

FOOT LOCKER INC
Form 10-Q
September 11, 2007

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

FORM 10 - Q

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

For the quarterly period ended August 4, 2007

Commission file no. 1-10299

FOOT LOCKER, INC.

(Exact name of registrant as specified in its charter)

New York **13-3513936**
(State or other jurisdiction of incorporation or organization) **(I.R.S. Employer Identification No.)**

112 W. 34th Street, New York, New York **10120**
(Address of principal executive offices) **(Zip Code)**

Registrant's telephone number: (212) 720-3700

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

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

Number of shares of Common Stock outstanding at September 1, 2007: 154,353,607

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PART I - FINANCIAL INFORMATIONItem 1. Financial StatementsFOOT LOCKER, INC.CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions, except shares)

| | August 4, 2007 | July 29, 2006 (Unaudited □ See note 1) | Feb 2 |
|---|----------------------|---|----------|
| <u>ASSETS</u> | | | |
| Current assets | | | |
| Cash and cash equivalents | \$ 204 | \$ 185 | \$ |
| Short-term investments | 159 | 133 | |
| Total cash, cash equivalents and short-term investments | 363 | 318 | |
| Merchandise inventories | 1,452 | 1,476 | |
| Other current assets | 290 | 191 | |
| | 2,105 | 1,985 | |
| Property and equipment, net | 648 | 667 | |
| Deferred taxes | 134 | 214 | |
| Goodwill | 265 | 264 | |

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|--|--------------|--------------|----|
| Intangible and other assets | 188 | 206 | |
| | \$ 3,340 | \$ 3,336 | \$ |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | |
| Current liabilities | | | |
| Accounts payable | \$ 368 | \$ 441 | \$ |
| Accrued expenses and other current liabilities | 254 | 237 | |
| Current portion of long-term debt and obligations under capital leases | 14 | 22 | |
| | 636 | 700 | |
| Long-term debt and obligations under capital leases | 216 | 249 | |
| Other liabilities | 245 | 307 | |
| | 1,097 | 1,256 | |
| Shareholders' equity | | | |
| Common stock and paid-in capital: 158,872,043, 157,682,405, and 157,810,352 shares, respectively | 669 | 645 | |
| Retained earnings | 1,746 | 1,640 | |
| Accumulated other comprehensive loss | (73) | (158) | |
| Less: Treasury stock at cost: 4,522,437, 2,105,662, and 2,107,682 shares, respectively | (99) | (47) | |
| Total shareholders' equity | 2,243 | 2,080 | |
| | \$ 3,340 | \$ 3,336 | \$ |

See Accompanying Notes to Condensed Consolidated Financial Statements.

* The balance sheet at February 3, 2007 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended February 3, 2007.

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FOOT LOCKER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in millions, except per share amounts)

| | Thirteen weeks ended | | Twenty-six weeks ended | |
|--|----------------------|---------------|------------------------|---------------|
| | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 |
| Sales | \$ 1,283 | \$ 1,303 | \$ 2,599 | \$ 2,668 |
| Costs and Expenses | | | | |
| Cost of sales | 981 | 942 | 1,937 | 1,888 |
| Selling, general and administrative expenses | 286 | 273 | 576 | 556 |
| Depreciation and amortization | 44 | 44 | 87 | 87 |
| Impairment charge | □ | 17 | □ | 17 |
| Interest expense, net | □ | 1 | □ | 2 |
| Other expense | 1 | 1 | 1 | 1 |
| | 1,312 | 1,278 | 2,601 | 2,551 |
| (Loss) income before income taxes and cumulative effect of accounting change | (29) | 25 | (2) | 117 |
| Income tax (benefit) expense | (11) | 11 | (1) | 45 |

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| | | | | |
|--|-----------|---------|-----------|---------|
| (Loss) income before cumulative effect of accounting change | (18) | 14 | (1) | 72 |
| Cumulative effect of accounting change, net of income tax of \$- | □ | □ | □ | 1 |
| Net (loss) income | \$ (18) | \$ 14 | \$ (1) | \$ 73 |
| Basic (loss) earnings per share: | | | | |
| (Loss) income before cumulative effect of accounting change | \$ (0.12) | \$ 0.09 | \$ (0.01) | \$ 0.46 |
| Cumulative effect of accounting change | □ | □ | □ | 0.01 |
| Net (loss) income | \$ (0.12) | \$ 0.09 | \$ (0.01) | \$ 0.47 |
| Weighted-average common shares outstanding | 154.0 | 154.9 | 154.4 | 154.2 |
| Diluted (loss) earnings per share: | | | | |
| (Loss) income before cumulative effect of accounting change | \$ (0.12) | \$ 0.09 | \$ (0.01) | \$ 0.46 |
| Cumulative effect of accounting change | □ | □ | □ | 0.01 |
| Net (loss) income | \$ (0.12) | \$ 0.09 | \$ (0.01) | \$ 0.47 |
| Weighted-average common shares assuming dilution | 154.0 | 156.7 | 154.4 | 156.7 |

See Accompanying Notes to Condensed Consolidated Financial Statements.

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FOOT LOCKER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME
(Unaudited)
(in millions)

| | Thirteen weeks ended | | Twenty-six weeks ended | |
|--|----------------------|---------------|------------------------|---------------|
| | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 |
| Net (loss) income | \$ (18) | \$ 14 | \$ (1) | \$ 73 |
| Other comprehensive income (expense), net of tax | | | | |
| Foreign currency translation adjustments arising during the period | 5 | 8 | 25 | 13 |
| Pension and postretirement plan adjustments | □ | □ | 1 | |
| Comprehensive (loss) income | \$ (13) | \$ 22 | \$ 25 | \$ 86 |

See Accompanying Notes to Condensed Consolidated Financial Statements.

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FOOT LOCKER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in millions)

| | Twenty-six weeks ended | |
|-----------------------------------|------------------------|--------------------------|
| | August 4, 2007 | July 29, 2006 (See note) |
| From Operating Activities: | | |

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| | | | |
|--|----|-------|-------|
| Net (loss) income | \$ | (1) | \$ |
| Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities: | | | |
| Impairment charge | | □ | |
| Cumulative effect of accounting change, net of tax | | □ | |
| Depreciation and amortization | | 87 | |
| Deferred income taxes | | (19) | |
| Share-based compensation expense | | 5 | |
| Change in assets and liabilities: | | | |
| Merchandise inventories | | (132) | (2) |
| Accounts payable and other accruals | | 98 | |
| Pension contributions | | □ | |
| Other, net | | 15 | |
| Net cash provided by (used in) operating activities | | 53 | (1) |
| From Investing Activities: | | | |
| Purchases of short-term investments | | (929) | (1,0) |
| Sales of short-term investments | | 1,019 | 1,1 |
| Capital expenditures | | (83) | |
| Net cash provided by investing activities | | 7 | |
| From Financing Activities: | | | |
| Reduction in long-term debt | | (2) | |
| Issuance of common stock, net | | 8 | |
| Purchase of treasury stock | | (50) | |
| Excess tax benefit from stock based compensation | | 1 | |
| Dividends paid | | (39) | |
| Net cash used in financing activities | | (82) | |
| Effect of exchange rate fluctuations on Cash and Cash Equivalents | | 5 | |
| Net change in Cash and Cash Equivalents | | (17) | (1) |
| Cash and Cash Equivalents at beginning of year | | 221 | 2 |
| Cash and Cash Equivalents at end of interim period | \$ | 204 | \$ 1 |
| Cash paid during the period: | | | |
| Interest | \$ | 9 | \$ |
| Income taxes | \$ | 22 | \$ 1 |

See Accompanying Notes to Condensed Consolidated Financial Statements.

