

YUM BRANDS INC  
Form 10-K  
February 28, 2007

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

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FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 for the fiscal year ended December 30, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-13163

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**YUM! BRANDS, INC.**

(Exact name of registrant as specified in its charter)

North Carolina  
(State or other jurisdiction of  
incorporation or organization)

13-3951308  
(I.R.S. Employer  
Identification No.)

1441 Gardiner Lane, Louisville, Kentucky  
(Address of principal executive offices)

40213  
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Stock, no par value	New York Stock Exchange
Rights to purchase Series A Participating Preferred Stock, no par value of the Registrant	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in the 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

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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 S-K is not contained herein, and will not be contained, to the best of 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 non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12-b 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 (which consists solely of shares of Common Stock) held by non-affiliates of the registrant as of June 17, 2006 computed by reference to the closing price of the registrant's Common Stock on the New York Stock Exchange Composite Tape on such date was \$14,065,440,170. All executive officers and directors of the registrant have been deemed, solely for the purpose of the foregoing calculation, to be affiliates of the registrant.

The number of shares outstanding of the registrant's Common Stock as of February 23, 2007 was 263,625,626 shares.

### **Documents Incorporated by Reference**

Portions of the definitive proxy statement furnished to shareholders of the registrant in connection with the annual meeting of shareholders to be held on May 17, 2007 are incorporated by reference into Part III.

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PART I

**Item 1. Business.**

YUM! Brands, Inc. (referred to herein as **YUM** or the **Company** ), was incorporated under the laws of the state of North Carolina in 1997. The principal executive offices of YUM are located at 1441 Gardiner Lane, Louisville, Kentucky 40213, and the telephone number at that location is (502) 874-8300.

YUM, the registrant, together with its subsidiaries, is referred to in this Form 10-K annual report ( **Form 10-K** ) as the **Company**. The terms **we**, **us** and **our** are also used in the Form 10-K to refer to the **Company**.

This Form 10-K should be read in conjunction with the Cautionary Statements on page 52.

**(a) General Development of Business**

In January 1997, PepsiCo announced its decision to spin-off its restaurant businesses to shareholders as an independent public company (the **Spin-off** ). Effective October 6, 1997, PepsiCo disposed of its restaurant businesses by distributing all of the outstanding shares of common stock of YUM to its shareholders.

On May 7, 2002, YUM completed the acquisition of Yorkshire Global Restaurants, Inc. ( **YGR** ), the parent company and operator of Long John Silver's ( **LJS** ) and A&W All-American Food Restaurants ( **A&W** ). On May 16, 2002, following receipt of shareholder approval, the **Company** changed its name from TRICON Global Restaurants, Inc. to YUM! Brands, Inc.

Throughout this Form 10-K, the terms **restaurants**, **stores** and **units** are used interchangeably.

**(b) Financial Information about Operating Segments**

YUM consists of six operating segments: KFC, Pizza Hut, Taco Bell, LJS/A&W, YUM Restaurants International ( **YRI** or **International Division** ) and YUM Restaurants China ( **China Division** ). For financial reporting purposes, management considers the four U.S. operating segments to be similar and, therefore, has aggregated them into a single reportable operating segment. The **China Division** includes mainland China ( **China** ), Thailand and KFC Taiwan, and the **International Division** includes the remainder of our international operations.

Operating segment information for the years ended December 30, 2006, December 31, 2005 and December 25, 2004 for the **Company** is included in Management's Discussion and Analysis of Financial Condition and Results of Operations ( **MD&A** ) in Part II, Item 7, pages 25 through 52 and in the related Consolidated Financial Statements and footnotes in Part II, Item 8, pages 53 through 101.

(c) **Narrative Description of Business**

**General**

YUM is the world's largest quick service restaurant ( QSR ) company based on number of system units, with more than 34,000 units in more than 100 countries and territories. Through the five concepts of KFC, Pizza Hut, Taco Bell, LJS, and A&W (the Concepts ), the Company develops, operates, franchises and licenses a worldwide system of restaurants which prepare, package and sell a menu of competitively priced food items. In all five of its Concepts, the Company either operates units or they are operated by independent franchisees or licensees under the terms of franchise or license agreements. Franchisees can range in size from individuals owning just one unit to large publicly traded companies. In addition, the Company owns non-controlling interests in Unconsolidated Affiliates who operate similar to franchisees. As

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of year-end 2006, approximately 22 percent of YUM's worldwide units were operated by the Company, approximately 68 percent by franchisees, approximately 6 percent by licensees and approximately 4 percent by Unconsolidated Affiliates.

At year-end 2006, we had more than 20,000 system units in the U.S. which generated revenues of \$5.6 billion and operating profit of \$763 million during 2006. As of year-end 2006, approximately 21 percent of U.S. units were operated by the Company, approximately 69 percent by franchisees and approximately 10 percent by licensees.

The International Division, based in Dallas, Texas, comprises more than 11,000 restaurants, primarily KFCs and Pizza Huts, operating in over 100 countries outside the U.S. In 2006, YRI achieved revenues of \$2.3 billion and operating profit of \$407 million. As of year-end 2006, approximately 15 percent of International Division units were operated by the Company, approximately 79 percent by franchisees, approximately 1 percent by licensees and approximately 5 percent by Unconsolidated Affiliates. In 2006, YRI opened more than 700 new restaurants for the seventh straight year.

The China Division, based in Shanghai, China, has been reported separately since the beginning of 2005. The China Division has more than 2,600 system restaurants, predominately KFCs. In 2006, the China Division achieved revenues of \$1.6 billion and operating profit of \$290 million. As of year-end 2006, approximately 67 percent of China Division units were operated by the Company, approximately 8 percent by franchisees and approximately 25 percent by Unconsolidated Affiliates. In 2006, the China Division opened nearly 400 new restaurants.

### **Restaurant Concepts**

In each Concept, consumers can dine in and/or carry out food. In addition, Taco Bell, KFC, LJS and A&W offer a drive-thru option in many stores. Pizza Hut offers a drive-thru option on a much more limited basis. Pizza Hut and, on a much more limited basis, KFC offer delivery service.

Each Concept has proprietary menu items and emphasizes the preparation of food with high quality ingredients as well as unique recipes and special seasonings to provide appealing, tasty and attractive food at competitive prices.

The franchise program of the Company is designed to assure consistency and quality, and the Company is selective in granting franchises. Under standard franchise agreements, franchisees supply capital initially by paying a franchise fee to YUM, purchasing or leasing the land, building and equipment and purchasing signs, seating, inventories and supplies and, over the longer term, by reinvesting in the business. Franchisees then contribute to the Company's revenues through the payment of royalties based on a percentage of sales.

The Company believes that it is important to maintain strong and open relationships with its franchisees and their representatives. To this end, the Company invests a significant amount of time working with the franchisee community and their representative organizations on all aspects of the business, including new products, equipment and management techniques.

The Company and its franchisees also operate multibrand units, primarily in the U.S., where two or more of the Concepts are operated in a single unit. At year-end 2006, there were 3,636 multibranded units in the worldwide system, of which 3,433 were in the U.S. These units were comprised of 2,619 units offering food products from two of the Concepts (a 2n1 ), 48 units offering food products from three of the Concepts (a 3n1 ), and 946 units offering food products from Pizza Hut and WingStreet, a flavored chicken wings concept. YUM has developed 23 units

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offering food products from KFC and Wing Works, another flavored chicken wings concept developed by YUM.

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Following is a brief description of each concept:

### KFC

KFC was founded in Corbin, Kentucky by Colonel Harland D. Sanders, an early developer of the quick service food business and a pioneer of the restaurant franchise concept. The Colonel perfected his secret blend of 11 herbs and spices for Kentucky Fried Chicken in 1939 and signed up his first franchisee in 1952. KFC is based in Louisville, Kentucky.

As of year-end 2006, KFC was the leader in the U.S. chicken QSR segment among companies featuring chicken-on-the-bone as their primary product offering, with a 46 percent market share (Source: The NPD Group, Inc.; NPD Foodworld; CREST) in that segment which is nearly four times that of its closest national competitor.

KFC operates in 102 countries and territories throughout the world. As of year-end 2006, KFC had 5,394 units in the U.S., and 8,864 units outside the U.S., including 1,822 units in Mainland China. Approximately 19 percent of the U.S. units and 24 percent of the non-U.S. units are operated by the Company.

Traditional KFC restaurants in the U.S. offer fried chicken-on-the-bone products, primarily marketed under the names Original Recipe and Extra Tasty Crispy. Other principal entree items include chicken sandwiches (including the Snacker and the Twister), KFC Famous Bowls, Colonel's Crispy Strips, Wings, Popcorn Chicken and, seasonally, Chunky Chicken Pot Pies. KFC restaurants in the U.S. also offer a variety of side items, such as biscuits, mashed potatoes and gravy, coleslaw, corn, and potato wedges, as well as desserts. While many of these products are offered outside of the U.S., international menus are more focused on chicken sandwiches and Colonel's Crispy Strips, and include side items that are suited to local preferences and tastes. Restaurant decor throughout the world is characterized by the image of the Colonel.

### Pizza Hut

The first Pizza Hut restaurant was opened in 1958 in Wichita, Kansas, and within a year, the first franchise unit was opened. Today, Pizza Hut is the largest restaurant chain in the world specializing in the sale of ready-to-eat pizza products. Pizza Hut is based in Dallas, Texas.

As of year-end 2006, Pizza Hut was the leader in the U.S. pizza QSR segment, with a 15 percent market share (Source: The NPD Group, Inc.; NPD Foodworld; CREST) in that segment.

Pizza Hut operates in 92 countries and territories throughout the world. As of year-end 2006, Pizza Hut had 7,532 units in the U.S., and 5,153 units outside of the U.S. Approximately 19 percent of the U.S. units and 26 percent of the non-U.S. units are operated by the Company.

Pizza Hut features a variety of pizzas, which may include Pan Pizza, Thin n Crispy, Hand Tossed, Sicilian, Stuffed Crust, Twisted Crust, Sicilian Lasagna Pizza, Cheesy Bites Pizza, The Big New Yorker, The Insider, The Chicago Dish and 4forALL. Each of these pizzas is offered with a variety of different toppings. In some restaurants, Pizza Hut also offers breadsticks, pasta, salads and sandwiches. Menu items outside of the U.S. are generally similar to those offered in the U.S., though pizza toppings are often suited to local preferences and tastes.

### Taco Bell

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The first Taco Bell restaurant was opened in 1962 by Glen Bell in Downey, California, and in 1964, the first Taco Bell franchise was sold. Taco Bell is based in Irvine, California.

As of year-end 2006, Taco Bell was the leader in the U.S. Mexican QSR segment, with a 58 percent market share (Source: The NPD Group, Inc.; NPD Foodworld; CREST) in that segment.



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Taco Bell operates in 14 countries and territories throughout the world. As of year-end 2006, there were 5,608 Taco Bell units in the U.S., and 238 units outside of the U.S. Approximately 23 percent of the U.S. units and 1 percent of the non-U.S. units are operated by the Company.

Taco Bell specializes in Mexican-style food products, including various types of tacos, burritos, gorditas, chalupas, quesadillas, salads, nachos and other related items. Additionally, proprietary entrée items include Grilled Stuff Burritos and Border Bowls. Taco Bell units feature a distinctive bell logo on their signage.

### LJS

The first LJS restaurant opened in 1969 and the first LJS franchise unit opened later the same year. LJS is based in Louisville, Kentucky.

As of year-end 2006, LJS was the leader in the U.S. seafood QSR segment, with a 32 percent market share (Source: The NPD Group, Inc.; NPD Foodworld; CREST) in that segment.

LJS operates in 6 countries and territories throughout the world. As of year-end 2006, there were 1,121 LJS units in the U.S., and 35 units outside the U.S. Approximately 41 percent of the U.S. units and 3 percent of the non-U.S. units are operated by the Company.

LJS features a variety of seafood and chicken items, including meals featuring batter-dipped fish, chicken, shrimp, hushpuppies and portable snack items. LJS units typically feature a distinctive seaside/nautical theme.

### A&W

A&W was founded in Lodi, California by Roy Allen in 1919 and the first A&W franchise unit opened in 1925. A&W is based in Louisville, Kentucky.

A&W operates in 11 countries and territories throughout the world. As of year-end 2006, there were 406 A&W units in the U.S., and 238 units outside the U.S. Approximately 2 percent of the U.S. units are operated by the Company. All non-U.S. units are operated by franchisees or licensees.

