

STARBUCKS CORP  
Form 10-K/A  
December 21, 2006

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, DC 20549**  
**Form 10-K/A**  
**Amendment No. 1**

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

**For The Fiscal Year Ended October 1, 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: 0-20322**

**Starbucks Corporation**

*(Exact Name of Registrant as Specified in Its Charter)*

**WASHINGTON**

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

**91-1325671**

*(IRS Employer Identification No.)*

**2401 Utah Avenue South  
Seattle, Washington 98134**

*(Address of principal executive offices, zip code)*

**(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE):**

**(206) 447-1575**

**SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:**

**Common Stock, \$0.001 Par Value Per Share**

**SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:**

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation of S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of the last business day of the registrant's most recently completed second fiscal quarter, based upon the closing sale price of the registrant's common stock on March 31, 2006 as reported on the National Market tier of The NASDAQ Stock Market, Inc. was \$28.2 billion.

As of December 8, 2006, there were 754,857,728 shares of the registrant's Common Stock outstanding.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the definitive Proxy Statement for the registrant's Annual Meeting of Shareholders to be held on March 21, 2007 have been incorporated by reference into Part III of this Annual Report on Form 10-K/A.

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### EXPLANATORY NOTE

Starbucks Corporation is filing this Amendment No. 1 on Form 10-K/A ( Form 10-K/A ) to its Annual Report on Form 10-K for the fiscal year ended October 1, 2006 as filed with the Securities and Exchange Commission on December 14, 2006 (the Original Filing ) solely to correct an administrative error in the content of Item 7,

Management's Discussion and Analysis of Financial Condition and Results of Operations. The error appears in the first full paragraph on page 25 of the Original Filing. In the third sentence of that paragraph the 7% increase in comparable store sales growth in fiscal 2006 compared to fiscal 2005 is attributed to a 5% increase in the average value per transaction and a 2% increase in the number of customer transactions. The correct explanation is as follows: The increase in comparable store sales was due to a 5% increase in the number of customer transactions and a 2% increase in the average value per transaction.

This Amendment does not update any disclosures to reflect developments since the filing date of the Original Filing.

In accordance with SEC Rule 12b-15, this Form 10-K/A sets forth the complete text of Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations , as amended. However, in order to reduce printing and mailing costs, for purposes of providing the disclosure required under SEC rules in the Company's fiscal 2006 Annual Report to Shareholders (the Annual Report ), the Company intends to provide shareholders (1) this Form 10-K/A, with only its explanatory note, signatures and certifications, (but excluding the full Item 7 as amended), together with (2) the Original Filing filed on December 14, 2006. The complete Form 10-K/A, including the full Item 7 as amended, will be available at the Company's web site set forth below and on the SEC's web site at [www.sec.gov](http://www.sec.gov), and will be provided without charge upon written request to the following address:

Investor Relations  
Starbucks Corporation  
2401 Utah Avenue South, Mail Stop: FP1  
Seattle, Washington 98134-1435  
(206) 447-1575 x87118  
[investorrelations@starbucks.com](mailto:investorrelations@starbucks.com)  
<http://investor.starbucks.com>

In addition, we have filed the following exhibits herewith:

- 31.1 Certification of Principal Executive Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer Pursuant to Rule 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Principal Financial Officer Pursuant to Rule 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Except as described above, no other changes have been made to the Original Filing and this Form 10-K/A does not amend, update or change the financial statements or any other items or disclosures in the Original Filing.



## **PART II**

### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **GENERAL**

Starbucks Corporation's fiscal year ends on the Sunday closest to September 30. The fiscal years ended on October 1, 2006 and October 2, 2005, included 52 weeks. The fiscal year ended October 3, 2004, included 53 weeks, with the 53rd week falling in the fiscal fourth quarter.

#### **MANAGEMENT OVERVIEW**

During the fiscal year ended October 1, 2006, the Company's focus on execution in all areas of its business, from U.S. and International Company-operated retail operations to the Company's specialty businesses, delivered strong financial performance. Management believes that its ability to achieve the balance between growing the core business and building the foundation for future growth is the key to increasing long-term shareholder value. Starbucks fiscal 2006 performance reflects the Company's continuing commitment to achieving this balance.

The primary driver of the Company's revenue growth continues to be the opening of new retail stores, both Company-operated and licensed, in pursuit of the Company's objective to establish Starbucks as one of the most recognized and respected brands in the world. Starbucks opened 2,199 new stores in fiscal 2006 and plans to open approximately 2,400 in fiscal 2007. With a presence in 37 countries, serving customers more than 40 million times per week, management continues to believe that the Company's long-term goal of approximately 20,000 Starbucks retail locations throughout the United States and at least 20,000 stores in International markets is achievable.

In addition to opening new retail stores, Starbucks works to increase revenues generated at new and existing Company-operated stores by attracting new customers and increasing the frequency of visits by current customers. The strategy is to increase comparable store sales by continuously improving the level of customer service, introducing innovative products and improving speed with service through training, technology and process improvement.

Global comparable store sales for Company-operated markets increased by 7%, making fiscal 2006 the 15th consecutive year with comparable store sales growth of 5% or greater. Comparable store sales growth for fiscal 2007 is expected to be in the range of 3% to 7%.

In licensed retail operations, Starbucks shares operating and store development experience to help licensees improve the profitability of existing stores and build new stores. Internationally, the Company's strategy is to selectively increase its equity stake in licensed international operations as these markets develop. In January 2006, the Company increased its equity ownership from 5% to 100% in its operations in Hawaii and Puerto Rico, and subsequent to the end of fiscal 2006 purchased a 90% stake in its previously-licensed operations in Beijing, China.

The combination of more retail stores, comparable store sales growth of 7% and growth in other business channels in the U.S., International, and CPG operating segments resulted in a 22% increase in total net revenues for fiscal 2006, compared to fiscal 2005. The Company expects revenue growth of approximately 20% in fiscal 2007, consistent with its three to five year revenue growth target.

Operating income as a percentage of total net revenues decreased to 11.5% in fiscal 2006 from 12.3% in fiscal 2005, due to the recognition of stock-based compensation. Net earnings increased by 14% in fiscal 2006, compared to fiscal 2005. Reported operating margin and net earnings include the effects of stock-based compensation in fiscal 2006, while stock-based compensation expense was not included in the Company's consolidated financial results in fiscal 2005.

## **ACQUISITIONS**

In January 2006, Starbucks increased its equity ownership to 100% in its operations in Hawaii and Puerto Rico and applied the consolidation method of accounting from the acquisition date. Previously the Company owned 5% of both

2

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Coffee Partners Hawaii and Café del Caribe in Puerto Rico. Because Coffee Partners Hawaii was a general partnership, the equity method of accounting was previously applied. Retroactive application of the equity method of accounting for the Puerto Rico investment, which was previously accounted for under the cost method, resulted in a reduction of retained earnings of \$0.5 million as of April 2, 2006. The cumulative effect of the accounting change for financial results previously reported under the cost method and as restated in this report under the equity method reduced net earnings by \$97 thousand for the fiscal year ended October 2, 2005 and \$93 thousand for the fiscal year ended October 2, 2004. Previously reported earnings per share amounts were not impacted.