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FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Notes to Consolidated Financial Statements contained in the Company's Form 10-K for the year ended February 3, 2007, as filed with the Securities and Exchange Commission (the "SEC") on April 2, 2007. Certain items included in these statements are based on management's estimates. In the opinion of management, all material adjustments, which are of a normal recurring nature, necessary for a fair presentation of the results for the interim periods have been included.

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The year-end reporting period for the Company is the Saturday closest to the last day in January. Fiscal year 2007 will comprise 52 weeks, ending on February 2, 2008. Fiscal year 2006 was comprised of 53 weeks and ended on February 3, 2007. The fiscal interim periods ended August 4, 2007 and July 29, 2006 were comprised of 26 weeks. The results for the twenty-six and thirteen weeks ended August 4, 2007 are not necessarily indicative of the results expected for the year.

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). Interpretation No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

In 2006, in accordance with SAB 108, the Company adjusted its opening retained earnings to correct for prior misstatements. Accordingly, the Company has reflected these adjustments in its July 29, 2006 Condensed Consolidated Balance Sheet and Condensed Consolidated Statements of Cash Flows.

2. Income Taxes

The Company adopted the provisions of FIN 48 effective February 4, 2007. Upon the adoption of FIN 48, the Company recognized a \$1 million increase to retained earnings to reflect the change to its liability for unrecognized income tax benefits as required. At February 4, 2007, the total amount of gross unrecognized tax benefits was \$33 million. The Company recognizes interest and penalties related to unrecognized tax benefits in income tax expense. The amount recognized for the thirteen and twenty-six weeks ended August 4, 2007 was not significant. The liability for unrecognized tax benefits at February 4, 2007 included \$4 million of interest and no penalties.

The Company is subject to taxation in the U.S. and various state, local, and foreign jurisdictions. The Company's U.S. Federal income tax filings have been examined by the Internal Revenue Service (the "IRS") through 2005. The Company is participating in the IRS's Compliance Assurance Process ("CAP") for 2006, which is expected to conclude during 2007. The Company has started the CAP for 2007. Due to the recent utilization of net operating loss carryforwards, the Company is subject to state and local tax examinations effectively including years from 1993 to the present. The Company is currently under examination in the Netherlands for tax years 2002-2005. To date, no adjustments have been proposed in any audits that will have a material effect on the Company's financial position or results of operations.

The Company does not anticipate that any adjustments to unrecognized benefits due to settlement of audits and expiration of statute of limitations will materially affect the financial position or operations prior to August 2, 2008. However, actual results could differ from those currently anticipated.

3. Goodwill and Intangible Assets

The Company accounts for goodwill and other intangibles in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," which requires that goodwill and intangible assets with indefinite lives be reviewed for impairment if impairment indicators arise and, at a minimum, annually. During the first quarters of 2007 and 2006, the Company completed its annual reviews of goodwill, which did not result in an impairment charge.

| Goodwill (in millions) | August 4, 2007 | July 29, 2006 | February 3, 2007 |
|-------------------------------|---------------------------|--------------------------|-----------------------------|
| Athletic Stores | \$ 185 | \$ 184 | \$ 184 |
| Direct-to-Customers | 80 | 80 | 80 |
| | \$ 265 | \$ 264 | \$ 264 |

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The effect of foreign exchange fluctuations on goodwill for the twenty-six weeks ended August 4, 2007 was \$1 million resulting from the strengthening of the euro as compared with the U.S. dollar.

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| (in millions) | August 4, 2007 | | | July 29, 2006 | | |
|--|----------------|---------------|-----------|---------------|---------------|-----------|
| | Gross value | Accum. amort. | Net value | Gross value | Accum. amort. | Net value |
| Indefinite life intangible assets | \$ 3 | \$ 0 | \$ 3 | \$ 4 | \$ 0 | \$ 4 |
| Finite life intangible assets | | | | | | |
| Lease acquisition costs | \$ 185 | \$ (110) | \$ 75 | \$ 173 | \$ (88) | \$ 85 |
| Trademark | 21 | (3) | 18 | 21 | (2) | 19 |
| Loyalty program | 1 | (1) | 0 | 1 | (1) | 0 |
| Favorable leases | 10 | (6) | 4 | 9 | (5) | 4 |
| Total finite life intangible assets | \$ 217 | \$ (120) | \$ 97 | \$ 204 | \$ (96) | \$ 108 |
| Total intangible assets | \$ 220 | \$ (120) | \$ 100 | \$ 208 | \$ (96) | \$ 112 |

Intangible assets not subject to amortization at August 4, 2007, July 29, 2006, and February 3, 2007 include a \$3 million trademark related to the 11 stores acquired in the Republic of Ireland. The additional intangible asset of \$1 million at July 29, 2006 was eliminated with the adoption of SFAS No. 158 in 2006.

Lease acquisition costs represent amounts that are required to secure prime lease locations and other lease rights, primarily in Europe. Included in finite life intangibles is the trademark for the Footaction name, amounts paid for leased locations with rents below their fair value for the acquisitions of both the Footaction stores and the stores in the Republic of Ireland and amounts paid to obtain names of members of the Footaction loyalty program.

The weighted-average amortization period as of August 4, 2007 was approximately 12.3 years. Amortization expense was \$4 million for both the thirteen week periods ended August 4, 2007 and July 29, 2006. Amortization expense was \$9 million for both the twenty-six week periods ended August 4, 2007 and July 29, 2006. Additionally, for the twenty-six weeks ended August 4, 2007, net intangible activity includes additional lease acquisition costs of \$1 million, as well as the strengthening of the euro as compared with the U.S. dollar of \$3 million. Annual estimated amortization expense is expected to be approximately \$10 million for the remainder of 2007, \$18 million for 2008, \$15 million for 2009, \$14 million for 2010, and \$11 million for 2011.

4. Long-Term Debt

In the second quarter of 2007, the Company repaid \$2 million of its 5-year \$175 million term loan in advance of its original due date of May 2008. The balance remaining at August 4, 2007 is \$88 million.

5. Derivative Financial Instruments

Derivative Holdings Designated as Hedges

Net changes in the fair value of foreign exchange derivative financial instruments designated as cash flow hedges, and income/losses recognized in the income statement related to settled contracts, were not significant for the twenty-six weeks ended August 4, 2007 and July 29, 2006.

The Company has numerous investments in foreign subsidiaries, and the net assets of those subsidiaries are exposed to foreign currency exchange-rate volatility. The Company has entered into two net investment hedges for its European and Canadian subsidiaries. Gains and losses in the net investments in the Company's subsidiaries

due to foreign exchange volatilities will be partially offset by losses and gains related to these transactions. The gains and losses will be recorded within the foreign currency translation adjustment included in accumulated other comprehensive loss on the Condensed Consolidated Balance Sheet. The amount recorded within the foreign currency translation adjustment (net of tax) related to these net investment hedges during the thirteen weeks ended August 4, 2007 and July 29, 2006, was a reduction of \$1 million and \$2 million, respectively, and \$11 million and \$4 million for the twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively.