A&W serves A&W draft Root Beer and a signature A&W Root Beer float, as well as hot dogs and hamburgers.

### **Restaurant Operations**

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

The Company's restaurant management structure varies by concept and unit size. Generally, each Company restaurant is led by a restaurant general manager ( RGM ), together with one or more assistant managers, depending on the operating complexity and sales volume of the restaurant. In the U.S., the average restaurant has 25 to 30 employees, while internationally this figure can be significantly higher depending on the location and sales volume of the restaurant. Most of the employees work on a part-time basis. We issue detailed manuals, which may then be customized to meet local regulations and customs, covering all aspects of restaurant operations, including food handling and product preparation

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procedures, safety and quality issues, equipment maintenance, facility standards and accounting control procedures. The restaurant management teams are responsible for the day-to-day operation of each unit and for ensuring compliance with operating standards. CHAMPS which stands for Cleanliness, Hospitality, Accuracy, Maintenance, Product Quality and Speed of Service is our proprietary core systemwide program for training, measuring and rewarding employee performance against key customer measures. CHAMPS is intended to align the operating processes of our entire system around one set of standards. RGMs' efforts, including CHAMPS performance measures, are monitored by Area Coaches. Area Coaches typically work with approximately six to twelve restaurants. The Company's restaurants are visited from time to time by various senior operators who help ensure adherence to system standards and mentor restaurant team members.

RGMs attend and complete their respective Concepts' required training programs. These programs consist of initial training, as well as additional continuing development and training programs that may be offered or required from time to time. Initial manager training programs generally last at least six weeks and emphasize leadership, business management, supervisory skills (including training, coaching, and recruiting), product preparation and production, safety, quality control, customer service, labor management, and equipment maintenance.

### Supply and Distribution

The Company is a substantial purchaser of a number of food and paper products, equipment and other restaurant supplies. The principal items purchased include chicken products, cheese, beef and pork products, paper and packaging materials, flour, produce, certain beverages, seafood, cooking oils, pinto beans, seasonings and tomato-based products.

U.S. Division. The Company, along with the representatives of the Company's KFC, Pizza Hut, Taco Bell, LJS and A&W franchisee groups, are members in the Unified FoodService Purchasing Co-op, LLC (the Unified Co-op) which was created for the purpose of purchasing certain restaurant products and equipment in the U.S. The core mission of the Unified Co-op is to provide the lowest possible sustainable store-delivered prices for restaurant products and equipment. This arrangement combines the purchasing power of the Company and franchisee restaurants in the U.S. which the Company believes will further leverage the system's scale to drive cost savings and effectiveness in the purchasing function. The Company also believes that the Unified Co-op has resulted, and should continue to result, in closer alignment of interests and a stronger relationship with its franchisee community.

The Company is committed to conducting its business in an ethical, legal and socially responsible manner. To encourage compliance with all legal requirements and ethical business practices, YUM has a supplier code of conduct for all U.S. suppliers to our business. To ensure the quality and safety of food products, suppliers are required to meet strict quality control standards. Long-term contracts and long-term vendor relationships are used to ensure availability of products. The Company has not experienced any significant continuous shortages of supplies, and alternative sources for most of these products are generally available. Prices paid for these supplies are subject to fluctuation. When prices increase, the Company may be able to pass on such increases to its customers, although there is no assurance this can be done in the future.

Most food products, paper and packaging supplies, and equipment used in the operation of the Company's restaurants are distributed to individual restaurant units by third party distribution companies. Since November 30, 2000, McLane Company, Inc. (McLane) has been the exclusive distributor for Company-operated KFCs, Pizza Huts and Taco Bells in the U.S. and for a substantial number of franchisee and licensee stores. McLane became the distributor when it assumed all distribution responsibilities under an existing agreement between AmeriServe Food Distribution, Inc. (AmeriServe) and the Company (the AmeriServe Agreement). McLane acquired AmeriServe after AmeriServe emerged from Chapter 11 bankruptcy on November 28, 2000. A discussion of the impact of the AmeriServe bankruptcy reorganization process on the Company is contained in Note 4 to the Consolidated Financial Statements. The terms of the AmeriServe agreement with the Company extend through October 31, 2010 and generally prohibit company-operated KFC, Pizza Hut and Taco Bell restaurants from using alternative distributors in the U.S. The Company stores within the LJS and A&W systems are covered under a separate agreement with McLane.

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International and China Divisions. Outside of the U.S. we and our franchisees use decentralized sourcing and distribution systems involving many different global, regional, and local suppliers and distributors. In certain countries, we own all or a portion of the distribution system, including Mainland China where we own the entire distribution system.

### **Trademarks and Patents**

The Company and its Concepts own numerous registered trademarks and service marks. The Company believes that many of these marks, including its Kentucky Fried Chicken®, KFC®, Pizza Hut®, Taco Bell® and Long John Silver's® marks, have significant value and are materially important to its business. The Company's policy is to pursue registration of its important marks whenever feasible and to oppose vigorously any infringement of its marks. The Company also licenses certain A&W trademarks and service marks (the A&W Marks), which are owned by A&W Concentrate Company (formerly A&W Brands, Inc.). A&W Concentrate Company, which is not affiliated with the Company, has granted the Company an exclusive, worldwide (excluding Canada), perpetual, royalty-free license (with the right to sublicense) to use the A&W Marks for restaurant services.

The use of these marks by franchisees and licensees has been authorized in KFC, Pizza Hut, Taco Bell, LJS and A&W franchise and license agreements. Under current law and with proper use, the Company's rights in its marks can generally last indefinitely. The Company also has certain patents on restaurant equipment which, while valuable, are not material to its business.

### **Working Capital**

Information about the Company's working capital is included in MD&A in Part II, Item 7, pages 25 through 52 and the Consolidated Statements of Cash Flows in Part II, Item 8, page 57.

### **Customers**

The Company's business is not dependent upon a single customer or small group of customers.

### **Seasonal Operations**

The Company does not consider its operations to be seasonal to any material degree.

### **Backlog Orders**

Company restaurants have no backlog orders.

**Government Contracts**

No material portion of the Company's business is subject to renegotiation of profits or termination of contracts or subcontracts at the election of the U.S. government.

**Competition**

The retail food industry, in which the Company competes, is made up of supermarkets, supercenters, warehouse stores, convenience stores, coffee shops, snack bars, delicatessens and restaurants (including the QSR segment), and is intensely competitive with respect to food quality, price, service, convenience, location and concept. The industry is often affected by changes in consumer tastes; national, regional or local economic conditions; currency fluctuations; demographic trends; traffic patterns; the type, number and location of competing food retailers and products; and disposable purchasing power. Each of the Concepts compete with international, national and regional restaurant chains as well as locally-owned

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restaurants, not only for customers, but also for management and hourly personnel, suitable real estate sites and qualified franchisees. In 2006, the restaurant business in the U.S. consisted of about 925,000 restaurants representing approximately \$511 billion in annual sales. The Company's Concepts accounted for about 2% of those restaurants and about 3% of those sales. There is currently no way to reasonably estimate the size of the competitive market outside the U.S.

### **Research and Development ( R&D )**

The Company operates R&D facilities in Louisville, Kentucky; Dallas, Texas; and Irvine, California and in several locations outside the U.S., including Shanghai, China. The Company expensed \$33 million, \$33 million and \$26 million in 2006, 2005 and 2004, respectively, for R&D activities. From time to time, independent suppliers also conduct research and development activities for the benefit of the YUM system.

### **Environmental Matters**

The Company is not aware of any federal, state or local environmental laws or regulations that will materially affect its earnings or competitive position, or result in material capital expenditures. However, the Company cannot predict the effect on its operations of possible future environmental legislation or regulations. During 2006, there were no material capital expenditures for environmental control facilities and no such material expenditures are anticipated.

### **Government Regulation**

U.S. Division. The Company and its U.S. Division are subject to various federal, state and local laws affecting its business. Each of the Company's restaurants in the United States must comply with licensing and regulation by a number of governmental authorities, which include health, sanitation, safety and fire agencies in the state or municipality in which the restaurant is located. In addition, the Company must comply with various state laws that regulate the franchisor/franchisee relationship. To date, the Company has not been significantly affected by any difficulty, delay or failure to obtain required licenses or approvals.

A small portion of Pizza Hut's and LJS's sales are attributable to the sale of beer and wine. A license is required in most cases for each site that sells alcoholic beverages (in most cases, on an annual basis) and licenses may be revoked or suspended for cause at any time. Regulations governing the sale of alcoholic beverages relate to many aspects of restaurant operations, including the minimum age of patrons and employees, hours of operation, advertising, wholesale purchasing, inventory control and handling, storage and dispensing of alcoholic beverages.

The Company is also subject to federal and state laws governing such matters as employment and pay practices, overtime, tip credits and working conditions. The bulk of the Company's employees are paid on an hourly basis at rates related to the federal and state minimum wages.

The Company is also subject to federal and state child labor laws which, among other things, prohibit the use of certain hazardous equipment by employees younger than 18 years of age. The Company has not to date been materially adversely affected by such laws.

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The Company continues to monitor its facilities for compliance with the Americans with Disabilities Act ( ADA ) in order to conform to its requirements. Under the ADA, the Company could be required to expend funds to modify its restaurants to better provide service to, or make reasonable accommodation for the employment of, disabled persons. We believe that expenditures, if required, would not have a material adverse effect on the Company s results of operations or cash flows.

*International and China Divisions.* The Company s restaurants outside the U.S. are subject to national and local laws and regulations which are similar to those affecting the Company s U.S. restaurants, including laws and regulations

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concerning labor, health, sanitation and safety. The restaurants outside the U.S. are also subject to tariffs and regulations on imported commodities and equipment and laws regulating foreign investment. International compliance with environmental requirements has not had a material adverse effect on the Company's results of operations, capital expenditures or competitive position.

### Employees

As of year-end 2006, the Company employed over 280,000 persons, approximately 81 percent of whom were part-time. Approximately 39 percent of the Company's employees are employed in the U.S. The Company believes that it provides working conditions and compensation that compare favorably with those of its principal competitors. Most Company employees are paid on an hourly basis. Some of the Company's non-U.S. employees are subject to labor council relationships that vary due to the diverse cultures in which the Company operates. The Company considers its employee relations to be good.

### (d) Financial Information about Geographic Areas

Financial information about our significant geographic areas (U.S., International Division and China Division) is incorporated herein by reference from Selected Financial Data in Part II, Item 6, page 23; Management's Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) in Part II, Item 7, pages 25 through 52; and in the related Consolidated Financial Statements and footnotes in Part II, Item 8, pages 53 through 101.

### (e) Available Information

The Company makes available through the Investor Relations section of its internet website at [www.yum.com](http://www.yum.com) its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after electronically filing such material with the Securities and Exchange Commission. Our Corporate Governance Principles and our Code of Conduct are also located within this section of the website. The reference to the Company's website address does not constitute incorporation by reference of the information contained on the website and should not be considered part of this document. These documents, as well as our SEC filings, are available in print to any shareholder who requests a copy from our Investor Relations Department.

### Item 1A. Risk Factors.

We face a variety of risks that are inherent in our business and our industry, including operational, legal, regulatory and product risks. The following are some of the more significant factors that could affect our business and our results of operations. Other factors may exist that the Company cannot anticipate or that the Company does not consider to be significant based on information that is currently available.

*Health concerns arising from outbreaks of Avian Flu may have an adverse effect on our business.*

Asian and European countries have experienced outbreaks of Avian Flu, and some commentators have hypothesized that further outbreaks could occur and reach pandemic levels. While fully-cooked chicken has been determined to be safe for consumption, and while the Company has taken and continues to take measures to anticipate and minimize the effect of these outbreaks on our business, any further outbreaks could adversely affect the price and availability of poultry and cause customers to shift their preferences. In addition, outbreaks on a widespread basis



could also affect our ability to attract and retain employees.