On October 18, 2006, the Company acquired 90% equity ownership of the licensed operations of 61 Starbucks retail stores in Beijing and Tianjin, China (See Note 20 Subsequent Event ).

## RESULTS OF OPERATIONS FISCAL 2006 COMPARED TO FISCAL 2005

The following table presents the consolidated statement of earnings as well as the percentage relationship to total net revenues, unless otherwise indicated, of items included in the Company's consolidated statements of earnings (amounts in thousands):

FISCAL YEAR ENDED	Oct 1, 2006 (52 Wks)	% of Revenues	Oct 2, 2005 (52 Wks)	% of Revenues	Oct 3, 2004 (53 Wks)	% of Revenues
<b>STATEMENTS OF EARNINGS DATA</b>						
Net revenues:						
Company-operated retail	\$ 6,583,098	84.5%	\$ 5,391,927	84.7%	\$ 4,457,378	84.2%
Specialty:						
Licensing	860,676	11.1	673,015	10.5	565,798	10.7
Foodservice and other	343,168	4.4	304,358	4.8	271,071	5.1
Total specialty	1,203,844	15.5	977,373	15.3	836,869	15.8
Total net revenues	7,786,942	100.0	6,369,300	100.0	5,294,247	100.0
Cost of sales including						
occupancy costs	3,178,791	40.8	2,605,212	40.9	2,191,440	41.4
Store operating expenses	2,687,815	40.8 <sup>(1)</sup>	2,165,911	40.2 <sup>(1)</sup>	1,790,168	40.2 <sup>(1)</sup>
Other operating expenses	260,087	21.6 <sup>(2)</sup>	197,024	20.2 <sup>(2)</sup>	171,648	20.5 <sup>(2)</sup>
Depreciation and amortization expenses	387,211	5.0	340,169	5.3	289,182	5.5
General and administrative expenses	473,023	6.1	357,114	5.6	304,293	5.7
Subtotal operating expenses	6,986,927	89.7	5,665,430	88.9	4,746,731	89.7
Income from equity investees	93,937	1.2	76,648	1.2	58,978	1.1
Operating income	893,952	11.5	780,518	12.3	606,494	11.5



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Interest and other income, net	12,291	0.1	15,829	0.2	14,140	0.2
Earnings before income taxes	906,243	11.6	796,347	12.5	620,634	11.7
Income taxes	324,770	4.1	301,977	4.7	231,754	4.4
Earnings before cumulative effect of change in accounting principle	581,473	7.5%	494,370	7.8%	388,880	7.3%
Cumulative effect of accounting change for FIN 47, net of taxes	17,214	0.3				
Net earnings	\$ 564,259	7.2%	\$ 494,370	7.8%	\$ 388,880	7.3%

(1) Shown as a percentage of related Company-operated retail revenues.

(2) Shown as a percentage of related total specialty revenues.

## CONSOLIDATED RESULTS OF OPERATIONS

Net revenues for the fiscal year ended 2006 increased 22% to \$7.8 billion from \$6.4 billion for fiscal 2005, driven by increases in both Company-operated retail revenues and specialty operations. Net revenues are expected to grow approximately 20% in fiscal 2007 compared to fiscal 2006.

During the fiscal year ended 2006, Starbucks derived 85% of total net revenues from its Company-operated retail stores. Company-operated retail revenues increased 22% to \$6.6 billion for the fiscal year ended 2006, from \$5.4 billion for fiscal 2005. This increase was primarily due to the opening of 1,040 new Company-operated retail stores in the last 12 months and comparable store sales growth of 7% in fiscal 2006. The increase in comparable store sales was due to a 5% increase in the number of customer transactions and a 2% increase in the average value per transaction. Management believes increased customer traffic continues to be driven by sustained popularity of core products, new product innovation and a high level of customer satisfaction.

The Company derived the remaining 15% of total net revenues from channels outside the Company-operated retail stores, collectively known as Specialty Operations. Specialty revenues, which include licensing revenues and foodservice and other revenues, increased 23% to \$1.2 billion for the fiscal year ended 2006, from \$977 million for fiscal 2005.

Licensing revenues, which are derived from retail store licensing arrangements, as well as grocery, warehouse club and certain other branded product operations, increased 28% to \$861 million for fiscal 2006, from \$673 million for fiscal 2005. The increase is primarily due to higher product sales and royalty revenues from the opening of 1,159 new licensed retail stores in the last 12 months and, to a lesser extent, growth in the licensed grocery and warehouse club business.

Foodservice and other revenues increased 13% to \$343 million for fiscal 2006, from \$304 million for fiscal 2005. Foodservice and other revenues increased primarily due to growth in new and existing U.S. foodservice accounts.

Cost of sales including occupancy costs decreased slightly to 40.8% of total net revenues for fiscal 2006, from 40.9% in fiscal 2005. The decrease was primarily due to fixed rent costs in fiscal 2006 being distributed over an expanded revenue base, as well as increased occupancy costs in fiscal 2005 resulting from intensified store maintenance activities. These favorable items, combined with lower dairy costs, offset higher green coffee costs for fiscal 2006.

Store operating expenses as a percentage of Company-operated retail revenues increased to 40.8% for fiscal 2006 from 40.2% for fiscal 2005. The increase was due to the recognition of stock-based compensation expense and to higher provisions for incentive compensation.

Other operating expenses, which are expenses associated with the Company's Specialty Operations, increased to 21.6% of specialty revenues in fiscal 2006, compared to 20.2% in fiscal 2005. The increase was primarily due to the recognition of stock-based compensation expense as well as higher payroll-related expenditures to support the expanding licensed store operations, both in the U.S. and in existing and new international markets.

Depreciation and amortization expenses increased to \$387 million in fiscal 2006, from \$340 million in fiscal 2005. The increase of \$47 million was due to the opening of 1,040 new Company-operated retail stores in the last 12 months. As a percentage of total net revenues, depreciation and amortization decreased to 5.0% for fiscal 2006, from 5.3% for fiscal 2005.

General and administrative expenses increased to \$473 million in fiscal 2006, compared to \$357 million in fiscal 2005. The increase was due to higher payroll-related expenditures from the recognition of stock-based compensation

expense, additional employees to support continued global growth, and higher professional fees in support of global systems infrastructure development. As a percentage of total net revenues, general and administrative expenses increased to 6.1% for fiscal 2006, from 5.6% for fiscal 2005.

Income from equity investees increased to \$94 million in fiscal 2006, compared to \$77 million in fiscal 2005. The increase was primarily due to favorable volume-driven operating results for The North American Coffee Partnership, which produces ready-to-drink beverages which include, among others, bottled Frappuccino® coffee drinks and

Starbucks DoubleShot® espresso drinks, as well as improved operating results from international investees, including Korea and Japan, mainly as a result of new store openings.

Operating income increased 15% to \$894 million in fiscal 2006, from \$781 million in fiscal 2005. The operating margin decreased to 11.5% of total net revenues in fiscal 2006, compared to 12.3% in fiscal 2005, due to the recognition of stock-based compensation expense.