Derivative Holdings Designated as Non-Hedges

The Company had foreign currency option contracts with a total USD equivalent notional amount of \$48 million outstanding at the end the second quarter 2007 to mitigate the effect of fluctuating foreign exchange rates on the reporting of a portion of its expected 2007 foreign currency denominated earnings. Changes in the fair value of these foreign currency option contracts, which are designated as non-hedges, are recorded in earnings immediately. The premiums paid and changes in the fair market value were \$1 million for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively.

In addition, the Company entered into forward foreign exchange contracts to hedge foreign-currency denominated merchandise purchases and intercompany transactions. At August 4, 2007, the USD equivalent notional amount for outstanding forward foreign exchange contracts totaled \$39 million. Net changes in the fair value of foreign exchange derivative financial instruments designated as non-hedges were substantially offset by the changes in value of the underlying transactions, which were recorded in selling, general and administrative expenses in the current period.

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During the first six months of 2007, the Company entered into a series of monthly diesel fuel forward contracts to mitigate a portion of the Company's freight expense due to the variability caused by fuel surcharges charged by our third-party freight carriers. The notional values of these contracts were approximately \$1 million and extend through November 2007. Changes in the fair value of these contracts are recorded in earnings immediately. The effect was not significant for the thirteen and twenty-six weeks ended August 4, 2007.

Interest Rate Management

The Company has employed various interest rate swaps to minimize its exposure to interest rate fluctuations. These swaps, which mature in 2022, have been designated as a fair value hedge of the changes in fair value of \$100 million of the Company's 8.50 percent debentures payable in 2022 attributable to changes in interest rates. These swaps effectively convert the interest rate on the debentures from 8.50 percent to a 1-month variable rate of LIBOR plus 3.45 percent which totaled 8.78 percent and 8.82 percent at August 4, 2007 and July 29, 2006, respectively.

Fair Value

The fair value of derivative holdings and interest rate swaps recorded in the Company's Condensed Consolidated Balance Sheets are as follows:

| (in millions) | August 4, 2007 | July 29, 2006 | February 3, 2007 |
|-------------------------|-------------------------------|------------------------------|---------------------------------|
| Current assets | \$ 1 | \$ 1 | \$ 1 |
| Current liabilities | 1 | 1 | 2 |
| Non-current liabilities | 23 | 11 | 12 |

6. Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss comprised the following:

| (in millions) | August 4, 2007 | July 29, 2006 | February 3, 2007 |
|--|-------------------------------|------------------------------|---------------------------------|
| Foreign currency translation adjustments | \$ 62 | \$ 23 | \$ 37 |
| Minimum pension liability adjustment | □ | (181) | □ |
| Unrecognized pension cost and postretirement benefit | (135) | □ | (133) |
| | \$ (73) | \$ (158) | \$ (96) |

In 2006, the Company adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - An Amendment of FASB Statements No. 87, 88, 106, and 132(R)." The additional minimum pension liability amount, as well as the related intangible asset, was derecognized upon the adoption of SFAS No. 158. As part of the adoption of this standard, the Company recorded the unrecognized prior service costs and net actuarial gains/losses within shareholders' equity. The activity within accumulated other comprehensive loss in the second quarter of 2007 represents the amortization of prior service costs and net actuarial gains and losses through net periodic benefit cost, as well as changes related to foreign currency fluctuations.

7. Earnings Per Share

Basic earnings per share is computed using the weighted-average number of common shares outstanding for the period. Diluted earnings per share uses the weighted-average number of common shares outstanding during the period plus dilutive common stock equivalents, such as stock options and awards. The computation of earnings per share is as follows:

| (in millions) | Thirteen weeks ended | | Twenty-six weeks ended | |
|--|-------------------------------|--------------------------|-------------------------------|--------------------------|
| | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 |
| Net (loss) income | \$ (18) | \$ 14 | \$ (1) | \$ 73 |
| Weighted-average common shares outstanding | 154.0 | 154.9 | 154.4 | 154.2 |
| <i>Effect of Dilution:</i> | | | | |
| Stock options and awards | □ | 1.8 | □ | 2.5 |
| Weighted-average common shares assuming dilution | 154.0 | 156.7 | 154.4 | 156.7 |

Options and awards of 1.8 million were excluded from the calculation of diluted earnings per share as the effect would be antidilutive, due to a loss reported for both the thirteen and twenty-six weeks ended August 4, 2007. Additionally, options to purchase 3.5 million and 2.9 million shares of common stock were not included in the computation for the thirteen weeks ended August 4, 2007 and July 29, 2006, respectively. Options to purchase 3.3 million and 2.8 million shares of common stock were not included in the computation for the twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively. These options were not included because the exercise prices of the options were greater than the average market price of the common shares and, therefore, the effect would be antidilutive.

8. Segment Information

The Company has determined that its reportable segments are those that are based on its method of internal reporting. As of August 4, 2007, the Company has three reportable segments, Athletic Stores, Direct-to-Customers and Family Footwear. Subsequent to the close of the second quarter, the Company converted the Footquarters stores, which were the only stores reported under the Family Footwear segment, to Foot Locker and Champs Sports outlet stores.

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Sales and division results for the Company's reportable segments for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006 are presented below. Division profit reflects income (loss) before income taxes, corporate expense, non-operating income and net interest expense.

Sales

| (in millions) | Thirteen weeks ended | | Twenty-six weeks ended | |
|---------------------|----------------------|---------------|------------------------|---------------|
| | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 |
| Athletic Stores | \$ 1,209 | \$ 1,228 | \$ 2,435 | \$ 2,501 |
| Direct-to-Customers | 72 | 75 | 162 | 167 |
| Family Footwear | 2 | □ | 2 | □ |
| Total sales | \$ 1,283 | \$ 1,303 | \$ 2,599 | \$ 2,668 |

Operating Results

| (in millions) | Thirteen weeks ended | | Twenty-six weeks ended | |
|--|----------------------|---------------|------------------------|---------------|
| | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 |
| Athletic Stores (1) | \$ (13) | \$ 35 | \$ 21 | \$ 134 |
| Direct-to-Customers | 6 | 7 | 17 | 19 |
| Family Footwear | (4) | □ | (6) | □ |
| Division (loss) profit | (11) | 42 | 32 | 153 |
| Restructuring charge (2) | □ | 1 | □ | 1 |
| Corporate expense, net | 17 | 14 | 33 | 32 |
| Operating (loss) profit | (28) | 27 | (1) | 120 |
| Other expense (income) (3) | 1 | 1 | 1 | 1 |
| Interest expense, net | □ | 1 | □ | 2 |
| (Loss) income before income taxes and cumulative effect of accounting change | \$ (29) | \$ 25 | \$ (2) | \$ 117 |

(1) The thirteen and twenty-six weeks ended July 29, 2006 includes a \$17 million non-cash impairment charge related to the Company's European operations.

(2) During the second quarter of 2006, the Company recorded a restructuring charge of \$1 million, which represents a revision to the original estimate of the lease liability associated with the guarantee of The San Francisco Music Box Company distribution center. This charge is included in selling, general and administrative expenses in the Condensed Consolidated Statements of Operations.

(3) Other expense for the thirteen and twenty-six week periods represents premiums paid on foreign currency option contracts and changes in the fair value of these contracts.