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*Food safety and food-borne illness concerns may have an adverse effect on our business.*

The Company considers food safety a top priority and dedicates substantial resources to ensure that our customers enjoy safe, quality food products. However, food-borne illnesses (such as E. coli, hepatitis A, trichinosis or salmonella) and food safety issues have occurred in the past (see Item 3, Legal Proceedings, in this Form 10-K for a discussion of litigation arising from an E. coli outbreak allegedly linked to a number of Taco Bell restaurants in the Northeast U.S. during November/December 2006), and could occur in the future. If such instances of food-borne illness or other food safety issues were to occur, whether at our restaurants or those of our competitors, negative publicity could result which could adversely affect sales and profitability. If our customers become ill from food-borne illnesses, we could also be forced to temporarily close some restaurants. Additionally, the occurrence of food-borne illnesses or food safety issues could adversely affect the price and availability of affected ingredients. Finally, like other companies in the restaurant industry, some of our products may contain genetically engineered food products; increased regulation of and opposition to genetically engineered food products have on occasion and may in the future force us to use alternative sources at increased costs.

*Our foreign operations subject us to risks that could negatively affect our business.*

Our restaurants are operated in numerous countries and territories and our foreign business is significant. We intend to further expand our international operations over the next several years. As a result, our business and operations are subject to the risk of changes in economic conditions, tax systems, consumer preferences, social conditions and political conditions inherent in foreign operations, including changes in the laws and policies that govern foreign investment in countries where our restaurants are operated, as well as changes in United States laws and regulations relating to foreign trade and investment. In addition, our results of operations and the value of our foreign assets are affected by fluctuations in foreign currency exchange rates, which may favorably or adversely affect reported earnings. There can be no assurance as to the future effect of any such changes on our results of operations, financial condition or cash flows.

Mainland China is one of our fastest developing markets. Any significant or prolonged deterioration in U.S.-China relations could adversely affect our China business. Our growing investments in our China operations will increase our exposure in this market. Many of the risks and uncertainties of doing business in China are solely within the control of the Chinese government. China's government regulates the scope of our foreign investments and business conducted within China. Although management believes it has structured our China operations to comply with local laws, there are uncertainties regarding the interpretation and application of laws and regulations and the enforceability of intellectual property and contract rights in China. If we were unable to enforce our intellectual property and contract rights in China, our business would be adversely impacted.

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

While the Company takes measures to anticipate and react to changes in food and supply costs, any increase in the prices of the ingredients most critical to our menu, such as beef, chicken, cheese and produce, among others, could adversely affect our operating results. Although we try to manage the impact that these fluctuations have on our operating results, we remain susceptible to increases in food costs as a result of factors beyond our control, such as general economic conditions, seasonal fluctuations, weather conditions, demand, food safety concerns, product recalls, labor disputes and government regulations. In addition to food, we purchase electricity, oil and natural gas needed to operate our restaurants, and suppliers purchase gasoline needed to transport food and supplies to us. Any significant increase in energy costs could adversely affect our business through higher rates and the imposition of fuel surcharges by our suppliers. Because we provide moderately priced food, we may choose not to, or be unable to, pass along commodity price increases to our customers. Additionally, significant increases in gasoline prices could result in a decrease of customer traffic at our restaurants. We rely on third party distribution companies to deliver food and supplies to our stores. Interruption of distribution services due to financial distress or other issues could impact our operations. Our operating costs also include premiums that we pay for our insurance (including workers' compensation, general liability, property and health) which



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may increase over time, thereby further increasing our costs. Finally, our industry is susceptible to natural disasters which could result in restaurant closures and business disruptions.

*Our operating results are closely tied to the success of our Concepts franchisees.*

As a result of our franchising programs, our operating results are dependent upon the sales volumes and viability of our franchisees. Any significant inability of our franchisees to operate successfully could adversely affect our operating results. Franchisees may not have access to the financial or management resources that they need to open or continue operating the restaurants contemplated by their franchise agreements with us, or be able to find suitable sites on which to develop them. In addition, franchisees may not be able to negotiate acceptable lease or purchase terms for the sites, obtain the necessary permits and government approvals or meet construction schedules. Our franchisees generally depend upon financing from banks and other financial institutions in order to construct and open new restaurants. In some instances, financing has been difficult to obtain for some operators. Any of these problems could slow our planned growth.

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

As a restaurant industry participant, we are susceptible to claims filed by customers alleging that we are responsible for an illness or injury they suffered at or after a visit to our restaurants. Regardless of whether any claims against us are valid, or whether we are ultimately held liable, such litigation may be expensive to defend and may divert time and money away from our operations and hurt our performance. A judgment for significant monetary damages in excess of any insurance coverage could adversely affect our financial condition or results of operations. Any adverse publicity resulting from these allegations may also adversely affect our reputation, which in turn could adversely affect our results.

In addition, the restaurant industry has been subject to claims that relate to the nutritional content of food products, as well as claims that the menus and practices of restaurant chains have led to the obesity of some guests. We may also be subject to this type of claim in the future and, even if we are not, publicity about these matters (particularly directed at the quick service and fast-casual segments of the industry) may harm our reputation and adversely affect our results.

*Changes in governmental regulations may adversely affect our business operations.*

We and our franchisees are subject to various federal, state and local regulations. Each of our restaurants is subject to state and local licensing and regulation by health, sanitation, food and workplace safety and other agencies. Requirements of local authorities with respect to zoning, land use, licensing, permitting and environmental factors could delay or prevent development of new restaurants in particular locations.

We are subject to the Americans with Disabilities Act and similar state laws that give civil rights protections to individuals with disabilities in the context of employment, public accommodations and other areas. The expenses associated with any facilities modifications required by these laws could be material. Our operations are also subject to the U.S. Fair Labor Standards Act, which governs such matters as minimum wages, overtime and other working conditions, family leave mandates and a variety of similar state laws that govern these and other employment law matters. The compliance costs associated with these laws and evolving regulations could be substantial.

*We may not attain our target development goals.*

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We are pursuing a disciplined growth strategy, which, to be successful, will depend in large part on our ability and the ability of our franchisees to upgrade existing restaurants and open new restaurants, and to operate these restaurants on a profitable basis. We cannot guarantee that we, or our franchisees, will be able to achieve our expansion goals or that new, upgraded or converted restaurants will be operated profitably. Further, there is no assurance that any restaurant we open or convert will obtain operating results similar to those of our existing restaurants. The success of our planned expansion, including our multibranding initiatives, will depend upon numerous factors, many of which are beyond our control.

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*The restaurant industry in which we operate is highly competitive.*

The restaurant industry in which we operate is highly competitive with respect to price and quality of food products, new product development, advertising levels and promotional initiatives, customer service, reputation, restaurant location, and attractiveness and maintenance of properties. If our restaurants and franchised restaurants are unable to compete successfully with other restaurants in new and existing markets, our business could be adversely affected. In the restaurant industry, labor is a primary operating cost component. Competition for qualified employees could also require us to pay higher wages to attract a sufficient number of employees. In addition, our success depends to a significant extent on numerous factors affecting discretionary consumer spending, including economic conditions, disposable consumer income and consumer confidence. Adverse changes in these factors could reduce guest traffic or impose practical limits on pricing, either of which could harm our results of operations.

### **Item 1B. Unresolved Staff Comments.**

The Company has received no written comments regarding its periodic or current reports from the staff of the Securities and Exchange Commission that were issued 180 days or more preceding the end of its 2006 fiscal year and that remain unresolved.

### **Item 2. Properties.**

As of year-end 2006, the Company owned more than 1,800 units and leased land, building or both in more than 5,800 units worldwide. These units are further detailed as follows:

The Company owned more than 1,500 units and leased land, building or both in more than 2,600 units in the U.S.  
The International Division owned more than 200 units and leased land, building or both in more than 1,400 units.  
The China Division leased land, building or both in more than 1,700 units.

Company restaurants in the U.S. which are not owned are generally leased for initial terms of 15 or 20 years and generally have renewal options; however, Pizza Hut delivery/carryout units in the U.S. generally are leased for significantly shorter initial terms with short renewal options. Company restaurants in the International Division which are not owned have initial lease terms and renewal options that vary by country. Company restaurants in the China Division are generally leased for initial terms of 10 to 15 years and generally do not have renewal options. The Company generally does not lease or sub-lease units that it owns or leases to franchisees.

Pizza Hut and YRI lease their corporate headquarters and a research facility in Dallas, Texas. Taco Bell leases its corporate headquarters and research facility in Irvine, California. KFC owns its and LJS's, A&W's and YUM's corporate headquarters and a research facility in Louisville, Kentucky. In addition, YUM leases office facilities for certain support groups in Louisville, Kentucky. The China Division leases their corporate headquarters and research facilities in Shanghai, China. Additional information about the Company's properties is included in the Consolidated Financial Statements and footnotes in Part II, Item 8, pages 53 through 101.

The Company believes that its properties are generally in good operating condition and are suitable for the purposes for which they are being used.

### **Item 3. Legal Proceedings.**

The Company is subject to various claims and contingencies related to lawsuits, real estate, environmental and other matters arising in the normal course of business. The following is a brief description of the more significant of these categories of lawsuits and other matters. Except as stated below, the Company believes that the ultimate liability, if any, in excess of amounts already provided for these matters in the Consolidated Financial Statements, is not likely to have a material adverse effect on the Company's annual results of operations, financial condition or cash flows.

## Franchising

A substantial number of the restaurants of each of the Concepts are franchised to independent businesses operating under arrangements with the Concepts. In the course of the franchise relationship, occasional disputes arise between the Company and its Concepts franchisees relating to a broad range of subjects, including, without limitation, quality, service, and cleanliness issues, contentions regarding grants, transfers or terminations of franchises, territorial disputes and delinquent payments.

## Suppliers

The Company, through approved distributors, purchases food, paper, equipment and other restaurant supplies from numerous independent suppliers throughout the world. These suppliers are required to meet and maintain compliance with the Company's standards and specifications. On occasion, disputes arise between the Company and its suppliers on a number of issues, including, but not limited to, compliance with product specifications and terms of procurement and service requirements.

## Employees

At any given time, the Company or its affiliates employ hundreds of thousands of persons, primarily in its restaurants. In addition, each year thousands of persons seek employment with the Company and its restaurants. From time to time, disputes arise regarding employee hiring, compensation, termination and promotion practices.

Like other retail employers, the Company has been faced in a few states with allegations of purported class-wide wage and hour violations.

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

In November 2005, the parties agreed to a settlement, which we provided for in our 2005 Consolidated Financial Statements. The Court granted preliminary approval of the settlement on June 28, 2006. Final approval of the settlement was granted on October 5, 2006, and payment was made during the quarter ended December 30, 2006.

On November 26, 2001, a lawsuit against Long John Silver's, Inc. ( LJS ) styled Kevin Johnson, on behalf of himself and all others similarly situated v. Long John Silver's, Inc. ( Johnson ) was filed in the United States District Court for the Middle District of Tennessee, Nashville Division. Johnson's suit alleged that LJS's former Security/Restitution for Losses policy (the Policy ) provided for deductions from RGMs' and



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Assistant Restaurant General Managers ( ARGMs ) salaries that violate the salary basis test for exempt personnel under regulations issued pursuant to the FLSA. Johnson alleged that all RGMs and ARGMs who were employed by LJS for the three year period prior to the lawsuit i.e., since November 26, 1998 should be treated as the equivalent of hourly employees and thus were eligible under the FLSA for overtime for any hours worked over 40 during all weeks in the recovery period. In addition, Johnson claimed that the potential members of the class are entitled to certain liquidated damages and attorneys fees under the FLSA.

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LJS believed that Johnson's claims, as well as the claims of all other similarly situated parties, should be resolved in individual arbitrations pursuant to LJS's Dispute Resolution Program (DRP), and that a collective action to resolve these claims in court was clearly inappropriate under the current state of the law. Accordingly, LJS moved to compel arbitration in the Johnson case. LJS and Johnson also agreed to stay the action effective December 17, 2001, pending mediation, and entered into a tolling agreement for that purpose. After mediation did not resolve the case, and after limited discovery and a hearing, the Court determined on June 7, 2004, that Johnson's individual claims should be referred to arbitration. Johnson appealed, and the decision of the District Court was affirmed in all respects by the United States Court of Appeals for the Sixth Circuit on July 5, 2005.

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

Arbitrations under LJS's DRP, including the Cole Arbitration, are governed by the rules of the AAA. In October 2003, the AAA adopted its Supplementary Rules for Class Arbitrations (AAA Class Rules). The AAA appointed an arbitrator for the Cole Arbitration. On June 15, 2004, the arbitrator issued a clause construction award, ruling that the DRP does not preclude class arbitration. LJS moved to vacate the clause construction award in the United States District Court for the District of South Carolina. On September 15, 2005, the federal court in South Carolina ruled that it did not have jurisdiction to hear LJS's motion to vacate. LJS appealed the U.S. District Court's ruling to the United States Court of Appeals for the Fourth Circuit.