Net interest and other income, which primarily consists of interest income, decreased to \$12 million in fiscal 2006, from \$16 million in fiscal 2005. The decrease was primarily due to higher interest expense on the Company's revolving credit facility, as well as lower interest income earned due to lower average investment balances, offset in part by the recognition of \$4.4 million of income on unredeemed stored value card balances in fiscal 2006. There was no income recognized on unredeemed stored value card balances in fiscal 2005.

Income taxes for fiscal 2006 resulted in an effective tax rate of 35.8%, compared to 37.9% in fiscal 2005. The decline in the effective tax rate was due to the reversal of a valuation allowance in fiscal 2006 that had been established in fiscal 2005, the settlement in the third quarter of fiscal 2006 of a multi-year income tax audit in a foreign jurisdiction for which the Company had established a contingent liability, and to increased effectiveness of the Company's long-term tax planning strategies. The effective tax rate for fiscal 2007 is expected to be approximately 38%, with quarterly variations.

## OPERATING SEGMENTS

Segment information is prepared on the same basis that the Company's management reviews financial information for operational decision-making purposes. Beginning in the fiscal fourth quarter of 2006, the Company increased its reporting segments from two to three to include a Global CPG segment in addition to the United States and International segments. This additional operating segment reflects the culmination of internal management realignments in fiscal 2006, and the successful development and launch of certain branded products in the United States and internationally commencing in fiscal 2005 and continuing throughout fiscal 2006. Additionally, with the 100% acquisition of the Company's operations in Hawaii in fiscal 2006 and the shift in internal management of this market to the United States, these operations have been moved from the International segment into the United States segment. Segment information for all prior periods presented has been revised to reflect these changes.

The following tables summarize the Company's results of operations by segment for fiscal 2006 and 2005 (*in thousands*):

	52 Weeks Ended		%	52 Weeks Ended	
	Oct 1, 2006	Oct 2, 2005		Oct 1, 2006	Oct 2, 2005
			Change		As a % of U.S. Total Net Revenues
<b>UNITED STATES</b>					
Net revenues:					
Company-operated retail	\$ 5,495,240	\$ 4,539,455	21.1%	88.9%	89.1%
Specialty:					

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Licensing	369,155	277,987	32.8	6.0	5.4
Foodservice and other	314,162	280,073	12.2	5.1	5.5
Total specialty	683,317	558,060	22.4	11.1	10.9
Total net revenues	6,178,557	5,097,515	21.2	100.0	100.0
Cost of sales including occupancy costs	2,374,485	1,944,356		38.4	38.1
Store operating expenses	2,280,044	1,848,836		41.5 <sup>(1)</sup>	40.7 <sup>(1)</sup>
Other operating expenses	190,624	150,712		27.9 <sup>(2)</sup>	27.0 <sup>(2)</sup>
Depreciation and amortization expenses	284,625	250,339		4.6	4.9
General and administrative expenses	93,754	85,362		1.5	1.7
Income from equity investees	151	592			
Operating income	\$ 955,176	\$ 818,502	16.7%	15.5%	16.1%

(1) Shown as a percentage of related Company-operated retail revenues.

(2) Shown as a percentage of related total specialty revenues.

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	52 Weeks Ended			52 Weeks Ended	
	Oct 1, 2006	Oct 2, 2005	% Change	Oct 1, 2006	Oct 2, 2005
<b>INTERNATIONAL</b>					
As a % of International Total Net Revenues					
Net revenues:					
Company-operated retail	\$ 1,087,858	\$ 852,472	27.6%	83.5%	83.4%
Specialty:					
Licensing	186,050	145,736	27.7	14.3	14.2
Foodservice and other	29,006	24,285	19.4	2.2	2.4
Total specialty	215,056	170,021	26.5	16.5	16.6
Total net revenues	1,302,914	1,022,493	27.4	100.0	100.0
Cost of sales including occupancy costs	625,008	511,761		48.0	50.1
Store operating expenses	407,771	317,075		37.5 <sup>(1)</sup>	37.2 <sup>(1)</sup>
Other operating expenses	50,900	32,061		23.7 <sup>(2)</sup>	18.9 <sup>(2)</sup>
Depreciation and amortization expenses	66,800	56,705		5.1	5.5
General and administrative expenses	78,337	53,069		6.0	5.2
Income from equity investees	34,370	30,477		2.6	3.0
Operating income	\$ 108,468	\$ 82,299	31.8%	8.3%	8.0%

				As a % of CPG Total Net Revenues	
<b>GLOBAL CONSUMER PRODUCTS GROUP</b>					
Net revenues:					
Specialty:					
Licensing	\$ 305,471	\$ 249,292		100.0%	100.0%
Total specialty	305,471	249,292		100.0	100.0
Total net revenues	305,471	249,292	22.5%	100.0	100.0
Cost of sales	179,298	149,095		58.7	59.8
Other operating expenses	18,563	14,251		6.1	5.7

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Depreciation and amortization expenses	108	76		
Income from equity investees	59,416	45,579	19.4	18.2
Operating income	\$ 166,918	\$ 131,449	27.0%	54.6%

			As a % of Total Net Revenues	
UNALLOCATED CORPORATE				
Depreciation and amortization expenses	\$ 35,678	\$ 33,049	0.4%	0.5%
General and administrative expenses	300,932	218,683	3.9	3.4
Operating loss	\$ (336,610)	\$ (251,732)	(4.3)%	(3.9)%

(1) Shown as a percentage of related Company-operated retail revenues.

(2) Shown as a percentage of related total specialty revenues.

*United States*

The Company's United States operations ( United States ) represent 83% of Company-operated retail revenues, 57% of total specialty revenues and 79% of total net revenues. United States operations sell coffee and other beverages, whole bean coffees, complementary food, coffee brewing equipment and merchandise primarily through Company-operated retail stores. Specialty Operations within the United States include licensed retail stores, foodservice accounts and other initiatives related to the Company's core business.

United States total net revenues increased 21% to \$6.2 billion for the fiscal year ended 2006, compared to \$5.1 billion for fiscal 2005.

United States Company-operated retail revenues increased 21% to \$5.5 billion for the fiscal year ended 2006, compared to \$4.5 billion for fiscal 2005. United States Company-operated retail revenues increased primarily due to the opening of 810 new Company-operated retail stores in the last 12 months and comparable store sales growth of 7% for fiscal 2006. The increase in comparable store sales was due to a 5% increase in the number of customer transactions and a 2% increase in the average value per transaction. Management believes increased customer traffic continues to be driven by new product innovation, continued popularity of core products and a high level of customer satisfaction.

Total United States specialty revenues increased 22% to \$683 million for the fiscal year ended 2006, compared to \$558 million in fiscal 2005. United States licensing revenues increased 33% to \$369 million, compared to \$278 million for fiscal 2005. United States licensing revenues increased due to increased product sales and royalty revenues as a result of opening 733 new licensed retail stores in the last 12 months. Foodservice and other revenues increased 12% to \$314 million from \$280 million for fiscal 2005. United States foodservice and other revenues increased primarily due to growth in new and existing foodservice accounts.

United States operating income increased 17% to \$955 million for the fiscal year ended 2006, from \$819 million for the fiscal year ended 2005. Operating margin decreased to 15.5% of related revenues from 16.1% in fiscal 2005. The decrease was due to the recognition of stock-based compensation expense.