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9. Pension and Postretirement Plans

The Company has defined benefit pension plans covering most of its North American employees, which are funded in accordance with the provisions of the laws where the plans are in effect. In addition to providing pension benefits, the Company sponsors postretirement medical and life insurance plans, which are available to most of its retired U.S. employees. These medical and life insurance plans are contributory and are not funded. The following are the components of net periodic pension benefit cost and net period postretirement benefit income:

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| | Pension Benefits | | | | Postretirement Benefits | | | |
|---|----------------------|---------------|------------------------|---------------|-------------------------|---------------|------------------------|---------------|
| | Thirteen weeks ended | | Twenty-six weeks ended | | Thirteen weeks ended | | Twenty-six weeks ended | |
| | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 |
| Service cost | \$ 2 | \$ 3 | \$ 5 | \$ 5 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Interest cost | 9 | 9 | 18 | 18 | 0 | 0 | 0 | 0 |
| Expected return on plan assets | (14) | (14) | (28) | (28) | 0 | 0 | 0 | 0 |
| Amortization of unrecognized prior service cost | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Amortization of net loss (gain) | 3 | 3 | 6 | 6 | (2) | (2) | (4) | (5) |
| Net benefit cost (income) | \$ 0 | \$ 1 | \$ 1 | \$ 1 | \$ (2) | \$ (2) | \$ (4) | \$ (5) |

In February 2007, the Company and its U.S. pension plan, the Foot Locker Retirement Plan, were named as defendants in a class action in federal court in New York. The Complaint alleged that the Company's pension plan violated the Employee Retirement Income Security Act of 1974, including, without limitation, its age discrimination and notice provisions, as a result of the Company's conversion of its defined benefit plan to a defined benefit pension plan with a cash balance feature in 1996. The Company plans to defend the action vigorously.

10. Stock-Based Compensation

On May 30, 2007, the Company's shareholders approved the Company's 2007 Stock Incentive Plan (the "2007 Stock Plan"). Upon approval of the 2007 Stock Plan, the Company stated it would no longer make stock awards under the 2003 Stock Option and Award Plan, the 1998 Stock Option and Award Plan, and the 2002 Foot Lockers Directors' Stock Plan, although awards previously made under those plans and outstanding on May 30, 2007 continue in effect governed by the provisions of those plans.

Under the 2007 Stock Plan, stock options, restricted stock, stock appreciation rights (SARs), or other stock-based awards may be granted to officers and other employees of the Company, including our subsidiaries and operating divisions worldwide. Nonemployee directors are also eligible to receive awards under this plan. Options for employees become exercisable in substantially equal annual installments over a three-year period, beginning with the first anniversary of the date of grant of the option, unless a shorter or longer duration is established at the time of the option grant. Options for nonemployee directors become exercisable one year from the date of grant. The maximum number of shares of stock reserved for all awards under the 2007 Stock Plan is 6,000,000. The number of shares reserved for issuance as restricted stock and other stock-based awards cannot exceed 1,500,000 shares. The options terminate up to ten years from the date of grant.

The Company accounts for its share-based compensation in accordance with SFAS No. 123(R), "Share-Based Payment." The Company uses a Black-Scholes option-pricing model to estimate the fair value of share-based awards under SFAS No. 123(R). The Black-Scholes option-pricing model incorporates various and highly subjective assumptions, including expected term and expected volatility.

The following table shows the Company's assumptions used to compute the stock-based compensation expense for twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively.

| Stock Option Plans | | Stock Purchase Plan | |
|------------------------|---------------|------------------------|---------------|
| Twenty-six weeks ended | | Twenty-six weeks ended | |
| August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 |
| | | | |

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| | | | | |
|---|-----------|------------|----------|----------|
| Weighted-average risk free rate of interest | 4.50% | 4.68% | 5.00% | 3.82% |
| Expected volatility | 28% | 30% | 22% | 23% |
| Weighted-average expected award life | 4.17years | 3.96 years | 1.0 year | 1.0 year |
| Dividend yield | 2.2% | 1.5% | 1.7% | 1.3% |
| Weighted-average fair value | \$ 5.51 | \$ 6.32 | \$ 5.76 | \$ 4.91 |

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The information set forth in the following table covers options granted under the Company's stock option plans:

| (in thousands, except price per share) | Shares | Weighted- | Weighted- |
|--|--------|-----------|----------------|
| | | Average | Average |
| | | Term | Exercise Price |
| Options outstanding at the beginning of the year | 6,048 | | \$ 19.15 |
| Granted | 713 | | 23.14 |
| Exercised | (359) | | 16.85 |
| Expired or canceled | (155) | | 24.34 |
| Options outstanding at August 4, 2007 | 6,247 | 5.8 | 19.61 |
| Options exercisable at August 4, 2007 | 4,740 | 4.8 | 18.16 |
| Options available for future grant at August 4, 2007 | 5,880 | | |

The total intrinsic value of options exercised during the thirteen weeks ended August 4, 2007 was not significant and was \$2 million for the thirteen weeks ended July 29, 2006. The total intrinsic value of options exercised during the twenty-six weeks ended August 4, 2007 and July 29, 2006 was \$2 million and \$4 million, respectively. The aggregate intrinsic value for stock options outstanding and exercisable as of August 4, 2007 was \$12 million for both stock options outstanding and exercisable. The intrinsic value for stock options outstanding and exercisable is calculated as the difference between the fair market value as the end of the period and the exercise price of the shares.

The Company received \$1 million and \$2 million in cash from option exercises for the thirteen weeks ended August 4, 2007 and July 29, 2006, respectively and \$6 million and \$5 million for twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively. The tax benefit realized by the Company on the stock option exercises for the twenty-six weeks ended August 4, 2007 and July 29, 2006 was approximately \$1 million for both periods.

The following table summarizes information about stock options outstanding and exercisable at August 4, 2007:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | |
|--|---------------------|---|---------------------------------|---------------------|---------------------------------|
| | Number | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price | Number | Weighted-Average Exercise Price |
| (in thousands, except price per share) | | | | | |
| \$ 4.53 - \$ 11.91 | 1,480 | 4.0 | \$ 10.64 | 1,480 | \$ 10.64 |
| \$ 12.31 - \$ 16.19 | 1,256 | 4.3 | \$ 15.09 | 1,256 | \$ 15.09 |
| \$ 16.20 - \$ 23.92 | 1,502 | 8.8 | \$ 23.30 | 335 | \$ 23.05 |
| \$ 24.04 - \$ 26.26 | 1,252 | 5.1 | \$ 25.34 | 1,142 | \$ 25.37 |

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| | | | | | | | | | | |
|----|-------|----|-------|-------|-----|----|-------|-------|----|-------|
| \$ | 26.41 | \$ | 28.50 | 757 | 7.1 | \$ | 27.82 | 527 | \$ | 27.79 |
| \$ | 4.53 | \$ | 28.50 | 6,247 | 5.8 | \$ | 19.61 | 4,740 | \$ | 18.16 |

Changes in the Company's nonvested options for the twenty-six weeks ended August 4, 2007 are summarized as follows:

| | Number of shares (in thousands) | Weighted- average grant date fair value per share |
|-------------------------------|---------------------------------------|--|
| Nonvested at February 3, 2007 | 1,593 | \$ 25.33 |
| Granted | 713 | 23.14 |
| Vested | (644) | 25.83 |
| Canceled | (155) | 24.34 |
| Nonvested at August 4, 2007 | 1,507 | 24.18 |

As of August 4, 2007, there was \$4.5 million of total unrecognized compensation cost, related to nonvested stock options, which is expected to be recognized over a weighted-average period of 1.27 years.