On January 5, 2007, LJS moved to dismiss the clause construction award appeal and that motion was granted by the Fourth Circuit on January 10, 2007. LJS had also filed a motion to vacate the clause construction award in South Carolina state court, which was stayed pending a decision by the Fourth Circuit. LJS has agreed to dismiss the motion to vacate the clause construction award and has also agreed not to oppose claimants cross-motion to confirm that award by the South Carolina court. While judicial review of the clause construction award was pending in the U.S. District Court, the arbitrator permitted claimants to move for a class determination award, which was opposed by LJS. On September 19, 2005, the arbitrator issued a class determination award, certifying a class of LJS's RGMs and ARGMs employed between December 17, 1998, and August 22, 2004, on FLSA claims, to proceed on an opt-out basis under the AAA Class Rules. That class determination award was upheld on appeal by the United States District Court for the District of South Carolina on January 20, 2006, and the arbitrator declined to reconsider the award. LJS has appealed the ruling of the U.S. District Court to the United States Court of Appeals for the Fourth Circuit. LJS has also filed a motion to vacate the class determination award in South Carolina state court, which has been stayed by the South Carolina court pending a decision by the Fourth Circuit in the class determination award appeal. Oral argument in the Fourth Circuit was heard on January 31, 2007.

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

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On September 2, 2005, a collective action lawsuit against the Company and KFC Corporation, originally styled Parler v. Yum Brands, Inc., d/b/a KFC, and KFC Corporation, was filed in the United States District Court for the District of Minnesota. Plaintiff alleges that he and other current and former KFC Assistant Unit Managers ( AUMs ) were improperly classified as exempt employees under the FLSA. Plaintiff seeks overtime wages and liquidated damages. On January 17, 2006, the District Court dismissed the claims against the Company with prejudice, leaving KFC Corporation as the sole defendant. Notice was mailed to current and former AUMs advising them of the litigation and providing an opportunity to join the case if they choose to do so. Plaintiff amended the complaint on September 8, 2006, to add related state law claims on behalf of a putative class of KFC AUMs employed in Illinois, Minnesota, Nevada, New Jersey, New York, Ohio, and Pennsylvania. On October 24, 2006, plaintiff moved to decertify the conditionally certified FLSA action, and KFC Corporation did not oppose the motion. In January, 2007 the magistrate recommended that the motion for decertification be granted.

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

On August 4, 2006, a putative class action lawsuit against Taco Bell Corp. styled Rajeev Chhibber vs. Taco Bell Corp. was filed in Orange County Superior Court. On August 7, 2006, another putative class action lawsuit styled Marina Puchalski v. Taco Bell Corp. was filed in San Diego County Superior Court. Both lawsuits were filed by a Taco Bell RGM purporting to represent all current and former RGMs who worked at corporate-owned restaurants in California from August 2002 to the present. The lawsuits allege violations of California's wage and hour laws involving unpaid overtime and meal and rest period violations and seek unspecified amounts in damages and penalties. As of September 7, 2006, the Orange County case was voluntarily dismissed by the plaintiff and both cases have been consolidated in San Diego County.

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

### Customers

The Company's restaurants serve a large and diverse cross-section of the public and in the course of serving so many people, disputes arise regarding products, service, accidents and other matters typical of large restaurant systems such as those of the Company.

On December 17, 2002, Taco Bell was named as the defendant in a class action lawsuit filed in the United States District Court for the Northern District of California styled Moeller, et al. v. Taco Bell Corp. On August 4, 2003, plaintiffs filed an amended complaint that alleges, among other things, that Taco Bell has discriminated against the class of people who use wheelchairs or scooters for mobility by failing to make its approximately 220 company-owned restaurants in California (the California Restaurants ) accessible to the class. Plaintiffs contend that queue rails and other architectural and structural elements of the Taco Bell restaurants relating to the path of travel and use of the facilities by persons with mobility-related disabilities (including parking spaces, ramps, counters, restroom facilities and seating) do not comply with the U.S. Americans with Disabilities Act (the ADA ), the Unruh Civil Rights Act (the Unruh Act ), and the California Disabled Persons Act (the CDPA ). Plaintiffs have requested: (a) an injunction from the District Court ordering Taco Bell to comply with the ADA and its implementing regulations; (b) that the District Court declare Taco Bell in violation of the ADA, the Unruh Act, and the CDPA; and (c) monetary relief under the Unruh Act or CDPA. Plaintiffs, on behalf of the class, are seeking the minimum statutory damages per offense of either \$4,000 under the Unruh Act or \$2,000 under the CDPA for each aggrieved member of the class. Plaintiffs contend that there may be in excess of 100,000 individuals in the class. For themselves, the four named plaintiffs have claimed aggregate minimum statutory

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damages of no less than \$16,000, but are expected to claim greater amounts based on the number of Taco Bell outlets they visited at which they claim to have suffered discrimination.

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

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

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

### Intellectual Property

The Company has registered trademarks and service marks, many of which are of material importance to the Company's business. From time to time, the Company may become involved in litigation to defend and protect its use of its registered marks.

### Other Litigation

According to the Centers for Disease Control ( CDC ), there was an outbreak of illness associated with a particular strain of E. coli 0157:H7 in the northeast United States during November and December 2006. Also according to the CDC, the outbreak from this particular strain was associated with eating at Taco Bell restaurants in Pennsylvania, New Jersey, New York and Delaware. The CDC concluded that the outbreak ended on or about December 6, 2006. The CDC has confirmed 71 cases of persons who became ill from this particular strain of E. coli 0157:H7 in the above-mentioned area during the above time frame, and that no deaths have been reported.

On December 6, 2006, a lawsuit styled Tyler Vormittag, et. al. v. Taco Bell Corp. Taco Bell of America, Inc. and Yum! Brands, Inc. was filed in the Supreme Court of the State of New York, County of Suffolk. Mr. Vormittag, a minor, alleges he became ill after consuming food, which was allegedly contaminated with E. coli 0157:H7, purchased from a Taco Bell restaurant in Riverhead, New York. Subsequently, ten other cases have been filed naming the Company, Taco Bell Corp. and/or Taco Bell of America and alleging similar facts on behalf of other customers.

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According to the allegations common to all the Complaints, each Taco Bell customer became ill after ingesting contaminated food in late November or early December 2006 from Taco Bell restaurants located in the northeast states implicated in the outbreak. As these lawsuits are new, no discovery by any party has been undertaken. However, the Company believes, based on the allegations, that the stores identified in at least five of the Complaints are in fact not owned by the Company or any of its subsidiaries. As such, the Company believes that at a minimum it is not liable for

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any losses at these stores. We have provided for the estimated costs of this litigation, based on a projection of potential claims and their amounts as well as the results of settlement negotiations in similar matters. But in view of the inherent uncertainties of litigation, there can be no assurance that the outcome of the litigation will not result in losses in excess of those currently provided for in our Consolidated Financial Statements.

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

No matters were submitted to a vote of shareholders during the fourth quarter of 2006.

**Executive Officers of the Registrant**

The executive officers of the Company as of February 23, 2007, and their ages and current positions as of that date are as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
David C. Novak	54	Chairman of the Board, Chief Executive Officer and President
Richard T. Carucci	49	Chief Financial Officer
Peter R. Hearl	55	Chief Operating and Development Officer
Christian L. Campbell	56	Senior Vice President, General Counsel, Secretary and Chief Franchise Policy Officer
Jonathan D. Blum	48	Senior Vice President Public Affairs
Anne P. Byerlein	48	Chief People Officer
Ted F. Knopf	55	Senior Vice President Finance and Corporate Controller
Emil J. Brolick	59	President of U.S. Brand Building
Gregg R. Dedrick	47	President and Chief Concept Officer, KFC
Scott O. Bergren	60	President and Chief Concept Officer, Pizza Hut
Greg Creed	49	President and Chief Concept Officer, Taco Bell
Graham D. Allan	51	President, YUM! Restaurants International
Samuel Su	54	President, YUM! Restaurants China

**David C. Novak** is Chairman of the Board, Chief Executive Officer and President of YUM. He has served in this position since January 2001. From December 1999 to January 2001, Mr. Novak served as Vice Chairman of the Board, Chief Executive Officer and President of YUM. From October 1997 to December 1999, he served as Vice Chairman and President of YUM. Mr. Novak previously served as Group President and Chief Executive Officer, KFC and Pizza Hut from August 1996 to July 1997.

**Richard T. Carucci** is Chief Financial Officer of YUM. He has served in this position since March 2005. From October 2004 to February 2005, he served as Senior Vice President, Finance and Chief Financial Officer Designate of YUM. From May 2003 to October 2004, he served as Executive Vice President and Chief Development Officer of YRI. From November 2002 to May 2003, he served as Senior Vice President for YRI and also assisted Pizza Hut in asset strategy development. From November 1999 to July 2002, he was Chief Financial Officer of YRI.

**Peter R. Hearl** is Chief Operating and Development Officer of YUM. He has served in this position since December 2006. From December 2002 to November 2006, he served as President and Chief Concept Officer of Pizza Hut. From January 2002 to November 2002, he was Chief People Officer and Executive Vice President of YUM.

**Christian L. Campbell** is Senior Vice President, General Counsel, Secretary and Chief Franchise Policy Officer of YUM. He has served as Senior Vice President, General Counsel and Secretary since September 1997. In January 2003, his title and job responsibilities were expanded to include Chief Franchise Policy Officer.

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**Jonathan D. Blum** is Senior Vice President - Public Affairs for YUM. He has served in this position since July 1997.

**Anne P. Byerlein** is Chief People Officer of YUM. She has served in this position since December 2002. From October 1997 to December 2002, she was Vice President of Human Resources of YUM. From October 2000 to December 2002, she also served as KFC's Chief People Officer.



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**Ted F. Knopf** is Senior Vice President Finance and Corporate Controller of YUM. He has served in this position since April 2005. From September 2001 to April 2005, Mr. Knopf served as Vice President of Corporate Planning and Strategy of YUM.

**Emil J. Brolick** is President of U.S. Brand Building. He has served in this position since December 2006. Prior to this position, he served as President and Chief Concept Officer of Taco Bell, a position he held from July 2000 to November 2006. Prior to joining Taco Bell, Mr. Brolick served as Senior Vice President of New Product Marketing, Research & Strategic Planning for Wendy's International, Inc. from August 1995 to July 2000.

**Gregg R. Dedrick** is President and Chief Concept Officer of KFC. He has served in this position since September 2003. From January 2002 to September 2003, Mr. Dedrick acted as a Strategic Advisor to YUM while serving as Chief Administrative Officer of his church, which is one of the ten largest churches in the United States. From July 1997 to January 2002, he served as Chief People Officer of YUM and Executive Vice President of People and Shared Services.

**Scott O. Bergren** is President and Chief Concept Officer of Pizza Hut. He has served in this position since November 2006. Prior to this position, he served as Chief Marketing officer of KFC and YUM from January 2003 to November 2006. From September 2002 until July 2003, he was the Executive Vice President, Marketing and Chief Concept Officer for Yum Restaurants International, Inc. From April 2002 until September 2002, he was Senior Vice President New Concepts for Yum Restaurants International, Inc. From June 1995 until 2002, he was Chief Executive Officer of Chevy's Mexican Restaurants, Inc.

**Greg Creed** is President and Chief Concept Officer of Taco Bell. He has served in this position since December 2006. Prior to this position, Mr. Creed served as Chief Operating Officer of YUM from December 2005 to November 2006. Mr. Creed served as Chief Marketing Officer of Taco Bell from July 2001 to October 2005.

**Graham D. Allan** is the President of YRI. He has served in this position since November 2003. Immediately prior to this position he served as Executive Vice President of YRI. From December 2000 to May 2003, Mr. Allan was the Managing Director of YRI.

**Samuel Su** is the President of YUM! Restaurants China. He has served in this position since 1997. Prior to this, he was the Vice President of North Asia for both KFC and Pizza Hut. Mr. Su started his career with YUM in 1989 as KFC International's Director of Marketing for the North Pacific area.

Executive officers are elected by and serve at the discretion of the Board of Directors.