#### *International*

The Company's International operations ( International ) represent the remaining 17% of Company-operated retail revenues and 18% of total specialty revenues as well as 17% of total net revenues. International operations sell coffee and other beverages, whole bean coffees, complementary food, coffee brewing equipment and merchandise through Company-operated retail stores in the United Kingdom, Canada, Thailand, Australia, Germany, China, Singapore, Puerto Rico, Chile and Ireland. Specialty Operations in International primarily include retail store licensing operations in more than 25 countries and foodservice accounts in Canada and the United Kingdom. The Company's International store base continues to increase rapidly and Starbucks is achieving a growing contribution from established areas of the business while at the same time investing in emerging markets and channels, such as China. The Company's International operations are in various early stages of development that require a more extensive support organization, relative to the current levels of revenue and operating income, than in the United States. This continuing investment is part of the Company's long-term, balanced plan for profitable growth.

International total net revenues increased 27% to \$1.3 billion for the fiscal year ended 2006, compared to \$1.0 billion for fiscal 2005. International Company-operated retail revenues increased 28% to \$1.1 billion for the fiscal year ended 2006, compared to \$852 million for fiscal 2005. International Company-operated revenues increased due to the opening of 230 new Company-operated retail stores in the last 12 months, comparable store sales growth of 8% for fiscal 2006, and the weakening of the U.S. dollar against the Canadian dollar. The increase in comparable store sales resulted from a 5% increase in the number of customer transactions and a 3% increase in the average value per transaction.

Total International specialty revenues increased 26% to \$215 million for the fiscal year ended 2006, compared to \$170 million for fiscal 2005. International licensing revenues increased 28% to \$186 million for the fiscal year ended 2006, compared to \$146 million in fiscal 2005. International licensing revenues increased due to higher product sales and royalty revenues from opening 426 new licensed retail stores in the last 12 months. International foodservice and other revenues increased 19% to \$29 million for the fiscal year ended 2006, compared to \$24 million in fiscal 2005.



International foodservice and other revenues increased primarily due to growth in the total number of foodservice accounts.

International operating income increased to \$108 million for the fiscal year ended 2006, compared to \$82 million in fiscal 2005. Operating margin increased to 8.3% of related revenues from 8.0% in fiscal 2005, primarily due to lower cost of sales including occupancy costs due to leverage gained from fixed costs distributed over an expanded revenue base, as

well as lower dairy costs. These improvements were partially offset by higher store operating expenses and other operating expenses due to higher payroll-related expenditures primarily to support global expansion as well as the recognition of stock-based compensation expense.

#### *Global Consumer Products Group*

The Company's CPG segment represents 25% of total specialty revenues and 4% of total net revenues. CPG operations sell a selection of whole bean and ground coffees as well as a selection of premium Tazo® teas through licensing arrangements with Kraft and other grocery and warehouse club stores in United States and international markets. CPG operations also produce and sell ready-to-drink beverages which include, among others, bottled Frappuccino® coffee drinks and Starbucks DoubleShot® espresso drinks, and Starbucks® superpremium ice creams, through its joint venture partnerships, and Starbucks™ Coffee and Cream Liqueurs through a marketing and distribution agreement. Through other manufacturing, distribution and co-packing agreements, the Company produces and sells ready-to-drink products in international locations.

CPG total net revenues increased 23% to \$305 million for the fiscal year ended 2006, compared to \$249 million for fiscal 2005, primarily due to volume growth in the licensed grocery and warehouse club business as well as sales of ready-to-drink coffee beverages introduced in Japan, Taiwan and Korea in the fall of 2005.

CPG operating income increased to \$167 million for the fiscal year ended 2006, compared to \$131 million for fiscal 2005. Operating margin increased to 54.6% of related revenues, from 52.7% in fiscal 2005, primarily due to higher income from the Company's equity investees and lower cost of sales as a percentage of revenues. The increase in equity investee income was primarily due to volume-driven results for The North American Coffee Partnership, which produces ready-to-drink beverages which include, among others, bottled Frappuccino® coffee drinks and Starbucks Doubleshot® espresso drinks. Lower cost of sales was due to a sales mix shift to products with higher gross margins.

#### *Unallocated Corporate*

Unallocated corporate expenses pertain to corporate administrative functions that support but are not specifically attributable to the Company's operating segments, and include related depreciation and amortization expenses. Unallocated corporate expenses increased to \$337 million for the fiscal year ended 2006, from \$252 million in fiscal 2005. The increase was due to higher payroll-related expenditures from the recognition of stock-based compensation expense and to additional employees, as well as higher professional fees primarily in support of global systems infrastructure development. Total unallocated corporate expenses as a percentage of total net revenues were 4.3% for the fiscal year ended 2006, compared to 3.9% for fiscal 2005.

## **RESULTS OF OPERATIONS FISCAL 2005 COMPARED TO FISCAL 2004**

### **CONSOLIDATED RESULTS OF OPERATIONS**

Net revenues for the fiscal year ended 2005 increased 20% to \$6.4 billion from \$5.3 billion for the 53-week period of fiscal 2004, driven by increases in both Company-operated retail revenues and specialty operations. Net revenues increased 23% when calculated on a comparative 52-week basis for both fiscal 2005 and 2004.

During the fiscal year ended 2005, Starbucks derived 85% of total net revenues from its Company-operated retail stores. Company-operated retail revenues increased 21% to \$5.4 billion for the fiscal year ended 2005, from \$4.5 billion for the 53-week period of fiscal 2004. Company-operated retail revenues increased 23% when calculated on a comparative 52-week basis for both fiscal 2005 and 2004. This increase was primarily due to the opening of 746 new Company-operated retail stores in the last 12 months and comparable store sales growth of 8% for the 52 weeks

ended October 2, 2005. The increase in comparable store sales was due to a 4% increase in the number of customer transactions and a 4% increase in the average value per transaction. Comparable store sales growth percentages were calculated excluding the extra week of fiscal 2004. The increase in the average value per transaction was primarily due to a beverage price increase in October 2004 in the Company's U.S. and Canadian markets.

The Company derived the remaining 15% of total net revenues from channels outside the Company-operated retail stores. Specialty revenues, which include licensing revenues and foodservice and other revenues, increased 17% to \$977 million for the fiscal year ended 2005, from \$837 million for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, total specialty revenues increased 19%.

Licensing revenues, which are derived from retail store licensing arrangements, as well as grocery, warehouse club and certain other branded-product licensed operations, increased 19% to \$673 million for the 52-week period of 2005, from \$566 million for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, total licensing revenues increased 21%, primarily due to higher product sales and royalty revenues from the opening of 926 new licensed retail stores in the last 12 months.

Foodservice and other revenues increased 12% to \$304 million for the 52-week period of fiscal 2005, from \$271 million for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, foodservice and other revenues increased 15%, primarily attributable to growth in new and existing U.S. and International foodservice accounts and, to a lesser extent, growth in the Company's emerging entertainment business.