Restricted Shares and Units

Restricted shares of the Company's common stock may be awarded to certain officers and key employees of the Company. For executives outside of the United States, the Company issues restricted stock units. Each restricted stock unit represents the right to receive one share of the Company's common stock provided that the vesting conditions are satisfied. As of August 4, 2007, 90,000 restricted stock units were outstanding. Compensation expense is recognized using the fair market value at the date of grant and is amortized over the vesting period. These awards fully vest after the passage of time, generally three years. Restricted stock is considered outstanding at the time of grant, as the holders of restricted stock are entitled to receive dividends and have voting rights.

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Restricted stock activity for the twenty-six weeks ended August 4, 2007 and July 29, 2006 is summarized as follows:

| (in thousands) | Number of shares | |
|---|-------------------|------------------|
| | August 4, 2007 | July 29, 2006 |
| Outstanding at beginning of the year | 537 | 1,041 |
| Granted | 572 | 126 |
| Vested | (249) | (600) |
| Canceled or forfeited | (25) | (15) |
| Outstanding at August 4, 2007 | 835 | 552 |
| Aggregate value | \$ 19.8 million | \$ 14.0 million |
| Weighted-average remaining contractual life | 2.16 years | 1.29 years |

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The weighted-average grant-date fair value per share was \$23.06 and \$23.92 for the twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively. The total value of awards for which restrictions lapsed during the twenty-six weeks ended August 4, 2007 and July 29, 2006 was \$6.3 and \$6.7 million, respectively. As of August 4, 2007, there was \$12.7 million of total unrecognized compensation cost related to nonvested restricted stock awards. The Company recorded compensation expense related to restricted shares, net of forfeitures, of \$1.1 million and \$1.3 million in the twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively.

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

BUSINESS OVERVIEW

Foot Locker, Inc., through its subsidiaries, operates in three reportable segments — Athletic Stores, Direct-to-Customers and Family Footwear. The Athletic Stores segment is one of the largest athletic footwear and apparel retailers in the world, whose formats include Foot Locker, Lady Foot Locker, Kids Foot Locker, Champs Sports and Footaction. The Direct-to-Customers segment reflects Footlocker.com, Inc., which sells, through its affiliates, including Eastbay, Inc., to customers through catalogs and Internet websites. The Family Footwear segment includes the retail format under the Footquarters brand name. Subsequent to the close of the second quarter, the Company converted the Footquarters stores under the Family Footwear segment, to Foot Locker and Champs Sports outlet stores.

STORE COUNT

At August 4, 2007, the Company operated 3,905 stores as compared with 3,942 at February 3, 2007. During the first half of 2007, the Company opened 78 stores, remodeled or relocated 129 stores and closed 115 stores. During the next six months of 2007, the Company currently expects to open 40 stores and close 135 to 150 unproductive stores. Approximately 90 of the estimated store closings are expected to occur at or near their normal lease expiration and have minimal or no expense effect to the Company's results of operations or cash flows. Depending on the outcome of landlord negotiations, 50 to 60 of the stores are expected to close prior to normal lease expiration before the end of the fiscal year.

In 2006, the Company entered into a ten-year area development agreement with the Alshaya Trading Co. W.L.L., in which the Company agreed to enter into separate license agreements for the operation of a minimum of 75 Foot Locker stores, subject to certain restrictions, located within the Middle East. Seven of these franchised stores are operational at August 4, 2007. Revenue from these franchised stores was not significant for the thirteen and twenty-six weeks ended August 4, 2007. These stores are not included in the Company's operating store count.

SALES AND OPERATING RESULTS

All references to comparable-store sales for a given period relate to sales of stores that are open at the period-end and that have been open for more than one year. Accordingly, stores opened and closed during the period are not included. Sales from the Direct-to-Customers segment are included in the calculation of comparable-store sales for all periods presented. The following table summarizes sales and operating results by segment:

| (in millions) | Sales | | | |
|---------------------|-----------------------------|--------------------------|-------------------------------|--------------------------|
| | Thirteen weeks ended | | Twenty-six weeks ended | |
| | August 4, 2007 | July 29, 2006 | August 4, 2007 | July 29, 2006 |
| Athletic Stores | \$ 1,209 | \$ 1,228 | \$ 2,435 | \$ 2,501 |
| Direct-to-Customers | 72 | 75 | 162 | 167 |
| Family Footwear | 2 | □ | 2 | □ |
| Total sales | \$ 1,283 | \$ 1,303 | \$ 2,599 | \$ 2,668 |

Operating Results

| (in millions) | Thirteen weeks ended | | Twenty-six weeks ended | |
|--|----------------------|----------|------------------------|----------|
| | August 4, | July 29, | August 4, | July 29, |
| | 2007 | 2006 | 2007 | 2006 |
| Athletic Stores (1) | \$ (13) | \$ 35 | \$ 21 | \$ 134 |
| Direct-to-Customers | 6 | 7 | 17 | 19 |
| Family Footwear | (4) | □ | (6) | □ |
| Division (loss) profit (2) | (11) | 42 | 32 | 153 |
| Restructuring charge (3) | □ | 1 | □ | 1 |
| Corporate expense, net | 17 | 14 | 33 | 32 |
| Operating (loss) profit | (28) | 27 | (1) | 120 |
| Other expense (income) | 1 | 1 | 1 | 1 |
| Interest expense, net | □ | 1 | □ | 2 |
| (Loss) income before income taxes and cumulative effect of accounting change | \$ (29) | \$ 25 | \$ (2) | \$ 117 |

(1) The thirteen and twenty-six weeks ended July 29, 2006 includes a \$17 million non-cash impairment charge related to the Company's European operations.

(2) Division profit reflects income (loss) before income taxes and cumulative effect of accounting change, corporate expense, non-operating income and net interest expense.

(3) During the second quarter of 2006, the Company recorded a restructuring charge of \$1 million, which represents a revision to the original estimate of the lease liability associated with the guarantee of The San Francisco Music Box Company distribution center. This charge is included in selling, general and administrative expenses in the Condensed Consolidated Statements of Operations.

Sales of \$1,283 million for the second quarter of 2007 decreased 1.5 percent from sales of \$1,303 million for the second quarter of 2006. For the twenty-six weeks ended August 4, 2007, sales of \$2,599 million decreased 2.6 percent from sales of \$2,668 million for the twenty-six week period ended July 29, 2006. Excluding the effect of foreign currency fluctuations, total sales for the thirteen-week and twenty-six week periods decreased 3.3 percent and 4.3 percent, respectively, as compared with the corresponding periods. Comparable-store sales decreased by 7.3 percent and 6.2 percent, for the thirteen and twenty-six weeks ended August 4, 2007, respectively.