**PART II****Item 5. Market for the Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

The Company's common stock trades under the symbol YUM and is listed on the New York Stock Exchange ( NYSE ). The following sets forth the high and low NYSE composite closing sale prices by quarter for the Company's common stock and dividends per common share.

2006			Dividends	Dividends
Quarter	High	Low	Declared	Paid
First	\$51.17	\$46.75	\$0.115	\$0.115
Second	53.67	47.66	0.15	0.115
Third	51.91	44.93		0.15
Fourth	63.47	51.18	0.60	0.15

2005			Dividends	Dividends
Quarter	High	Low	Declared	Paid
First	\$51.65	\$45.12	\$0.10	\$0.10
Second	53.19	46.96	0.115	0.10
Third	53.32	46.86		0.115
Fourth	52.17	46.70	0.23	0.115

In 2005, the Company declared one cash dividend of \$0.10 per share of common stock and three cash dividends of \$0.115 per share of common stock. In 2006, the Company declared one cash dividend of \$0.115 per share of common stock, three cash dividends of \$0.15 per share of common stock and one cash dividend of \$0.30 per share of common stock. A dividend of \$0.15 per share of common stock and the dividend of \$0.30 per share of common stock declared in 2006 had distribution dates of February 2, 2007 and March 30, 2007, respectively. The increased quarterly dividend payable on March 30, 2007 is expected to double our dividend yield to approximately 2%.

As of February 23, 2007, there were approximately 90,521 registered holders of record of the Company's common stock.

The Company had no sales of unregistered securities during 2006, 2005 or 2004.

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### Issuer Purchases of Equity Securities

The following table provides information as of December 30, 2006 with respect to shares of Common Stock repurchased by the Company during the quarter then ended:

Fiscal Periods	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or programs
Period 10 9/10/06 10/7/06	531,800	\$52.30	531,800	\$575,071,536
Period 11 10/8/06 11/4/06	228,500	\$58.52	228,500	\$561,698,667
Period 12 11/5/06 12/2/06	49,200	\$59.56	49,200	\$558,768,414
Period 13 12/3/06 12/30/06	1,522,350	\$59.04	1,522,350	\$468,891,948
Total	2,331,850	\$57.46	2,331,850	\$468,891,948

In March 2006, our Board of Directors authorized share repurchases, through March 2007, of up to \$500 million (excluding applicable transaction fees) of our outstanding Common Stock. For the quarter ended December 30, 2006, approximately 1.8 million shares were repurchased under this authorization. This authorization was completed during the quarter.

In September 2006, our Board of Directors authorized share repurchases, through September 2007, of up to \$500 million (excluding applicable transaction fees) of our outstanding Common Stock. For the quarter ended December 30, 2006, approximately 0.5 million shares were repurchased under this authorization.

**Stock Performance Graph**

This graph compares the cumulative total return of our common stock to the cumulative total return of the S&P 500 Stock Index and the S&P 500 Consumer Discretionary Sector, a peer group that includes YUM, for the period from December 28, 2001 to December 29, 2006, the last trading day of our 2006 fiscal year. The graph assumes that the value of the investment in our common stock and each index was \$100 at December 28, 2001 and that all dividends were reinvested.

YUM	\$ 100	\$ 98	\$ 137	\$ 189	\$ 193	\$ 245
S&P 500	\$ 100	\$ 75	\$ 94	\$ 104	\$ 107	\$ 122
S&P Consumer Discretionary	\$ 100	\$ 73	\$ 100	\$ 112	\$ 106	\$ 124

**Item 6. Selected Financial Data.****Selected Financial Data****YUM! Brands, Inc. and Subsidiaries**

(in millions, except per share and unit amounts)

	Fiscal Year				
	2006	2005	2004	2003	2002
<b>Summary of Operations</b>					
Revenues					
Company sales	\$ 8,365	\$ 8,225	\$ 7,992	\$ 7,441	\$ 6,891
Franchise and license fees	1,196	1,124	1,019	939	866
Total	9,561	9,349	9,011	8,380	7,757
Closures and impairment expenses <sup>(a)</sup>	(59)	(62)	(38)	(40)	(51)
Refranchising gain (loss) <sup>(a)</sup>	24	43	12	4	19
Wrench litigation income (expense) <sup>(b)</sup>		2	14	(42)	
AmeriServe and other (charges) credits <sup>(c)</sup>	1	2	16	26	27
Operating profit	1,262	1,153	1,155	1,059	1,030
Interest expense, net	154	127	129	173	172
Income before income taxes and cumulative effect of accounting change	1,108	1,026	1,026	886	858
Income before cumulative effect of accounting change	824	762	740	618	583
Cumulative effect of accounting change, net of tax <sup>(d)</sup>				(1)	
Net income	824	762	740	617	583
Basic earnings per common share	3.02	2.66	2.54	2.10	1.97
Diluted earnings per common share	2.92	2.55	2.42	2.02	1.88
<b>Cash Flow Data</b>					
Provided by operating activities	\$ 1,302	\$ 1,238	\$ 1,186	\$ 1,099	\$ 1,112
Capital spending, excluding acquisitions	614	609	645	663	760
Proceeds from refranchising of restaurants	257	145	140	92	81
Repurchase shares of common stock	983	1,056	569	278	228
Dividends paid on common shares	144	123	58		
<b>Balance Sheet</b>					
Total assets	\$ 6,353	\$ 5,797	\$ 5,696	\$ 5,620	\$ 5,400
Long-term debt	2,045	1,649	1,731	2,056	2,299
Total debt	2,272	1,860	1,742	2,066	2,445
<b>Other Data</b>					
Number of stores at year end					
Company	7,736	7,587	7,743	7,854	7,526
Unconsolidated Affiliates	1,206	1,648	1,662	1,512	2,148
Franchisees	23,516	22,666	21,858	21,471	20,724
Licensees	2,137	2,376	2,345	2,362	2,526
System	34,595	34,277	33,608	33,199	32,924
U.S. Company blended same store sales growth <sup>(e)</sup>					
		4%	3%		2%
International Division system sales growth <sup>(f)</sup>					
Reported	7%	9%	14%	13%	6%
Local currency <sup>(g)</sup>	7%	6%	6%	5%	7%
China Division system sales growth <sup>(f)</sup>					
Reported	26%	13%	23%	23%	25%
Local currency <sup>(g)</sup>	23%	11%	23%	23%	25%
Shares outstanding at year end	265	278	290	292	294

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Cash dividends declared per common share	\$ 0.865	\$ 0.445	\$ 0.30		
Market price per share at year end	\$ 58.80	\$ 46.88	\$ 46.27	\$ 33.64	\$ 24.12

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Fiscal years 2006, 2004, 2003 and 2002 include 52 weeks and fiscal year 2005 includes 53 weeks.

Fiscal years 2006 and 2005 include the impact of the adoption of Statement of Financial Accounting Standards ( SFAS ) No. 123R (Revised 2004), Share Based Payment, ( SFAS 123R ). This resulted in a \$39 million and \$38 million decrease in net income, or a decrease of \$0.14 and \$0.13 to both basic and diluted earnings per share for 2006 and 2005, respectively. If SFAS 123R had been effective for prior years presented, reported basic and diluted earnings per share would have decreased \$0.12 and \$0.12, \$0.12 and \$0.12, and \$0.14 and \$0.13 per share for 2004, 2003 and 2002, respectively, consistent with previously disclosed pro-forma information. See Note 2 to the Consolidated Financial Statements.

From May 7, 2002, results include Long John Silver s ( LJS ) and A&W All-American Food Restaurants ( A&W ), which were added when we acquired Yorkshire Global Restaurants, Inc.

The selected financial data should be read in conjunction with the Consolidated Financial Statements and the Notes thereto.

- (a) See Note 4 to the Consolidated Financial Statements for a description of Closures and Impairment Expenses and Refranchising Gain (Loss) in 2006, 2005 and 2004.
- (b) See Note 4 to the Consolidated Financial Statements for a description of Wrench litigation in 2006, 2005 and 2004.
- (c) See Note 4 to the Consolidated Financial Statements for a description of AmeriServe and other (charges) credits in 2006, 2005 and 2004.
- (d) Fiscal year 2003 includes the impact of the adoption of SFAS No. 143, Accounting for Asset Retirement Obligations, which addresses the financial accounting and reporting for legal obligations associated with the retirement of long-lived assets and the associated asset retirement costs.
- (e) U.S. Company blended same-store sales growth includes the results of Company owned KFC, Pizza Hut and Taco Bell restaurants that have been open one year or more. LJS and A&W are not included.
- (f) International Division and China Division system sales growth includes the results of all restaurants regardless of ownership, including Company owned, franchise, unconsolidated affiliate and license restaurants. Sales of franchise, unconsolidated affiliate and license restaurants generate franchise and license fees for the Company (typically at a rate of 4% to 6% of sales). Franchise, unconsolidated affiliate and license restaurant sales are not included in Company sales we present on the Consolidated Statements of Income; however, the fees are included in the Company s revenues. We believe system sales growth is useful to investors as a significant indicator of the overall strength of our business as it incorporates all our revenue drivers, Company and franchise same store sales as well as net unit development. Additionally, as previously noted, we began reporting information for our international business in two separate operating segments (the International Division and the China Division) in 2005 as a result of changes in our management structure. Segment information for periods prior to 2005 has been restated to reflect this reporting.
- (g) Local currency represents the percentage change excluding the impact of foreign currency translation. These amounts are derived by translating current year results at prior year average exchange rates. We believe the elimination of the foreign currency translation impact provides better year-to-year comparability without the distortion of foreign currency fluctuations.





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

**Introduction and Overview**

Description of Business

YUM! Brands, Inc. ( "YUM" or the "Company" ) is the world's largest restaurant company in terms of system restaurants with over 34,000 restaurants in more than 100 countries and territories operating under the KFC, Pizza Hut, Taco Bell, Long John Silver's or A&W All-American Food Restaurants brands. Four of the Company's restaurant brands — KFC, Pizza Hut, Taco Bell and Long John Silver's — are the global leaders in the chicken, pizza, Mexican-style food and quick-service seafood categories, respectively. Of the over 34,000 restaurants, 22% are operated by the Company, 72% are operated by franchisees and unconsolidated affiliates and 6% are operated by licensees.

YUM's business consists of three reporting segments: United States, the International Division and the China Division. The China Division includes mainland China, Thailand and KFC Taiwan and the International Division includes the remainder of our international operations. The China and International Divisions have been experiencing dramatic growth and now represent approximately half of the Company's operating profits. The U.S. business operates in a highly competitive marketplace resulting in slower profit growth, but continues to produce strong cash flows.

Strategies

The Company continues to focus on four key strategies:

**Build Dominant China Brands** — The Company has developed the KFC and Pizza Hut brands into the leading quick service and casual dining restaurants, respectively, in mainland China. Additionally, the Company owns and operates the distribution system for its restaurants in mainland China which we believe provides a significant competitive advantage. Given this strong competitive position, a rapidly growing economy and a population of 1.3 billion in mainland China, the Company is rapidly adding KFC and Pizza Hut Casual Dining restaurants and testing the additional restaurant concepts of Pizza Hut Home Service (pizza delivery) and East Dawning (Chinese food).

**Drive Profitable International Division Expansion** — The Company and its franchisees opened over 700 new restaurants in 2006 in the Company's International Division, representing seven straight years of opening over 700 restaurants. The International Division generated over \$400 million in operating profit in 2006 up from \$186 million in 1998. The Company expects to continue to experience strong growth by building out existing markets and growing in new markets including India, France and Russia.

**Improve U.S. Brands Positions and Returns** — The Company continues to focus on improving its U.S. position through differentiated products and marketing and an improved customer experience. The Company also strives to provide industry leading new product innovation which adds sales layers and expands day parts. We are the leader in multibranding, with over 3,000 restaurants providing customers two or more of our brands at a single location. We continue to evaluate our returns and ownership positions with an earn the right to own philosophy on Company owned restaurants.

**Drive High Return on Invested Capital & Strong Shareholder Payout** — The Company is focused on delivering high returns and returning substantial cash flows to its shareholders via share repurchases and dividends. The Company has one of the highest returns on invested capital in the Quick Service Restaurants ( "QSR" ) industry. Additionally, 2006 was the second consecutive year in which the Company returned over \$1.1 billion to its shareholders via share repurchases and dividends. The Company recently announced that it was doubling its quarterly dividend rate

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for the second quarter, 2007 dividend payment, and now expects to generate an approximate 2% dividend yield.