Cost of sales including occupancy costs decreased to 40.9% of total net revenues in the 52-week period of fiscal 2005, from 41.4% in the 53-week period of 2004. The decrease was primarily due to higher average revenue per retail transaction, offset in part by higher initial costs associated with the continued expansion of a lunch program in Company-operated retail stores. Approximately 3,800 Company-operated stores had the lunch program at the end of fiscal 2005, compared to approximately 2,600 at the end of fiscal 2004.

Store operating expenses as a percentage of Company-operated retail revenues were 40.2% for both the 52-week period of fiscal 2005 and the 53-week period of fiscal 2004, primarily due to higher average revenue per retail transaction in fiscal 2005, offset by higher payroll-related expenditures, as well as higher maintenance and repair expenditures to ensure a consistent *Starbucks Experience* in existing stores. In order to facilitate ongoing retail store revenue growth, the Company opened a higher number of Drive Thru locations over the past year and extended store operating hours, which contributed to the higher payroll-related expenditures.

Other operating expenses, which are expenses associated with the Company's Specialty Operations, decreased to 20.2% of specialty revenues in the 52-week period of fiscal 2005, compared to 20.5% in the 53-week period of fiscal 2004. The decrease was primarily due to lower expenditures within the grocery, warehouse club and foodservice businesses, partially offset by higher payroll-related expenditures to support the Company's emerging entertainment business and to support the growth of Seattle's Best Coffee licensed café operations.

Depreciation and amortization expenses increased to \$340 million in the 52-week period of fiscal 2005, from \$289 million in the 53-week period of fiscal 2004. The increase was primarily from the opening of 746 new Company-operated retail stores in the last 12 months. As a percentage of total net revenues, depreciation and amortization decreased to 5.3% for the 52 weeks ended October 2, 2005, from 5.5% for the corresponding 53-week fiscal 2004 period.

General and administrative expenses increased to \$357 million in the 52-week period of fiscal 2005, compared to \$304 million in the 53-week period of fiscal 2004. The increase was primarily due to higher payroll-related expenditures in support of both domestic and international business growth and increased charitable donations to support multi-year corporate commitments. As a percentage of total net revenues, general and administrative expenses decreased to 5.6% for the 52 weeks ended October 2, 2005, from 5.7% for the 53 weeks ended October 3, 2004.

Income from equity investees increased to \$77 million in the 52-week period of fiscal 2005, compared to \$59 million in the 53-week period of fiscal 2004. The increase was primarily due to volume-driven operating results for The North

American Coffee Partnership, which produces ready-to-drink beverages which include, among others, bottled Frappuccino® coffee drinks and Starbucks DoubleShot® espresso drinks, and improved operating results from international investees, particularly in Japan and Korea, mainly as a result of new store openings.

Operating income increased 29% to \$781 million in the 52-week period of fiscal 2005, from \$606 million in the 53-week period of fiscal 2004. The operating margin increased to 12.3% of total net revenues in the 52-week period of fiscal 2005, compared to 11.5% in the 53-week period of fiscal 2004, primarily due to strong revenue growth.

Net interest and other income, which primarily consists of interest income, increased to \$16 million in the 52-week period of fiscal 2005, from \$14 million in the 53-week period of fiscal 2004. The increase was primarily due to higher interest income earned due to higher interest rates in fiscal 2005 compared to fiscal 2004 and to foreign exchange gains in fiscal 2005 compared to losses in fiscal 2004. Partially offsetting these increases were higher realized losses on sales of available-for-sale securities. Starbucks funded the majority of its share repurchases during fiscal 2005 through sales of its available-for-sale securities.

Income taxes for the 52 weeks ended October 2, 2005, resulted in an effective tax rate of 37.9%, compared to 37.3% in fiscal 2004. The effective tax rate differs from the statutory rate of 35% due to a variety of factors, including state income taxes, the impact from foreign operations, tax credits and other provision adjustments.

## OPERATING SEGMENTS

Segment information is prepared on the same basis that the Company's management reviews financial information for operational decision-making purposes. The following tables summarize the Company's results of operations by segment for fiscal 2005 and 2004 (*in thousands*):

	52 Weeks Ended	53 Weeks Ended	% Change	52 Weeks Ended	53 Weeks Ended
	Oct 2, 2005	Oct 3, 2004		Oct 2, 2005	Oct 3, 2004
UNITED STATES				As a % of U.S. Total Net Revenues	
Net revenues:					
Company-operated retail	\$ 4,539,455	\$ 3,800,367	19.4%	89.1%	89.1%
Specialty:					
Licensing	277,987	211,269	31.6	5.4	5.0
Foodservice and other	280,073	253,502	10.5	5.5	5.9
Total specialty	558,060	464,771	20.1	10.9	10.9
Total net revenues	5,097,515	4,265,138	19.5	100.0	100.0
Cost of sales including occupancy costs	1,944,356	1,642,745		38.1	38.5
Store operating expenses	1,848,836	1,546,871		40.7 <sup>(1)</sup>	40.7 <sup>(1)</sup>
Other operating expenses	150,712	122,335		27.0 <sup>(2)</sup>	26.3 <sup>(2)</sup>

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Depreciation and amortization expenses	250,339	209,586	4.9	4.9
General and administrative expenses	85,362	80,221	1.7	1.9
Income from equity investees	592	564		
Operating income	\$ 818,502	\$ 663,944	23.3%	16.1%
				15.6%

(1) Shown as a percentage of related Company-operated retail revenues.

(2) Shown as a percentage of related total specialty revenues.

	52 Weeks Ended	53 Weeks Ended	% Change	52 Weeks Ended	53 Weeks Ended
	Oct 2, 2005	Oct 3, 2004		Oct 2, 2005	Oct 3, 2004
<b>INTERNATIONAL</b>					
	As a % of International Total Net Revenues				
Net revenues:					
Company-operated retail	\$ 852,472	\$ 657,011	29.8%	83.4%	82.8%
Specialty:					
Licensing	145,736	119,325	22.1	14.2	15.0
Foodservice and other	24,285	17,569	38.2	2.4	2.2
Total specialty	170,021	136,894	24.2	16.6	17.2
Total net revenues	1,022,493	793,905	28.8	100.0	100.0
Cost of sales including occupancy costs	511,761	403,870		50.1	50.9
Store operating expenses	317,075	243,297		37.2 <sup>(1)</sup>	37.0 <sup>(1)</sup>
Other operating expenses	32,061	26,795		18.9 <sup>(2)</sup>	19.6 <sup>(2)</sup>
Depreciation and amortization expenses	56,705	46,196		5.5	5.8
General and administrative expenses	53,069	48,206		5.2	6.1
Income from equity investees	30,477	20,961		3.0	2.6
Operating income	\$ 82,299	\$ 46,502	77.0%	8.0%	5.9%

	As a % of CPG Total Net Revenues				
<b>GLOBAL CONSUMER PRODUCTS GROUP</b>					
Net revenues:					
Specialty:					
Licensing	\$ 249,292	\$ 235,204		100.0%	100.0%
Total specialty	249,292	235,204		100.0	100.0



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Total net revenues	249,292	235,204	6.0%	100.0	100.0
Cost of sales	149,095	144,825		59.8	61.6
Other operating expenses	14,251	22,518		5.7	9.6
Depreciation and amortization expenses	76	862			0.3
Income from equity investees	45,579	37,453		18.2	15.9
Operating income	\$ 131,449	\$ 104,452	25.8%	52.7%	44.4%

UNALLOCATED CORPORATE				As a % of Total Net Revenues	
Depreciation and amortization expenses	\$ 33,049	\$ 32,538		0.5%	0.6%
General and administrative expenses	218,683	175,866		3.4	3.3
Operating loss	\$ (251,732)	\$ (208,404)		(3.9)%	(3.9)%

(1) Shown as a percentage of related Company-operated retail revenues.

