the effective date of the price increases. In addition, promotional allowances may be increased for certain products subsequent to the effective date, delaying or partially offsetting the impact of price increases on net sales.

Net Sales

Net sales for the second quarter of 2008 were higher than the comparable period of 2007 due to favorable price realization (as list price increases more than offset higher promotional allowances), incremental sales from the Godrej Hershey Ltd. acquisition, and a favorable foreign currency exchange rate. These increases were slightly offset by sales volume decreases primarily in the United States reflecting lower seasonal sales and reduced sales of snack and refreshment products. The acquisition of the Godrej Hershey Ltd. business increased net sales by $17.0 million, or 1.6%.

Key Marketplace Metrics

Consumer takeaway decreased 11.5% during the second quarter of 2008 compared with the same period of 2007 as a result of an early Easter season which shifted sales into the first quarter of 2008. Excluding seasonal sales, consumer takeaway increased 5.0%. Consumer takeaway is provided for channels of distribution accounting for approximately 80% of our U.S. confectionery retail business. These channels of distribution include food, drug, mass merchandisers, including Wal-Mart Stores, Inc., and convenience stores.

Market share in measured channels declined by 0.6 share points during the second quarter of 2008 also due to the earlier timing of the Easter season. Excluding seasonal sales, market share in measured channels increased by 0.1 share points. The change in market share is provided for measured channels which include sales in the food, drug, convenience store and mass merchandiser classes of trade, excluding sales of Wal-Mart Stores, Inc.

Cost of Sales and Gross Margin

Cost of sales in the second quarter of 2008 was slightly higher than 2007. The cost of sales increase was primarily associated with the Godrej Hershey Ltd. acquisition, higher costs associated with the introduction of new products and increased input costs. Input costs were only slightly higher in the second quarter of 2008 versus 2007, primarily reflecting lower costs for dairy products in 2008 compared with significantly higher costs in 2007 resulting from the recognition and timing of cost increases last year. Reduced costs for product obsolescence and improved supply chain productivity also offset the cost of sales increase. Business realignment charges of $15.0 million were included in cost of sales in the second quarter of 2008 compared with $41.3 million in the second quarter of 2007.

Approximately three-fourths of the gross margin increase was attributable to the impact of business realignment initiatives recorded in 2008 compared with 2007. The rest of the increase resulted from favorable price realization, reduced product obsolescence costs and improved supply chain productivity. These increases were offset somewhat by the impact of the acquisition of the Godrej Hershey Ltd. business and increased input costs.

Selling, Marketing and Administrative

Higher selling, marketing and administrative costs were principally associated with employee-related expenses primarily reflecting increased levels of retail coverage in the United States, the expansion of our international businesses, including the acquisition of Godrej Hershey Ltd. and incentive compensation costs. Incentive compensation costs increased in 2008 as compared to 2007 because of the impact of reduced performance expectations in the second quarter of 2007. Higher advertising and consumer promotion expenses related to the introduction of new products and increased core brand support also contributed to higher selling, marketing and administrative expenses. Expenses of $2.4 million related to our 2007 business realignment initiatives were included in selling, marketing and administrative expense for the second quarter of 2008 compared with $3.3 million recorded in the second quarter of 2007.

Business Realignment Initiatives

Business realignment charges of $21.8 million were recorded in the second quarter of 2008 associated with the 2007 business realignment initiatives. The charges were primarily associated with employee separation and contract termination costs, fixed asset disposals and plant closure expenses. Business realignment charges of $79.7 million were recorded in the second quarter of 2007 primarily associated with employee separation costs and losses on the sale of fixed assets, along with expenses for asset impairments, the closure of certain manufacturing facilities and the termination of certain contracts.

Income Before Interest and Income Taxes and EBIT Margin

EBIT increased in the second quarter of 2008 compared with the second quarter of 2007 principally as a result of lower net business realignment charges. Excluding the impact of business realignment charges, the increase in gross profit was more than offset by higher selling, marketing and administrative expenses. Net pre-tax business realignment charges of $39.3 million were recorded in the second quarter of 2008 compared with $124.4 million recorded in the second quarter of 2007, a decrease of $85.1 million.

EBIT margin increased from 3.1% for the second quarter of 2007 to 8.5% for the second quarter of 2008. The impact of net business realignment charges in 2008 reduced EBIT margin by 3.6 percentage points and in the second quarter of 2007, reduced EBIT margin by 11.8 percentage points. The remainder of the decrease resulted from the higher selling, marketing and administrative expense as a percentage of sales.