### 2006 Highlights

Worldwide system sales grew by 5% excluding the benefit of the 53rd week in 2005

Diluted earnings per share increased 14%

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Company restaurant margins increased 1.2 percentage points world wide and grew in all three reporting segments

China Division operating profit up a strong 37%

Mainland China restaurant growth of 18%

International Division operating profit up 11% excluding the benefit of the 53rd week in 2005

International Division opened 785 new restaurants

U.S. Division grew operating profit 3% excluding the benefit of the 53rd week in 2005

U.S. operating margin increased by 80 basis points to 13.6%

Throughout the Management's Discussion and Analysis ( MD&A ), the Company provides the percentage change excluding the impact of currency translation. These amounts are derived by translating current year results at prior year average exchange rates. We also provide the percentage change excluding the extra week certain of our businesses had in fiscal 2005. We believe the elimination of the currency translation impact and the 53rd week impact provides better year-to-year comparability without the distortion of foreign currency fluctuations or an extra week in fiscal 2005.

This MD&A should be read in conjunction with our Consolidated Financial Statements on pages 56 through 59 and the Cautionary Statements on page 52. All Note references herein refer to the Notes to the Consolidated Financial Statements on pages 60 through 101. Tabular amounts are displayed in millions except per share and unit count amounts, or as otherwise specifically identified.

### **Significant Known Events, Trends or Uncertainties Impacting or Expected to Impact Comparisons of Reported or Future Results**

The following factors impacted comparability of operating performance for the years ended December 30, 2006, December 31, 2005 and December 25, 2004 and could impact comparability with our results in 2007.

#### Extra Week in 2005

Our fiscal calendar results in a 53rd week every five or six years. Fiscal year 2005 included a 53rd week in the fourth quarter for the majority of our U.S. businesses as well as our international businesses that report on a period, as opposed to a monthly, basis. In the U.S., we permanently accelerated the timing of the KFC business closing by one week in December 2005, and thus, there was no 53rd week benefit for this business. Additionally, all China Division businesses report on a monthly basis and thus did not have a 53rd week.

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The following table summarizes the estimated increase (decrease) of the 53rd week on fiscal year 2005 revenues and operating profit:

	U.S.	International Division	Unallocated	Total
Revenues				
Company sales	\$ 58	\$ 27	\$	\$ 85
Franchise and license fees	8	3		11
Total Revenues	\$ 66	\$ 30	\$	\$ 96
Operating profit				
Franchise and license fees	\$ 8	\$ 3	\$	\$ 11
Restaurant profit	14	5		19
General and administrative expenses	(2 )	(3 )	(3 )	(8 )
Equity income from investments in unconsolidated affiliates		1		1
Operating profit	\$ 20	\$ 6	\$ (3 )	\$ 23

### Mainland China Recovery

Our KFC business in mainland China was negatively impacted by the interruption of product offerings and negative publicity associated with a supplier ingredient issue experienced in late March 2005 as well as consumer concerns related to Avian Flu in the fourth quarter of 2005. As a result of the aforementioned issues, the China Division experienced system sales growth in 2005 of 11% excluding currency translation which is below our ongoing target of at least 22%. During the year ended December 30, 2006, the China Division recovered from these issues and achieved growth rates of 23% for both system sales and Company sales, both excluding currency translation. During 2005, we entered into agreements with the supplier of the aforementioned ingredient. As a result, we recognized recoveries of approximately \$24 million in Other income (expense) in our Consolidated Statement of Income for the year ended December 31, 2005.

### United States Restaurant Profit

Restaurant profits in the U.S. were positively impacted by a decline of approximately \$45 million in commodity costs (principally meats and cheese) for the year ended 2006 versus the year ended 2005. We expect commodity inflation in the U.S. of 2% to 3% in 2007.

Our U.S. restaurant profits were also positively impacted by lower self-insured property and casualty insurance expenses of \$31 million for the year ended 2006 versus 2005. These lower insurance expenses were the result of improved loss trends, which we believe are driven by safety and other measures we have implemented over time, on our insurance reserves and lower property related losses (including the lapping of the unfavorable impact of Hurricane Katrina in 2005 and a small, related insurance recovery in 2006). While we anticipate that these favorable loss trends will continue, it is difficult to forecast their impact, including the impact of large property and casualty losses that may occur. However, we anticipate that given the significant favorability in 2006, property and casualty insurance expense in 2007 will be flat to slightly higher in comparison.

### Taco Bell Northeast United States Produce-Sourcing Issue

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Our Taco Bell business was negatively impacted by adverse publicity related to a produce-sourcing issue during November and December 2006. As a result, Taco Bell experienced significant sales declines at both company and franchise stores, particularly in the northeast United States where an outbreak of illness associated with a particular strain of E. coli 0157:H7 took place. According to the Centers for Disease Control this outbreak was associated with eating at Taco Bell restaurants in Pennsylvania, New Jersey, New York and Delaware. In the fourth quarter of 2006, Taco Bell's company same store sales were down 5%, driven largely by a very significant negative sales impact during the month of December. Overall, we estimate this issue negatively impacted operating profit by \$20 million in the fourth quarter of

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2006 due primarily to lost Company sales and franchise and license fees as well as incremental marketing costs. Same store sales at Taco Bell have begun to recover from their lowest point in the third week of December. While we anticipate that Taco Bell will fully recover from this issue by the middle of 2007, our experience has been that recoveries of this type vary in duration and could take longer. The timing of such recovery will determine the impact on 2007 operating profit. We currently forecast same store sales growth at Taco Bell in 2007 of one to two percent.

### U.S. Beverage Agreement Contract Termination

During the first quarter of 2006, we entered into an agreement with a beverage supplier to certain of our Concepts to terminate a long-term supply contract. As a result of the cash payment we made to the supplier in connection with this termination, we recorded a pre-tax charge of \$8 million to Other (income) expense in the quarter ended March 25, 2006. The affected Concepts have entered into an agreement with an alternative beverage supplier. The contract termination charge we recorded in the quarter ended March 25, 2006 was partly offset by more favorable beverage pricing for our Concepts in 2006. We expect to continue to benefit from the more favorable pricing in 2007 and beyond.

### Pizza Hut United Kingdom Acquisition

On September 12, 2006, we completed the acquisition of the remaining fifty percent ownership interest of our Pizza Hut United Kingdom ( U.K. ) unconsolidated affiliate from our partner, paying approximately \$178 million in cash, including transaction costs and net of \$9 million of cash assumed. Additionally, we assumed the full liability, as opposed to our fifty percent share, associated with the Pizza Hut U.K.'s capital leases of \$95 million and short-term borrowings of \$23 million. This unconsolidated affiliate operated more than 500 restaurants in the U.K.

Prior to the acquisition, we accounted for our fifty percent ownership interest using the equity method of accounting. Thus, we reported our fifty percent share of the net income of the unconsolidated affiliate (after interest expense and income taxes) as Other (income) expense in the Consolidated Statements of Income. We also recorded franchise fee income from the stores owned by the unconsolidated affiliate. From the date of the acquisition through December 4, 2006 (the end of the fiscal year for Pizza Hut U.K.), we reported Company sales and the associated restaurant costs, general and administrative expense, interest expense and income taxes associated with the restaurants previously owned by the unconsolidated affiliate in the appropriate line items of our Consolidated Statement of Income. We no longer recorded franchise fee income for the restaurants previously owned by the unconsolidated affiliate nor did we report other income under the equity method of accounting. As a result of this acquisition, company sales and restaurant profit increased \$164 million and \$16 million, respectively, franchise fees decreased \$7 million and general and administrative expenses increased \$8 million compared to the year ended December 31, 2005. The impacts on operating profit and net income were not significant.

### Adoption of Statement of Financial Accounting Standards No. 123R. Share-Based Payment

In the fourth quarter 2005, the Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 123R Share-Based Payment ( SFAS 123R ). SFAS 123R requires all new, modified and unvested share-based payments to employees, including grants of employee stock options and stock appreciation rights, be recognized in the financial statements as compensation cost over the service period based on their fair value on the date of grant. Compensation cost is recognized over the service period on a straight-line basis for the fair value of awards that actually vest. We adopted SFAS 123R using the modified retrospective application transition method effective September 4, 2005, the beginning of our 2005 fourth quarter. As permitted by SFAS 123R, we applied the modified retrospective application transition method to the beginning of the fiscal year of adoption (our fiscal year 2005). As such, the results for the first three quarters of 2005 were required to be adjusted to recognize the compensation cost previously reported in the pro forma footnote disclosures under the provisions of SFAS 123. However, years prior to 2005 have not been restated.

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As shown below, the adoption of SFAS 123R resulted in a decrease in net income of \$38 million and a reduction of basic and diluted earnings per share of \$0.13 for 2005. Additionally, cash flows from operating activities decreased \$87 million in 2005 and cash flows from financing activities increased \$87 million in 2005. The impact of applying SFAS 123R on the results of operations and cash flows for 2006 was similar to the impact on 2005.

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	2005				
	U.S.	International	China	Unallocated	Total
Payroll and employee benefits	\$ 8	\$ 2	\$	\$	\$ 10
General and administrative	14	11	4	19	48
Operating profit	\$ 22	\$ 13	\$ 4	\$ 19	58
Income tax benefit					(20)
Net income impact					\$ 38
Basic earnings per share					\$ 0.13
Diluted earnings per share					\$ 0.13

Prior to 2005, all stock options granted were accounted for under the recognition and measurement principles of APB 25, "Accounting for Stock Issued to Employees," and its related Interpretations. Accordingly, no stock-based employee compensation expense was reflected in the Consolidated Statements of Income for stock options, as all stock options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. Had the Company applied the fair value provisions of SFAS 123 to stock options in 2004, net income of \$740 million would have been reduced by \$37 million to \$703 million. Additionally, both basic and diluted earnings per common share would have decreased \$0.12 per share for 2004.

### Sale of an Investment in Unconsolidated Affiliate

During the second quarter of 2005, we sold our fifty percent interest in the entity that operated almost all KFCs and Pizza Huts in Poland and the Czech Republic to our then partner in the entity, principally for cash. Concurrent with the sale, our former partner completed an initial public offering ( IPO ) of the majority of the stock it then owned in the entity. Prior to the sale, we accounted for our investment in this entity using the equity method. Subsequent to the IPO, the new publicly held entity, in which YUM has no ownership interest, is a franchisee as was the entity in which we previously held a fifty percent interest.

In 2005, this transaction generated a gain of approximately \$11 million for YUM as cash proceeds (net of expenses) of approximately \$25 million from the sale of our interest in the entity exceeded our recorded investment in this unconsolidated affiliate. As with our equity income from investments in unconsolidated affiliates, the gain of approximately \$11 million was recorded in Other income (expense) in our Consolidated Statement of Income.

The sale did not have a significant impact on our subsequently reported results of operations in 2005 or 2006.

### Sale of Puerto Rico Business

Our Puerto Rico business was held for sale beginning the fourth quarter of 2002 and was sold on October 4, 2004 for an amount approximating its then carrying value. As a result of this sale, company sales and restaurant profit decreased \$159 million and \$29 million, respectively, franchise fees increased \$10 million and general and administrative expenses decreased \$9 million for the year ended December 31, 2005 as compared to the year ended December 25, 2004.

### Lease Accounting Adjustments



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In the fourth quarter of 2004, we recorded an adjustment to correct instances where our leasehold improvements were not being depreciated over the shorter of their useful lives or the term of the lease, including options in some instances, over which we were recording rent expense, including escalations, on a straight-line basis.

The cumulative adjustment, primarily through increased U.S. depreciation expense, totaled \$11.5 million (\$7 million after tax). The portion of this adjustment that related to 2004 was approximately \$3 million. As the portion of our adjustment recorded that was a correction of errors of amounts reported in our prior period financial statements was not material to

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any of those prior period financial statements, the entire adjustment was recorded in the 2004 Consolidated Financial Statements and no adjustment was made to any prior period financial statements.

### Wrench Litigation

We recorded income of \$2 million and \$14 million in 2005 and 2004, respectively. There was no impact from Wrench Litigation in 2006. See Note 4 for a discussion of the Wrench litigation.

### AmeriServe and Other Charges (Credits)

We recorded income of \$1 million, \$2 million and \$16 million in 2006, 2005 and 2004, respectively. See Note 4 for a detailed discussion of AmeriServe and other charges (credits).