Gross margin, as a percentage of sales, decreased to 23.5 percent for the thirteen weeks ended August 4, 2007 as compared with 27.7 percent in the corresponding prior-year period. Gross margin, as a percentage of sales, of 25.5 percent for the twenty-six weeks ended August 4, 2007 decreased as compared with 29.2 percent in the corresponding prior-year period. The second quarter of 2007 was negatively affected by \$50 million in additional markdowns, at cost, taken in the U.S. to liquidate slow-selling merchandise. These additional markdowns resulted in the Company's merchandise margin rate for the thirteen weeks ended August 4, 2007 declining by 320 basis points as compared with the corresponding prior-year period. Lower sales resulted in the occupancy rate increasing 100 basis points, as a percentage of sales, for the same period. The effect of vendor allowances, as a percentage of sales, improved gross margin by approximately 30 basis points for the thirteen week period ended August 4, 2007 as compared with the corresponding prior-year period. However, the effect of vendor allowances, as a percentage of sales, negatively affected gross margin by approximately 10 basis points for the twenty-six weeks ended August 4, 2007, as compared with the corresponding prior-year period.

Other expense of \$1 million for the thirteen and twenty-six week periods ended August 4, 2007 and July 29, 2006, respectively, represents premiums paid on foreign currency option contracts and changes in the fair value

of these contracts.

Segment Analysis

Athletic Stores

Athletic Stores sales decreased by 1.5 percent and 2.6 percent for the thirteen and twenty-six weeks ended August 4, 2007, respectively, as compared with the corresponding prior-year periods. Excluding the effect of foreign currency fluctuations, primarily related to the euro, sales from athletic stores decreased 3.2 percent and 4.4 percent for the thirteen and twenty-six weeks ended August 4, 2007, respectively, as compared with the corresponding prior-year periods. The decline in sales for the thirteen and twenty-six weeks ended August 4, 2007 was primarily related to the domestic operations, most significantly in Foot Locker. Comparable-store sales decreased by 7.3 percent and 6.4 percent for the thirteen and twenty-six weeks ended August 4, 2007, respectively. Due to the Company's decision to liquidate slow-selling merchandise, average selling prices for footwear in the U.S. declined approximately 10 percent, while unit sales increased approximately 3 percent for the thirteen weeks ended August 4, 2007. Sales in the U.S. were negatively affected by a decline in consumer spending coupled with a shift toward casual footwear, including the trend toward sandals and brown shoes. Additionally, in two key markets school openings and sales tax-free periods were later in August as compared with the prior-year period. Internationally, comparable-store sales declined mid-single digits. In Europe, the sales trend of higher priced technical footwear continued to improve during the second quarter, while sales of low-profile footwear styles declined.

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Due in large part to the inventory liquidation activity during the thirteen weeks ended August 4, 2007, the Athletic Stores segment recorded a loss of \$13 million, a decline of \$48 million as compared with the corresponding prior-year period. Division profit, as a percentage of sales, decreased to 0.9 percent for the twenty-six weeks ended August 4, 2007 as compared with 5.4 percent in the corresponding prior-year period. The decrease in division profit is mainly attributable to decreases in the U.S. divisions, offset, in part, by increases in International division profit. The U.S. divisions' profit decline was principally the result of a decline in sales, coupled with higher promotional markdowns taken due to the Company's decision to liquidate slower selling and aged merchandise aggressively. The Company is continuing to develop various merchandising initiatives in an effort to improve performance of the U.S. formats. Many of these initiatives are targeted for the back-to-school selling period; accordingly, management will monitor the progress of the domestic operations and will assess, if necessary, the impact of various initiatives on the projected performance of the divisions, which may include an analysis of recoverability of store long-lived assets pursuant to SFAS No. 144. During the second quarter ended July 29, 2006, the Company recorded an impairment charge of \$17 million (\$12 million after-tax) to write-down long-lived assets such as store fixtures and leasehold improvements, in 69 stores in the European operations to their estimated fair value. Excluding this charge, Foot Locker Europe's second quarter 2007 division profit increased significantly as compared with the corresponding prior-year period, reflecting an improved gross margin rate due to lower promotional markdowns, in particular for technical footwear styles.

Direct-to-Customers

Direct-to-Customers sales decreased by 4.0 percent to \$72 million and by 3.0 percent to \$162 million for the thirteen and twenty-six weeks ended August 4, 2007, respectively, as compared with the corresponding prior-year periods. Internet sales increased by 5.6 percent to \$57 million and by 6.7 percent to \$127 million for the thirteen and twenty-six weeks ended August 4, 2007, respectively, as compared with the corresponding prior-year period. Increases in Internet sales were offset by a decline in catalog sales, reflecting the continuing trend of the Company's customers to browse and select products through its catalogs, then make their purchases via the Internet. Additionally, sales for the twenty-six weeks ended August 4, 2007 were negatively affected by the termination of a third party arrangement at the end of the first quarter of 2006.

Direct-to-Customers division profit decreased 14.3 percent and 10.5 percent for thirteen and twenty-six weeks ended August 4, 2007, respectively, as compared with the corresponding prior-year periods. Division profit, as a percentage of sales, decreased to 8.3 percent and 10.5 percent for the thirteen and twenty-six weeks ended August 4, 2007, respectively, as compared to 9.3 percent and 11.4 percent, respectively, in the corresponding prior-year periods.

Family Footwear

During the first quarter of 2007, the Company launched a new family footwear concept, Footquarters. Sales and division results were not significant for the thirteen and twenty-six weeks ended August 4, 2007. The concept's results did not meet the Company's expectations and, therefore, the Company decided not to further invest in this business. Subsequent to the close of the second quarter, the Company converted these stores to Foot Locker and Champs Sports outlet stores. A charge of \$1.8 million was recorded in the second quarter, which primarily represented costs associated with the removal of signage and the write-off of unusable fixtures.

Corporate Expense

Corporate expense consists of unallocated general and administrative expenses as well as depreciation and amortization related to the Company's corporate headquarters, centrally managed departments, unallocated insurance and benefit programs, certain foreign exchange transaction gains and losses, and other items. Corporate expense was \$17 million for the thirteen weeks ended August 4, 2007, an increase of \$3 million as compared with the corresponding prior-year period. During the second quarter of 2007, the Company identified an under accrual related to employee vacation entitlements. The accrual was understated by \$1 million (\$0.6 million after-tax); accordingly, a charge was recorded to reflect the liability as of August 4, 2007. This under accrual was not material to the Company's consolidated statement of operations or cash flows for this period or any of the earlier reported periods. Additionally, the second quarter of 2006 reflected reduced incentive compensation expense of \$3 million, as well as a charge for an anticipated legal settlement of \$2 million. Corporate expense for the twenty-six weeks ended August 4, 2007 increased by \$1 million to \$33 million from the same period in the prior year.

Selling, General and Administrative

Selling, general and administrative expenses (SG&A) of \$286 million increased by \$13 million, or 4.8 percent, in the second quarter of 2007 as compared with the corresponding prior-year period. SG&A of \$576 million increased by \$20 million, or 3.6 percent, in the first half of 2007 as compared with the corresponding prior-year period. SG&A, as a percentage of sales increased to 22.3 percent for the thirteen weeks ended August 4, 2007 as compared with 21.0 percent in the corresponding prior-year period. SG&A, as a percentage of sales increased to 22.2 percent for the twenty-six weeks ended August 4, 2007 as compared with 20.8 percent in the corresponding prior-year period. The increases in SG&A as a percentage of sales are due, in large part, to the decline in sales during the current year coupled with the increase in corporate expense, both as discussed above. Excluding the effect of foreign currency fluctuations, SG&A increased \$9 million and \$10 million for the thirteen and twenty-six weeks ended August 4, 2007, respectively, as compared with the corresponding prior-year periods.