(2) Shown as a percentage of related total specialty revenues.

*United States*

United States total net revenues increased 20% to \$5.1 billion for the fiscal year ended 2005, compared to \$4.3 billion for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, United States total net revenues increased 22%. United States Company-operated retail revenues increased 19% to \$4.5 billion for the fiscal year ended 2005, compared to \$3.8 billion for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, United States Company-operated retail revenues increased 22%, primarily due to the opening of 580 new Company-operated retail stores in the last 12 months and comparable store sales growth of 9% for the 52-week period of fiscal 2005. The increase in comparable store sales was due to a 5% increase in the average value per transaction, including 3% attributable to a beverage price increase in October 2004, and a 4% increase in the number of customer transactions.

Total United States specialty revenues increased 20% to \$558 million for the fiscal year ended 2005, compared to \$465 million in the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, United States specialty revenues increased 23%. United States licensing revenues increased 32% to \$278 million, compared to \$211 million for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, United States licensing revenues increased 35%, due to increased product sales and royalty revenues as a result of opening 596 new licensed retail stores in the last 12 months. Foodservice and other revenues increased 10% to \$280 million from \$254 million for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, United States foodservice and other revenues increased 13%, primarily due to growth in new and existing foodservice accounts, as well as growth in the emerging entertainment business.

United States operating income increased by 23% to \$819 million for the fiscal year ended 2005, from \$664 million for the fiscal year ended 2004. Operating margin increased to 16.1% of related revenues from 15.6% in the 53-week period of fiscal 2004. The increase was primarily due to leverage from strong revenue growth.

*International*

International total net revenues increased 29% to \$1.0 billion for the fiscal year ended 2005, compared to \$794 million for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, International total net revenues increased 31%. International Company-operated retail revenues increased 30% to \$852 million for the fiscal year ended 2005, compared to \$657 million for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, International Company-operated revenues increased 32%, primarily due to the opening of 166 new Company-operated retail stores in the last 12 months, comparable store sales growth of 6% for the 52-week period of fiscal 2005, and the weakening of the U.S. dollar against both the Canadian dollar and British pound sterling. The increase in comparable store sales resulted from a 4% increase in the number of customer transactions and a 2% increase in the average value per transaction.

Total International specialty revenues increased 24% to \$170 million for the fiscal year ended 2005, compared to \$137 million for the 53-week period of fiscal 2004. Excluding the impact of the extra week in fiscal 2004, International specialty revenues increased 26%. International licensing revenues increased 22% to \$146 million for the fiscal year ended 2005, compared to \$119 million in the 53-week period of fiscal 2004. Excluding the impact of the extra week in 2004, International licensing revenues increased 24%, due to higher product sales and royalty revenues from opening 330 new licensed retail stores in the last 12 months. International foodservice and other revenues increased 38% to \$24 million for the fiscal year ended 2005, compared to \$18 million in the 53-week period of fiscal 2004. Excluding the impact of the extra week in 2004, international foodservice and other revenues increased 41%, primarily due to growth in new and existing foodservice accounts.

International operating income increased to \$82 million for the fiscal year ended 2005, compared to \$47 million in the 53-week period of fiscal 2004. Operating margin increased to 8.0% of related revenues from 5.9% in the 53-week period of fiscal 2004, primarily due to leverage gained on most fixed costs distributed over an expanded revenue base.

*Global Consumer Products Group*

CPG total net revenues increased 6% to \$249 million for the fiscal year ended 2005, compared to \$235 million for the 53-week period of fiscal 2004, due to the national rollout of the Starbucks<sup>™</sup> Coffee Liqueur during the fiscal second quarter of 2005 and growth in the licensed grocery and warehouse club business.

CPG operating income increased by 26% to \$131 million for the fiscal year ended 2005, compared to \$104 million for the 53-week period of fiscal 2004. Operating margin increased to 52.7% of related revenues from 44.4% in fiscal 2004, primarily due to lower other operating expenses from reduced expenditures within the grocery and warehouse club channels and higher equity investee income from volume-driven operating results for The North American Coffee Partnership, which produces ready-to-drink beverages which include, among others, bottled Frappuccino<sup>®</sup> coffee drinks and Starbucks DoubleShot<sup>®</sup> espresso drinks.

*Unallocated Corporate*

Unallocated corporate expenses increased to \$252 million for the fiscal year ended 2005, from \$208 million in the 53-week period of fiscal 2004, primarily due to increased charitable commitments as well as higher payroll-related expenditures. Total unallocated corporate expenses as a percentage of total net revenues remained unchanged at 3.9% for the fiscal year ended 2005 and the 53-week period of fiscal 2004.

**LIQUIDITY AND CAPITAL RESOURCES**

Components of the Company's most liquid assets are as follows (*in thousands*):

FISCAL YEAR ENDED	Oct 1, 2006	Oct 2, 2005
Cash and cash equivalents	\$ 312,606	\$ 173,809
Short-term investments available-for-sale securities	87,542	95,379
Short-term investments trading securities	53,496	37,848
Long-term investments available-for-sale securities	5,811	60,475
Total cash, cash equivalents and liquid investments	\$ 459,455	\$ 367,511

The Company manages its cash, cash equivalents and liquid investments in order to internally fund operating needs and pay down short-term borrowings. The \$92 million increase in total cash and cash equivalents and liquid investments from October 2, 2005 to October 1, 2006, was primarily due to strong operating cash flows.

The Company intends to use its cash and liquid investments, including any borrowings under its \$1 billion revolving credit facility, to invest in its core businesses and other new business opportunities related to its core businesses. The Company may use its available cash resources to make proportionate capital contributions to its equity method and cost method investees, as well as purchase larger ownership interests in selected equity method investees and licensed operations, particularly in international markets. Depending on market conditions, Starbucks may repurchase shares of its common stock under its authorized share repurchase program. Management believes that strong cash flow generated from operations, existing cash and liquid investments, as well as borrowing capacity under the revolving

credit facility, should be sufficient to finance capital requirements for its core businesses for the foreseeable future. Significant new joint ventures, acquisitions, share repurchases and/or other new business opportunities may require additional outside funding.

Other than normal operating expenses, cash requirements for fiscal 2007 are expected to consist primarily of capital expenditures for new Company-operated retail stores and the remodeling and refurbishment of existing Company-operated retail stores, as well as potential increased investments in International licensees and for additional share repurchases, if any. Management expects capital expenditures to be in the range of \$950 million to \$1.0 billion in fiscal 2007, primarily driven by new store development and existing store renovations.

Cash provided by operating activities totaled \$1.1 billion for fiscal 2006. Net earnings provided \$564 million and noncash depreciation and amortization expenses further increased cash provided by operating activities by \$413 million. In addition, an increase in accrued taxes payable due to the timing of payments provided \$133 million.