### Store Portfolio Strategy

From time to time we sell Company restaurants to existing and new franchisees where geographic synergies can be obtained or where franchisees' expertise can generally be leveraged to improve our overall operating performance, while retaining Company ownership of strategic U.S. and international markets. In the U.S., we are in the process of decreasing our Company ownership of restaurants from its current level of 23% to approximately 17%. This three-year plan calls for selling approximately 1,500 Company restaurants to franchisees from 2006 through 2008. In 2006, 452 company restaurants in the U.S. were sold to franchisees. In the International Division, we expect to rebrand approximately 300 Pizza Huts in the United Kingdom over the next several years reducing our Pizza Hut Company ownership in that market from approximately 80% currently to approximately 40%. Refranchisings reduce our reported revenues and restaurant profits and increase the importance of system sales growth as a key performance measure.

The following table summarizes our refranchising activities:

	2006	2005	2004
Number of units refranchised	622	382	317
Refranchising proceeds, pre-tax	\$257	\$145	\$140
Refranchising net gains, pre-tax	\$24	\$43	\$12

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

The following table summarizes Company store closure activities:

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	2006	2005	2004
Number of units closed	214	246	319
Store closure costs (income)	\$(1 )	\$	\$(3 )

The impact on operating profit arising from refranchising and Company store closures is the net of (a) the estimated reductions in restaurant profit, which reflects the decrease in Company sales, and general and administrative expenses and (b) the estimated increase in franchise fees from the stores refranchised. The amounts presented below reflect the estimated impact from stores that were operated by us for all or some portion of the respective previous year and were no longer operated by us as of the last day of the respective year. The amounts do not include results from new restaurants that we opened in connection with a relocation of an existing unit or any incremental impact upon consolidation of two or more of our existing units into a single unit.

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

2006				
	U.S.	International Division	China Division	Worldwide
Decreased Company sales	\$ (377 )	\$ (136 )	\$ (22 )	\$ (535 )
Increased franchise fees	14	6		20
Decrease in total revenues	\$ (363 )	\$ (130 )	\$ (22 )	\$ (515 )
2005				
	U.S.	International Division	China Division	Worldwide
Decreased Company sales	\$ (240 )	\$ (263 )	\$ (15 )	\$ (518 )
Increased franchise fees	8	13		21
Decrease in total revenues	\$ (232 )	\$ (250 )	\$ (15 )	\$ (497 )

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

2006				
	U.S.	International Division	China Division	Worldwide
Decreased restaurant profit	\$ (38 )	\$ (5 )	\$	\$ (43 )
Increased franchise fees	14	6		20
Decreased general and administrative expenses	1	1		2
Increase (decrease) in operating profit	\$ (23 )	\$ 2	\$	\$ (21 )
2005				
	U.S.	International Division	China Division	Worldwide
Decreased restaurant profit	\$ (22 )	\$ (34 )	\$ (1 )	\$ (57 )
Increased franchise fees	8	13		21
Decreased general and administrative expenses	1	10		11
Increase (decrease) in operating profit	\$ (13 )	\$ (11 )	\$ (1 )	\$ (25 )

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**Results of Operations**

		% B/(W)		% B/(W)
	2006	vs. 2005	2005	vs. 2004
Company sales	\$8,365	2	\$ 8,225	3
Franchise and license fees	1,196	7	1,124	10
Total revenues	\$9,561	2	\$ 9,349	4
Company restaurant profit	\$1,271	10	\$ 1,155	
% of Company sales	15.2%	1.2	ppts.	14.0%
				(0.5 ) ppts.
Operating profit	1,262	9	1,153	
Interest expense, net	154	(22 )	127	2
Income tax provision	284	(7 )	264	7
Net income	\$824	8	\$ 762	3
Diluted earnings per share <sup>(a)</sup>	\$2.92	14	\$ 2.55	5

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

**Restaurant Unit Activity**

<u>Worldwide</u>	Company	Unconsolidated		Franchisees	Total Excluding Licensees
Balance at end of 2004	7,759	1,664		21,859	31,282
New Builds	470	160		924	1,554
Acquisitions	1			(1 )	
Refranchising	(382 )	(142 )		522	(2 )
Closures	(246 )	(35 )		(664 )	(945 )
Other	(15 )	1		26	12
Balance at end of 2005	7,587	1,648		22,666	31,901
New Builds	426	136		953	1,515
Acquisitions	556	(541 )		(15 )	
Refranchising	(622 )	(1 )		626	3
Closures	(214 )	(33 )		(675 )	(922 )
Other	3	(3 )		(39 )	(39 )
Balance at end of 2006	7,736	1,206		23,516	32,458
% of Total	24%	4%		72%	100%

The above total excludes 2,137 and 2,376 licensed units at the end of 2006 and 2005, respectively. The worldwide total excludes 46 units from the acquisition of the Rostik's brand (see Note 10) that have not yet been co-branded into Rostik's/KFC restaurants. These units will be presented as franchisee new builds as the co-branding into Rostik's/KFC restaurants occurs. Balances at the end of 2004 for the worldwide and China unit activity have been adjusted to include December 2004 activity in mainland China due to the change in its reporting calendar. The net change was an addition of 16, 2, 1 and 19 units for company, unconsolidated affiliates, franchisees and total, respectively.



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		Unconsolidated		Total
<u>United States</u>	Company	Affiliates	Franchisees	Excluding Licensees
Balance at end of 2004	4,989		13,482	18,471
New Builds	125		240	365
Acquisitions				
Refranchising	(244 )		242	(2 )
Closures	(174 )		(364 )	(538 )
Other	(10 )		5	(5 )
Balance at end of 2005	4,686		13,605	18,291
New Builds	99		235	334
Acquisitions				
Refranchising	(452 )		455	3
Closures	(124 )		(368 )	(492 )
Other	3		(22 )	(19 )
Balance at end of 2006	4,212		13,905	18,117
% of Total	23%		77%	100%

The above total excludes 1,944 and 2,181 licensed units at the end of 2006 and 2005, respectively.

		Unconsolidated		Total
<u>International Division</u>	Company	Affiliates	Franchisees	Excluding Licensees
Balance at end of 2004	1,504	1,204	8,179	10,887
New Builds	53	61	666	780
Acquisitions	1		(1 )	
Refranchising	(137 )	(142 )	279	
Closures	(41 )	(28 )	(292 )	(361 )
Other	(5 )	1	17	13
Balance at end of 2005	1,375	1,096	8,848	11,319
New Builds	47	35	703	785
Acquisitions	555	(541 )	(14 )	
Refranchising	(168 )	(1 )	169	
Closures	(47 )	(25 )	(303 )	(375 )
Other		(3 )	(16 )	(19 )
Balance at end of 2006	1,762	561	9,387	11,710
% of Total	15%	5%	80%	100%

The above totals exclude 193 and 195 licensed units at the end of 2006 and 2005, respectively. The International Division total excludes 46 units from the acquisition of the Rostik's brand (see Note 10) that have not yet been co-branded into Rostik's/KFC restaurants. These units will be presented as franchisee new builds as the co-branding into Rostik's/KFC restaurants occurs.

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		Unconsolidated		Total Excluding
<u>China Division</u>	Company	Affiliates	Franchisees	Licensees
Balance at end of 2004	1,266	460	198	1,924
New Builds	292	99	18	409
Acquisitions				
Refranchising	(1 )		1	
Closures	(31 )	(7 )	(8 )	(46 )
Other			4	4
Balance at end of 2005	1,526	552	213	2,291
New Builds	280	101	15	396
Acquisitions	1		(1 )	
Refranchising	(2 )		2	
Closures	(43 )	(8 )	(4 )	(55 )
Other			(1 )	(1 )
Balance at end of 2006	1,762	645	224	2,631
% of Total	67%	25%	8%	100%

There are no licensed units in the China Division.

Included in the above totals are multibrand restaurants. Multibrand conversions increase the sales and points of distribution for the second brand added to a restaurant but do not result in an additional unit count. Similarly, a new multibrand restaurant, while increasing sales and points of distribution for two brands, results in just one additional unit count. Franchise unit counts include both franchisee and unconsolidated affiliate multibrand units. Multibrand restaurant totals were as follows:

<u>2006</u>	Company	Franchise	Total
United States	1,802	1,631	3,433
International Division	11	192	203
Worldwide	1,813	1,823	3,636

<u>2005</u>	Company	Franchise	Total
United States	1,696	1,400	3,096
International Division	17	176	193
Worldwide	1,713	1,576	3,289

For 2006 and 2005, Company multibrand unit gross additions were 212 and 373, respectively. For 2006 and 2005, franchise multibrand unit gross additions were 197 and 171, respectively. There are no multibrand units in the China Division.



**System Sales Growth**

	Increase		Increase excluding currency translation		Increase excluding currency translation and 53rd week	
	2006	2005	2006	2005	2006	2005
United States		5%	N/A	N/A	1%	4%
International Division	7%	9%	7%	6%	9%	5%
China Division	26%	13%	23%	11%	23%	11%
Worldwide	4%	7%	4%	6%	5%	5%

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

The explanations that follow for system sales growth consider year over year changes excluding the impact of currency translation and the 53rd week.

The increases in worldwide system sales in 2006 and 2005 were driven by new unit development and same store sales growth, partially offset by store closures.

The increase in U.S. system sales in 2006 was driven by new unit development and same store sales growth, partially offset by store closures. The increase in U.S. system sales in 2005 was driven by same store sales growth and new unit development, partially offset by store closures.

The increases in International Division system sales in 2006 and 2005 were driven by new unit development and same store sales growth, partially offset by store closures.

The increase in China Division system sales in 2006 was driven by new unit development and same store sales growth, partially offset by store closures. The increase in China Division system sales in 2005 was driven by new unit development, partially offset by the impact of same store sales declines.

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Revenues

	Amount 2006	2005	% Increase (Decrease)		% Increase(Decrease) excluding currency translation		% Increase (Decrease) excluding currency translation and 53rd week	
			2006	2005	2006	2005	2006	2005
Company sales								
United States	\$ 4,952	\$5,294	(6 )	3	N/A	N/A	(5)	1
International Division	1,826	1,676	9	(4 )	8	(8 )	10	(10)
China Division	1,587	1,255	26	16	23	14	23	14
Worldwide	8,365	8,225	2	3	1	2	2	1
Franchise and license fees								
United States	651	635	3	6	N/A	N/A	4	5
International Division	494	448	10	17	10	15	11	14
China Division	51	41	25	8	21	7	21	7
Worldwide	1,196	1,124	7	10	6	9	8	8
Total revenues								
United States	5,603	5,929	(5 )	3	N/A	N/A	(4)	2
International Division	2,320	2,124	9		9	(4 )	10	(5)
China Division	1,638	1,296	26	16	23	14	23	14
Worldwide	\$ 9,561	\$9,349	2	4	2	3	3	2

The explanations that follow for revenue fluctuations consider year over year changes excluding the impact of currency translation and the 53rd week.

Excluding the favorable impact of the Pizza Hut U.K. acquisition, worldwide Company sales were flat in 2006. Increases from new unit development and same store sales growth were offset by decreases in refranchising and store closures. In 2005, the increase in worldwide Company sales was driven by new unit development and same store sales growth, partially offset by refranchising and store closures.

In 2006 and 2005, the increase in worldwide franchise and license fees was driven by new unit development, same store sales growth and refranchising, partially offset by store closures. In 2006, franchise and license fees were also negatively impacted by the Pizza Hut U.K. acquisition.

In 2006, the decrease in U.S. Company sales was driven by refranchising and store closures, partially offset by new unit development. In 2005, the increase in U.S. Company sales was driven by same store sales growth and new unit development, partially offset by refranchising and store closures.

In 2006, blended U.S. Company same store sales were flat as a decrease in transactions was offset by an increase in average guest check. In 2005, blended U.S. Company same store sales increased 4% due to increases in average guest check and transactions. U.S. blended same store sales includes KFC, Pizza Hut and Taco Bell Company-owned restaurants only. U.S. same store sales for Long John Silver's and A&W restaurants are not included.

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In 2006, the increase in U.S. franchise and license fees was driven by new unit development, refranchising and same store sales growth, partially offset by store closures. In 2005, the increase in U.S. franchise and license fees was driven by new unit development, same store sale growth and refranchising, partially offset by store closures.