Depreciation and Amortization

Depreciation and amortization remained essentially unchanged for the thirteen and twenty-six weeks ended August 4, 2007 as compared with the corresponding prior-year period.

Interest Expense

Interest expense was \$5 million and \$6 million for the thirteen week periods ended August 4, 2007 and July 29, 2006, respectively. Interest expense was \$10 million and \$11 million for the twenty-six week periods ended August 4, 2007 and July 29, 2006, respectively. The reduction in interest expense relates primarily to the \$38 million purchase and retirement in 2006 of the Company's 8.5 percent debentures. Interest income was \$5 million for the thirteen weeks ended August 4, 2007 and July 29, 2006, respectively. Interest income increased to \$10 million from \$9 million for the twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively. The increase in interest income is primarily the result of higher average interest rates on cash, cash equivalents, and short-term investments, coupled with an increase in the average short-term investment balance.

Income Taxes

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The Company's effective tax rate for the thirteen and twenty-six weeks ended August 4, 2007 was 38.4 percent and 71.6 percent as compared with 44.2 percent and 38.4 percent for the corresponding prior-year periods. The difference in the second quarter rate is primarily due to the proportion of the U.S. loss to the total loss for the quarter, offset in part by the effect of a change in the German statutory tax rates. The 2007 year-to-date effective rate is distorted by the fact that the first quarter represented income whereas the second quarter was a loss of essentially the same amount. The Company expects its effective rate to approximate 35 percent for the remaining quarters of 2007, as well as for the full year. The actual rate will depend in significant part on the proportion of the Company's worldwide income that is earned in the U.S.

Net Income (Loss)

For the thirteen weeks ended August 4, 2007, the Company reported a net loss \$18 million, or \$0.12 per diluted share. This compares to net income of \$14 million or \$0.09 per diluted share for the corresponding prior-year period. The decline is a result of lower sales due to the continued challenging athletic retail environment and approximately \$50 million in additional markdowns recorded to liquidate slow-moving merchandise. Included in the thirteen weeks ended July 29, 2006 is a non-cash impairment charge of \$17 million (\$12 million after-tax) or \$0.08 per share, to write-down the value of long-lived assets of underperforming stores in the Company's European operations. For the twenty-six weeks ended August 4, 2007, the Company reported a net loss of \$1 million, or \$0.01 per diluted share, a decrease of \$0.48 per diluted share from \$73 million, or \$0.47 per diluted share, for the twenty-six weeks ended July 29, 2006. The twenty-six weeks ended July 29, 2006 reflects a benefit of \$1 million, or \$0.01 per diluted share, from a cumulative effect of accounting change related to the required adoption of SFAS No. 123 (R).

LIQUIDITY AND CAPITAL RESOURCES

Generally, the Company's primary sources of cash have been from operations. The Company generally finances real estate with operating leases. The principal uses of cash have been to finance inventory requirements, capital expenditures related to store openings, store remodelings, and management information systems, and to fund other general working capital requirements.

Management believes operating cash flows will be adequate to fund its working capital requirements, future pension contributions for the Company's retirement plans, anticipated quarterly dividend payments, scheduled debt repayments, potential share repurchases, and to support the development of its short-term and long-term operating strategies. Additionally, the Company has a \$200 million revolving credit facility. Other than to support standby letter of credit commitments, of which \$14 million were in place at August 4, 2007, this revolving credit facility has not been used during 2007. In 2004, the Company obtained a 5-year, \$175 million amortizing term loan from the bank group participating in the revolving credit facility, of which \$88 million is outstanding as of August 4, 2007. Under the Company's revolving credit and term loan agreement the Company is required to satisfy certain financial and operating covenants, including a minimum fixed charge coverage ratio. In addition, this agreement restricts the amount the Company may expend in any year for dividends to 50 percent of its prior year's net income. Based upon the Company's second quarter financial results and business uncertainties for the second half of the year, the Company may not continue to be in compliance with the fixed charge coverage ratio. In addition, the restricted payment provision may prohibit the Company from the payment of the dividend at the current rate in 2008. In the event that the Company does not satisfy one or more of the covenants, the Company will evaluate several options and expects that it would be able to obtain a waiver, amend the agreement, or enter into a new credit facility.

Any materially adverse change in customer demand, fashion trends, competitive market forces, or customer acceptance of the Company's merchandise mix and retail locations, uncertainties related to the effect of competitive products and pricing, the Company's reliance on a few key vendors for a significant portion of its merchandise purchases and risks associated with foreign global sourcing or economic conditions worldwide, as well as other factors listed under the heading "Disclosure Regarding Forward-Looking Statements," could affect the ability of the Company to continue to fund its needs from business operations.

Net cash provided by operating activities was \$53 million for the twenty-six weeks ended August 4, 2007 and net cash used in operating activities was \$113 million for the twenty-six weeks ended July 29, 2006. These amounts reflect net income adjusted for non-cash items and working capital changes. The Company reported a loss of \$1 million for the twenty-six weeks ended August 4, 2007, as compared with a profit of \$73 million in the corresponding prior-year period primarily as a result of the liquidation of slow-moving merchandise. While the

liquidation negatively affected the results for the period, the Company's operating cash flows were enhanced by the liquidation activity. The Company believes its inventory levels are well positioned for the back-to-school selling period. Additionally, in the first half of 2007 the Company did not contribute to the U.S. and Canadian qualified pension plans as a contribution was not required. This compares with \$68 million contributed in the first half of 2006.

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Net cash provided by investing activities was \$7 million for the twenty-six weeks ended August 4, 2007 and was \$85 million for the twenty-six weeks ended July 29, 2006. The Company's sales of short-term investments, net of purchases, provided cash of \$90 million as compared with \$165 million in the corresponding prior-year period. Planned capital expenditures for 2007 are expected to total \$147 million, of which \$121 million relates to new store openings and modernizations of existing stores, and \$26 million reflects the development of information systems and other support facilities. This amount is \$23 million less than was originally planned primarily because the Company will no longer be investing in the Footquarters concept coupled with the reduced number of store modernizations planned for the U.S. formats. The Company has the ability to revise and reschedule its anticipated capital expenditure program in the event that any changes to the Company's financial position require it.

Net cash used in financing activities for the Company's operations was \$82 million for the twenty-six weeks ended August 4, 2007 and was \$77 million for the twenty-six weeks ended July 29, 2006. During the second quarters of 2007 and 2006, the Company made payments of \$2 million and \$50 million, respectively, related to its 5-year term loan. The Company recorded an excess tax benefit related to stock-based compensation of \$1 million and \$2 million for the twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively. The Company declared and paid a \$0.125 per share dividend during the first and second quarters of 2007 totaling \$39 million, as compared with a \$0.09 per share dividend during the first and second quarters of 2006, which totaled \$28 million. The Company received proceeds from the issuance of common stock in connection with employee stock programs of \$8 million and \$7 million for the twenty-six weeks ended August 4, 2007 and July 29, 2006, respectively. In the first quarter of 2007, the Company announced that the Board of Directors authorized a new \$300 million, three-year repurchase program replacing a prior \$150 million program. As part of the new authorized repurchase program, the Company purchased 2,283,254 shares of its common stock during the twenty-six weeks ended August 4, 2007 for approximately \$50 million. The Company purchased 334,200 shares of its common stock during the twenty-six weeks ended July 29, 2006 for approximately \$8 million. Under the current share repurchase program, subject to legal and contractual restrictions, the Company may make purchases of its common stock, from time to time, depending on market conditions, availability of other investment opportunities and other factors.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

There have been no significant changes to the Company's critical accounting policies and estimates from the information provided in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in the Annual Report on Form 10-K for the fiscal year ended February 3, 2007, except for the following.