Cash used by investing activities for fiscal 2006 totaled \$841 million. Net capital additions to property, plant and equipment used \$771 million, primarily from opening 1,040 new Company-operated retail stores and remodeling certain existing stores. During fiscal 2006, the Company used \$92 million for acquisitions, net of cash acquired. In addition, the net activity in the Company's portfolio of available-for-sale securities provided \$61 million.

Cash used by financing activities for fiscal 2006 totaled \$155 million. Cash used to repurchase shares of the Company's common stock totaled \$854 million. This amount includes the effect of the net change in unsettled trades from October 2, 2005. Share repurchases, up to the limit authorized by the Board of Directors, are at the discretion of management and depend on market conditions, capital requirements and other factors. Approximately 21.5 million shares remained available for repurchase as of October 1, 2006.

The Company had net borrowings under its credit facility of \$423 million during fiscal 2006, which consisted of additional gross borrowings of \$1.4 billion offset by gross principal repayments of \$993 million. Management increased the Company's borrowing capacity under its credit facility during the fiscal fourth quarter of 2006, from \$500 million to \$1.0 billion, as provided in the original credit facility. As of October 1, 2006, a total of \$700 million was outstanding under the facility.

Partially offsetting cash used for share repurchases were proceeds of \$159 million from the exercise of employee stock options and the sale of the Company's common stock from employee stock purchase plans. As options granted are exercised, the Company will continue to receive proceeds and a tax deduction; however, the amounts and the timing cannot be predicted.

The following table summarizes the Company's contractual obligations and borrowings as of October 1, 2006, and the timing and effect that such commitments are expected to have on the Company's liquidity and capital requirements in future periods (*in thousands*):

CONTRACTUAL OBLIGATIONS	Total	PAYMENTS DUE BY PERIOD			
		Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
Debt obligations <sup>(1)</sup>	\$ 740,480	\$ 738,405	\$ 1,660	\$ 415	\$
Operating lease obligations <sup>(2)</sup>	3,892,938	531,634	1,013,312	861,271	1,486,721
Purchase obligations <sup>(3)</sup>	619,862	440,720	153,044	21,761	4,337
Total	\$ 5,253,280	\$ 1,710,759	\$ 1,168,016	\$ 883,447	\$ 1,491,058

(1) Debt amounts include principal maturities and expected interest payments. Rates utilized to determine interest payments for variable rate debt are based on an estimate of future interest rates. The amount due in less than one year includes \$700 million of short term borrowings under the facility.

- (2) Amounts include the direct lease obligations, excluding any taxes, insurance and other related expenses.
- (3) Purchase obligations include agreements to purchase goods or services that are enforceable and legally binding on Starbucks and that specify all significant terms. Purchase obligations relate primarily to green coffee and other commodities.

Starbucks expects to fund these commitments primarily with operating cash flows generated in the normal course of business, as well as ongoing borrowings under the facility.

#### **OFF-BALANCE SHEET ARRANGEMENT**

The Company has unconditionally guaranteed the repayment of certain Japanese yen-denominated bank loans and related interest and fees of an unconsolidated equity investee, Starbucks Coffee Japan, Ltd. ( Starbucks Japan ). The guarantees continue until the loans, including accrued interest and fees, have been paid in full, with the final loan amount due in 2014. The maximum amount is limited to the sum of unpaid principal and interest amounts, as well as other

related expenses. These amounts will vary based on fluctuations in the yen foreign exchange rate. As of October 1, 2006, the maximum amount of the guarantees was approximately \$6.0 million. Since there has been no modification of these loan guarantees subsequent to the Company's adoption of Financial Accounting Standards Board ( FASB ) Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indebtedness of Others, Starbucks has applied the disclosure provisions only and has not recorded the guarantees on its balance sheet.

## **PRODUCT WARRANTIES**

Coffee brewing and espresso equipment sold to customers through Company-operated and licensed retail stores, as well as equipment sold to the Company's licensees for use in retail licensing operations, are under warranty for defects in materials and workmanship for a period ranging from 12 to 24 months. Effective fiscal 2006, the Company elected to discontinue repairing brewing machines and instead offer an exchange to customers as a general right of return for any of its products. As a result, Starbucks maintains a sales return allowance based on historical patterns to reduce related revenues for estimated future product returns. Prior to fiscal 2006, the Company established an accrual for estimated warranty costs at the time of sale, also based on historical experience. Product warranty costs and changes to the related accrual were not significant for the periods ended October 1, 2006 and October 2, 2005.

## **COMMODITY PRICES, AVAILABILITY AND GENERAL RISK CONDITIONS**

The Company manages its exposure to various risks within the consolidated financial statements according to an umbrella risk management policy. Under this policy, market-based risks, including commodity costs and foreign currency exchange rates, are quantified and evaluated for potential mitigation strategies, such as entering into hedging transactions. Additionally, this policy restricts, among other things, the amount of market-based risk the Company will tolerate before implementing approved hedging strategies and prohibits speculative trading activity.

The Company purchases significant amounts of coffee and dairy products to support the needs of its Company-operated retail stores. The price and availability of these commodities directly impacts the Company's results of operations and can be expected to impact its future results of operations. For additional details see Product Supply in Item 1, as well as Risk Factors in Item 1A of this Form 10-K.

## **FINANCIAL RISK MANAGEMENT**

The Company is exposed to market risk related to foreign currency exchange rates, equity security prices and changes in interest rates.

## **FOREIGN CURRENCY EXCHANGE RISK**

The majority of the Company's revenue, expense and capital purchasing activities are transacted in U.S. dollars. However, because a portion of the Company's operations consists of activities outside of the United States, the Company has transactions in other currencies, primarily the Canadian dollar, British pound sterling, euro and Japanese yen. Under the Company's umbrella risk management policy, the Company frequently evaluates its foreign currency exchange risk by monitoring market data and external factors that may influence exchange rate fluctuations. As a result, Starbucks may engage in transactions involving various derivative instruments, with maturities generally not exceeding five years, to hedge assets, liabilities, revenues and purchases denominated in foreign currencies.

As of October 1, 2006, the Company had forward foreign exchange contracts that qualify as cash flow hedges under Statement of Financial Accounting Standard ( SFAS ) No. 133, Accounting for Derivative Instruments and Hedging Activities, to hedge a portion of anticipated international revenue and product purchases. In addition, Starbucks had forward foreign exchange contracts that qualify as hedges of its net investment in Starbucks Japan, an equity method



investment, as well as the Company's net investments in its Canadian and U.K. subsidiaries. These contracts expire within 33 months.

Based on the foreign exchange contracts outstanding as of October 1, 2006, a 10% devaluation of the U.S. dollar as compared to the level of foreign exchange rates for currencies under contract as of October 1, 2006, would result in a reduced fair value of these derivative financial instruments of approximately \$44 million, of which \$22 million may reduce the Company's future earnings. Conversely, a 10% appreciation of the U.S. dollar would result in an increase in the fair value of these instruments of approximately \$38 million, of which \$20 million may increase the Company's future earnings. Consistent with the nature of the economic hedges provided by these foreign exchange contracts, increases or decreases in their fair value would be mostly offset by corresponding decreases or increases in the dollar value of the Company's foreign investment, future foreign currency royalty fee payments and product purchases that would occur within the hedging period.

### **EQUITY SECURITY PRICE RISK**

The Company has minimal exposure to price fluctuations on equity mutual funds within its trading portfolio. The trading securities approximate a portion of the Company's liability under the Management Deferred Compensation Plan ( MDCP ). A corresponding liability is included in Accrued compensation and related costs on the consolidated balance sheets. These investments are recorded at fair value with unrealized gains and losses recognized in Interest and other income, net in the consolidated statements of earnings. The offsetting changes in the MDCP liability are recorded in General and administrative expenses.

### **INTEREST RATE RISK**

The Company's available-for-sale securities comprise a diversified portfolio consisting mainly of fixed income instruments. The primary objectives of these investments are to preserve capital and liquidity. Available-for-sale securities are investment grade and are recorded on the balance sheet at fair value with unrealized gains and losses reported as a separate component of Accumulated other comprehensive income. The Company does not hedge the interest rate exposure on its available-for-sale securities. The Company performed a sensitivity analysis based on a 10% change in the underlying interest rate of its interest bearing financial instruments, including its short-term borrowings and long-term debt, as of the end of fiscal 2006, and determined that such a change would not have a significant effect on the fair value of these instruments.

### **SEASONALITY AND QUARTERLY RESULTS**

The Company's business is subject to seasonal fluctuations. Significant portions of the Company's net revenues and profits are realized during the first quarter of the Company's fiscal year, which includes the holiday season. In addition, quarterly results are affected by the timing of the opening of new stores, and the Company's rapid growth may conceal the impact of other seasonal influences. Because of the seasonality of the Company's business, results for any quarter are not necessarily indicative of the results that may be achieved for the full fiscal year.

### **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

Critical accounting policies are those that management believes are both most important to the portrayal of the Company's financial condition and results, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Judgments and uncertainties affecting the application of those policies may result in materially different amounts being reported under different conditions or using different assumptions.

Starbucks considers its policies on impairment of long-lived assets, accounting for self insurance reserves, stock-based compensation and accounting for operating leases to be the most critical in understanding the judgments that are involved in preparing its consolidated financial statements.



## **IMPAIRMENT OF LONG-LIVED ASSETS**

When facts and circumstances indicate that the carrying values of long-lived assets may be impaired, an evaluation of recoverability is performed by comparing the carrying values of the assets to projected future cash flows, in addition to other quantitative and qualitative analyses. For goodwill and other intangible assets, impairment tests are performed annually and more frequently if facts and circumstances indicate goodwill carrying values exceed estimated reporting unit fair values and if indefinite useful lives are no longer appropriate for the Company's trademarks. Upon indication that the carrying values of such assets may not be recoverable, the Company recognizes an impairment loss as a charge against current operations. Property, plant and equipment assets are grouped at the lowest level for which there are identifiable cash flows when assessing impairment. Cash flows for retail assets are identified at the individual store level. Long-lived assets to be disposed of are reported at the lower of their carrying amount or fair value, less estimated costs to sell. Judgments made by the Company related to the expected useful lives of long-lived assets and the ability of the Company to realize undiscounted cash flows in excess of the carrying amounts of such assets are affected by factors such as the ongoing maintenance and improvements of the assets, changes in economic conditions and changes in operating performance. As the Company assesses the ongoing expected cash flows and carrying amounts of its long-lived assets, these factors could cause the Company to realize material impairment charges.

## **STOCK-BASED COMPENSATION**

Starbucks accounts for stock-based compensation in accordance with the fair value recognition provisions of SFAS 123R. The Company uses the Black-Scholes-Merton option pricing model which requires the input of highly subjective assumptions. These assumptions include estimating the length of time employees will retain their stock options before exercising them ( expected term ), the estimated volatility of the Company's common stock price over the expected term and the number of options that will ultimately not complete their vesting requirements ( forfeitures ). Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized on the consolidated statements of earnings.

## **OPERATING LEASES**

Starbucks leases retail stores, roasting and distribution facilities and office space under operating leases. The Company provides for an estimate of asset retirement obligation ( ARO ) expense at the lease inception date for operating leases with requirements to remove leasehold improvements at the end of the lease term. Estimating AROs involves subjective assumptions regarding both the amount and timing of actual future retirement costs. Future actual costs could differ significantly from amounts initially estimated. In addition, the large number of operating leases, and the significant number of international markets in which the Company has operating leases, adds administrative complexity to the calculation of ARO expense as well as to the other technical accounting requirements of operating leases such as contingent rent.

## **SELF INSURANCE RESERVES**

The Company uses a combination of insurance and self-insurance mechanisms, including a wholly owned captive insurance entity and participation in a reinsurance pool, to provide for the potential liabilities for workers compensation, healthcare benefits, general liability, property insurance, director and officers' liability insurance and vehicle liability. Liabilities associated with the risks that are retained by the Company are not discounted and are estimated, in part, by considering historical claims experience, demographic factors, severity factors and other actuarial assumptions. The estimated accruals for these liabilities, portions of which are calculated by third party actuarial firms, could be significantly affected if future occurrences and claims differ from these assumptions and historical trends.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In July 2006, the FASB issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, which seeks to reduce the diversity in practice associated with the accounting

and reporting for uncertainty in income tax positions. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. FIN 48 is effective for fiscal years beginning after December 15, 2006 and the Company will adopt the new requirements in its fiscal first quarter of 2008. The cumulative effects, if any, of adopting FIN 48 will be recorded as an adjustment to retained earnings as of the beginning of the period of adoption. The Company has not yet determined the impact, if any, of adopting FIN 48 on its consolidated financial statements.

In September 2006, the FASB issued SFAS 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Starbucks must adopt these new requirements no later than its first fiscal quarter of 2009. Starbucks has not yet determined the effect on the Company's consolidated financial statements, if any, upon adoption of SFAS 157, or if it will adopt the requirements prior to the first fiscal quarter of 2009.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). The intent of SAB 108 is to reduce diversity in practice for the method companies use to quantify financial statement misstatements, including the effect of prior year uncorrected errors. SAB 108 establishes an approach that requires quantification of financial statement errors using both an income statement and a cumulative balance sheet approach. SAB 108 is effective for fiscal years beginning after November 15, 2006, and the Company will adopt the new requirements in fiscal 2008. The adoption of SAB 108 is not currently expected to have a significant impact on the Company's consolidated financial statements.

#### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

The information required by this item is incorporated by reference to the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations - Commodity Prices, Availability and General Risk Conditions and Management's Discussion and Analysis of Financial Condition and Results of Operations - Financial Risk Management in Item 7 of this Report.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**STARBUCKS CORPORATION**

By: /s/ Michael Casey

Michael Casey  
executive vice president, chief financial officer and chief administrative officer

December 21, 2006

**INDEX TO EXHIBITS**

Exhibit Number	Exhibit Description	INCORPORATED BY REFERENCE			Filed Herewith
		Form	File No.	Date of First Filing	
31.1	Certification of Principal Executive Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
31.2	Certification of Principal Financial Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
32.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				X
32.2	Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of Sarbanes-Oxley Act of 2002				X