Income Taxes

The Company accounts for uncertain tax positions in accordance with FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). The Company has operations in multiple taxing jurisdictions and is subject to audit in these jurisdictions. Tax audits by their nature are often complex and can require several years to resolve. Accruals of tax contingencies require management to make estimates and judgments with respect to the ultimate outcome of tax audits. Actual results could vary from these estimates.

The Company expects that FIN 48 may, over time, create more volatility in the effective tax rate from quarter to quarter because we are required each quarter to determine whether new information changes our assessment of both the probability that a tax position will effectively be sustained and the appropriateness of the amount of recognized benefit.

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of the federal securities laws. All statements, other than statements of historical facts, which address activities, events or developments that the Company expects or anticipates will or may occur in the future, including, but not limited to, such things as future capital expenditures, expansion, strategic plans, dividend payments, stock repurchases, growth of the Company's business and operations, including future cash flows, revenues and earnings, and other such matters are forward-looking statements. These forward-looking statements are based on many assumptions and factors detailed in the Company's filings with the Securities and Exchange Commission, including the effects of currency fluctuations, customer demand, fashion trends, competitive market forces, uncertainties related to the effect of competitive products and pricing, customer acceptance of the Company's merchandise mix and retail locations, the Company's reliance on a few key vendors for a majority of its merchandise purchases (including a significant portion from one key vendor), unseasonable weather, economic conditions worldwide, any changes in business, political and economic conditions due to the threat of future terrorist activities in the United States or in other parts of the world and related U.S. military action overseas, the ability of the Company to execute its business plans effectively with regard to each of its business units, risks associated with foreign global sourcing, including political instability, changes in import regulations, and disruptions to transportation services and distribution. Any changes in such assumptions or factors could produce significantly different results. The Company undertakes no obligation to update forward-looking statements, whether as a result of new information, future events, or otherwise.

Item 4. Controls and Procedures

The Company's management performed an evaluation under the supervision and with the participation of the Company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO), and completed an evaluation as of August 4, 2007 of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as that term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)). Based on that evaluation, the Company's CEO and CFO concluded that the Company's disclosure controls and procedures were effective to ensure that information relating to the Company that is required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

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During the quarter ended August 4, 2007, there were no changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) of the Exchange Act) that materially affected or are reasonably likely to affect the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Legal proceedings pending against the Company or its consolidated subsidiaries consist of ordinary, routine litigation, including administrative proceedings, incidental to the business of the Company, as well as litigation incidental to the sale and disposition of businesses that have occurred in past years. These legal proceedings include commercial, intellectual property, customer, and labor-and-employment-related claims. Certain of the Company's subsidiaries are defendants in a number of lawsuits filed in state and federal courts containing various class action allegations under state and federal wage and hour laws, including allegations concerning classification of employees as exempt or nonexempt, unpaid overtime, meal and rest breaks, and uniforms. Management does not believe that the outcome of such proceedings would have a material adverse effect on the Company's consolidated financial position, liquidity, or results of operations, taken as a whole.

Item 1A. Risk Factors

There were no material changes to the risk factors disclosed in the 2006 Annual Report on Form 10-K.

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

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This table provides information with respect to purchases by the Company of shares of its Common Stock during the second quarter of 2007:

| | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Approximate Dollar Value of Shares that May Yet be Purchased Under the Program (1) |
|-------------------------------------|---|---------------------------------------|--|---|
| May 6, 2007 through June 2, 2007 | | | | \$ 274,328,977 |
| June 3, 2007 through July 7, 2007 | 1,109,543 | \$ 21.6330 | 1,109,543 | \$ 250,326,223 |
| July 8, 2007 through August 4, 2007 | | | | \$ 250,326,223 |
| Total | 1,109,543 | \$ 21.6330 | 1,109,543 | |

(1) On March 7, 2007, the Company announced that the Board of Directors authorized a new \$300 million, three-year repurchase program, replacing the \$150 million program. This authorization will terminate on January 30, 2010.

Item 4. Submission of Matters to a Vote of Security Holders

(a) The Company's annual meeting of shareholders was held on May 30, 2007. There were represented at the meeting, in person or by proxy, 133,051,984 shares of Common Stock, par value \$0.01 per share, which represented 85.7 percent of the shares outstanding on April 5, 2007, the record date for the meeting.

(b) Christopher A. Sinclair was elected as a director in Class II for a one-year term ending at the annual meeting of shareholders in 2008. Each of James E. Preston, Matthew D. Serra, and Dona D. Young was elected as a director in Class I for a three-year term ending at the annual meeting of shareholders of the Company in 2010. All of these individuals previously served as directors of the Company. Nicholas DiPaolo, Alan D. Feldman, Jarobin Gilbert Jr., Matthew M. McKenna, David Y. Schwartz, and Cheryl Nido Turpin, having previously been elected directors of the Company for terms continuing beyond the 2007 annual meeting of shareholders, continue in office as directors of the Company. Purdy Crawford and Philip H. Geier Jr. retired as directors at the conclusion of the annual shareholders' meeting in accordance with the retirement policy for directors.

(c) In addition to the election of directors, shareholders ratified the appointment of KPMG as independent accountants and approved the 2007 Stock Plan. The results of the voting were as follows:

(1) Election of Directors:

| Name | Votes For | Votes Withheld | Abstentions and Broker Non- Votes |
|-------------------------|-------------|----------------|--|
| James E. Preston | 124,557,069 | 8,494,915 | 0 |
| Matthew D. Serra | 129,150,447 | 3,901,537 | 0 |
| Christopher A. Sinclair | 129,634,923 | 3,417,061 | 0 |
| Dona D. Young | 131,039,249 | 2,012,735 | 0 |

(2) Proposal to ratify the appointment of independent accountants:

| Votes For | Votes Against | Abstentions | Broker Non-Votes |
|-------------|---------------|-------------|------------------|
| 132,163,901 | 810,369 | 77,714 | 0 |

(3) Proposal to approve the 2007 Stock Incentive Plan:

| Votes For | Votes Against | Abstentions | Broker Non-Votes |
|-------------|---------------|-------------|------------------|
| 107,859,662 | 12,412,666 | 238,863 | 12,540,793 |

Item 6.
Exhibits

- (a) Exhibits
The exhibits that are in this report immediately follow the index.
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SIGNATURE

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

Date: September 11, 2007

FOOT LOCKER, INC.
(Company)

/s/ Robert W. McHugh
ROBERT W. MCHUGH
Senior Vice President and Chief Financial Officer

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FOOT LOCKER, INC.
INDEX OF EXHIBITS REQUIRED BY ITEM 6(a) OF FORM 10-Q
AND FURNISHED IN ACCORDANCE WITH ITEM 601 OF REGULATION S-K

| Exhibit No. in Item 601 | Description |
|-------------------------|--|
| 12 | Computation of Ratio of Earnings to Fixed Charges. |
| 15 | Accountant's Acknowledgment. |
| 31.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley act of 2002. |
| 31.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley act of 2002. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