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Excluding the favorable impact of the Pizza Hut U.K. acquisition, International Division Company sales were flat in 2006. The impacts of refranchising and store closures were partially offset by new unit development and same store sales growth. In 2005, the decrease in International Division Company sales was driven by refranchising (primarily our Puerto Rico business) and store closures, partially offset by new unit development.

Excluding the unfavorable impact of the Pizza Hut U.K. acquisition, International Division franchise and licenses fees increased 13% in 2006. The increase was driven by new unit development and same store growth, partially offset by store closures. In 2005, the increase in International Division franchise and license fees was driven by new unit development, refranchising (primarily our Puerto Rico business) and royalty rate increases.

In 2006, the increase in China Division Company sales and franchise and licenses fees was driven by new unit development and same store sales growth. In 2005, the increase in China Division Company sales and franchise and licenses fees was driven by new unit development, partially offset by the impact of same store sales declines.

### Company Restaurant Margins

	U.S.		International		China		Worldwide	
<u>2006</u>		%		%		%		%
Company sales	100.0		100.0		100.0		100.0	
Food and paper	28.2		32.2		35.4		30.5	
Payroll and employee benefits	30.1		24.6		12.9		25.6	
Occupancy and other operating expenses	27.1		31.0		31.3		28.7	
Company restaurant margin	14.6	%	12.2	%	20.4	%	15.2	%

	U.S.		International		China		Worldwide	
<u>2005</u>		%		%		%		%
Company sales	100.0		100.0		100.0		100.0	
Food and paper	29.8		33.1		36.2		31.4	
Payroll and employee benefits	30.2		24.1		13.3		26.4	
Occupancy and other operating expenses	26.2		30.7		33.1		28.2	
Company restaurant margin	13.8	%	12.1	%	17.4	%	14.0	%

	U.S.		International		China		Worldwide	
<u>2004</u>		%		%		%		%
Company sales	100.0		100.0		100.0		100.0	
Food and paper	29.9		33.8		37.1		31.8	
Payroll and employee benefits	30.5		23.8		11.5		26.4	
Occupancy and other operating expenses	25.8		29.4		31.1		27.3	
Company restaurant margin	13.8	%	13.0	%	20.3	%	14.5	%

In 2006, the increase in U.S. restaurant margin as a percentage of sales was driven by the impact of lower commodity costs (primarily meats and cheese), the impact of same store sales on restaurant margin (due to higher average guest check) and the favorable impact of lower property and casualty insurance expense. These increases were partially offset by higher occupancy and other costs, higher labor costs, primarily driven by wage rates and benefits, and the lapping of the favorable impact of the 53rd week in 2005. The higher occupancy and other costs were driven by increased advertising and higher utility costs.

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In 2005, U.S. restaurant margin as a percentage of sales was flat compared to 2004. The impact of same store sales growth on restaurant margin was offset by higher occupancy and other costs. Higher occupancy and other costs were

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driven by increases in utility costs and advertising costs. A favorable impact from the 53rd week (13 basis points) was offset by the unfavorable impact of the adoption of SFAS 123R (17 basis points).

In 2006, the increase in International Division restaurant margin as a percentage of sales was driven by the impact of same store sales growth on restaurant margin as well as the favorable impact of refranchising and closing certain restaurants. These increases were offset by higher labor costs and higher food and paper costs.

In 2005, the decrease in the International Division restaurant margins as a percentage of sales included a 51 basis point unfavorable impact of refranchising our restaurants in Puerto Rico. Also contributing to the decrease were higher occupancy and other costs and higher labor costs. The decrease was partially offset by the impact of same store sales growth on restaurant margin. The unfavorable impact of the adoption of SFAS 123R (10 basis points) was largely offset by the favorable impact of the 53rd week (8 basis points).

In 2006, the increase in China Division restaurant margin as a percentage of sales was driven by the impact of same store sales growth on restaurant margin. The increase was partially offset by the impact of lower margins associated with new units during the initial periods of operations.

In 2005, China Division restaurant margins as a percentage of sales decreased. The decrease was driven by the impact on restaurant margin of same store sales declines and lower margins associated with new units during the initial periods of operation. Also contributing to the decrease was higher labor costs. The decrease was partially offset by lower food and paper costs (principally due to supply chain savings initiatives).

### **Worldwide General and Administrative Expenses**

General and administrative (G&A) expenses increased \$29 million or 2% in 2006, including a 1% favorable impact from lapping the 53rd week in 2005. The increase was primarily driven by higher compensation related costs, including amounts associated with investments in strategic initiatives in China and other international growth markets, as well as G&A expenses for our Pizza Hut U.K. business which were previously netted within equity income prior to our acquisition of the remaining fifty percent interest of the business in 2006. These increases were partially offset by lapping higher prior year litigation related costs.

G&A expenses increased \$102 million or 10% in 2005, including a 4% unfavorable impact of the adoption of SFAS 123R, a 1% unfavorable impact from the 53rd week and a 1% unfavorable impact from foreign currency translation. Excluding the unfavorable impact of these factors, general and administrative expenses increased \$38 million or 4%. The increase was driven by higher compensation related costs, including amounts associated with investments in strategic initiatives in China and other international growth markets, and higher litigation related costs including charges of \$16 million for the potential resolution of certain legal matters. Higher charitable contributions and expense associated with discontinuing certain corporate software development projects also contributed to the increase. Such increases were partially offset by reductions associated with operating restaurants which were refranchised in 2004 (primarily the Puerto Rico business) and the effect of lapping certain prior year reserve increases related to potential development sites and surplus facilities.

**Worldwide Other (Income) Expense**

	2006	2005	2004
Equity income from investments in unconsolidated affiliates	\$ (51 )	\$ (51 )	\$ (54 )
Gain upon sale of investment in unconsolidated affiliate <sup>(a)</sup>	(2 )	(11 )	
Recovery from supplier <sup>(b)</sup>		(20 )	
Foreign exchange net (gain) loss and other	(6 )	2	(1 )
Contract termination charge <sup>(c)</sup>	8		
Other (income) expense	\$ (51 )	\$ (80 )	\$ (55 )

(a) Reflects gains related to the 2005 sale of our fifty percent interest in the entity that operated almost all KFCs and Pizza Huts in Poland and the Czech Republic to our then partner in the entity.

(b) Relates to a financial recovery from a supplier ingredient issue in mainland China totaling \$24 million, \$4 million of which was recognized through equity income from investments in unconsolidated affiliates.

(c) Reflects an \$8 million charge associated with the termination of a beverage agreement in the United States segment.

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

See the Store Portfolio Strategy section for more detail of our refranchising and closure activities and Note 4 for a summary of the components of facility actions by reportable operating segment.

**Operating Profit**

	2006	2005	% Increase/(Decrease)	
			2006	2005
United States	\$763	\$ 760		(2 )
International Division	407	372	9	11
China Division	290	211	37	3
Unallocated and corporate expenses	(229 )	(246 )	(7 )	21
Unallocated other income (expense)	6	9	NM	NM
Unallocated refranchising gain (loss)	24	43	NM	NM
Wrench litigation income (expense)		2	NM	NM
AmeriServe and other (charges) credits	1	2	NM	NM
Operating profit	\$1,262	\$ 1,153	9	
United States operating margin	13.6 %	12.8 %	0.8 ppts	(0.7) ppts
International Division operating margin	17.6 %	17.5 %	0.1 ppts.	1.7 ppts.

Neither unallocated and corporate expenses, which comprise G&A expenses, nor unallocated refranchising gain (loss) are allocated to the U.S., International Division, or China Division segments for performance reporting purposes. The decrease in corporate and unallocated expenses in 2006 was driven by the lapping of the unfavorable impact of 2005 litigation related costs.

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Excluding the unfavorable impact of lapping the 53rd week in 2005, U.S. operating profit increased \$23 million or 3% in 2006. The increase was driven by the impact of same store sales on restaurant profit (due to higher average guest check)



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and franchise and license fees, new unit development and lower closures and impairment expenses. These increases were partially offset by the unfavorable impact of refranchising, higher G&A expenses and a charge associated with the termination of a beverage agreement in 2006. The impact of lower commodity costs and lower property and casualty insurance expense on restaurant profit was largely offset by higher other restaurant costs, including labor, advertising and utilities.

U.S. operating profit decreased \$17 million or 2% in 2005. The decrease was driven by higher closures and impairment expenses and higher G&A expenses. These decreases were partially offset by the impact of same store sales growth on restaurant profit and franchise and license fees. The impact of same store sales growth on restaurant profit was partially offset by higher occupancy and other costs. A 3% unfavorable impact from the adoption of SFAS 123R was offset by a 3% favorable impact from the 53rd week.

Excluding the unfavorable impact of lapping the 53rd week in 2005, International Division operating profit increased \$41 million or 11% in 2006. The increase was driven by the impact of same store sales growth and new unit development on franchise and license fees and restaurant profit. These increases were partially offset by higher restaurant operating costs and lower equity income from unconsolidated affiliates. Currency translation did not have a significant impact.

International Division operating profit increased \$35 million or 11% in 2005, including a 4% favorable impact from currency translation, a 2% favorable impact from the 53rd week, and a 4% unfavorable impact from the adoption of SFAS 123R. Excluding the net favorable impact from these factors, International Division operating profit increased \$31 million or 9% in 2005. The increase was driven by the impact of same store sales growth on restaurant profit and franchise and license fees, the impact of new unit development on franchise and license fees and restaurant profit, and lower closures and impairment expenses. These increases were partially offset by higher occupancy and other costs, higher labor costs and the impact on operating profit of refranchising our restaurants in Puerto Rico.

China Division operating profit increased \$79 million or 37% in 2006 including a 4% favorable impact from currency translation. The increase was driven by the impact of same store sales growth on restaurant profit, new unit development and an increase in equity income from our unconsolidated affiliates. These increases were partially offset by higher G&A expenses and the lapping of a prior year financial recovery from a supplier.

China Division operating profit increased \$6 million or 3% in 2005. The increase was driven by the impact on restaurant profit of new unit development and a financial recovery from a supplier. These increases were partially offset by the impact on restaurant profit of same store sales declines, a decrease in equity income from unconsolidated affiliates, and increased general and administrative expense. A 2% favorable impact from currency translation was offset by a 2% unfavorable impact of the adoption of SFAS 123R.

### Interest Expense, Net

	2006	2005	2004
Interest expense	\$ 172	\$ 147	\$ 145
Interest income	(18 )	(20 )	(16 )
Interest expense, net	\$ 154	\$ 127	\$ 129

Interest expense increased \$25 million or 17% in 2006. The increase was driven by both an increase in interest rates on the variable rate portion of our debt and increased borrowings as compared to prior year.

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Interest expense increased \$2 million or 2% in 2005. An increase in our average interest rates was largely offset by a decrease in our bank fees attributable to an upgrade in our credit rating.

**Income Taxes**

	2006	2005	2004
Reported			
Income taxes	\$ 284	\$ 264	\$ 286
Effective tax rate	25.6 %	25.8 %	27.9 %

The reconciliation of income taxes calculated at the U.S. federal tax statutory rate to our effective tax rate is set forth below:

	2006	2005	2004
U.S. federal statutory rate	35.0 %	35.0 %	35.0 %
State income tax, net of federal tax benefit	2.0	1.6	1.3
Foreign and U.S. tax effects attributable to foreign operations	(7.8 )	(8.4 )	(7.8 )
Adjustments to reserves and prior years	(3.5 )	(1.1 )	(6.7 )
Repatriation of foreign earnings	(0.4 )	2.0	0.5
Non-recurring foreign tax credit adjustment	(6.2 )	(1.7 )	
Valuation allowance additions (reversals)	6.8	(1.1 )	5.7
Other, net	(0.3 )	(0.5 )	(0.1 )
Effective income tax rate	25.6 %	25.8 %	27.9 %

Our 2006 effective income tax rate was positively impacted by the reversal of tax reserves in connection with our regular U.S. audit cycle as well as certain out-of-year adjustments to reserves and accruals that lowered our effective income tax rate by 2.2 percentage points. The reversal of tax reserves was partially offset by valuation allowance additions on foreign tax credits for which, as a result of the tax reserve reversals, we currently believe we are not likely to utilize before they expire. We also recognized deferred tax assets for the foreign tax credit impact of non-recurring decisions to repatriate certain foreign earnings in 2007. However, we provided full valuation allowances on such assets as we do not believe it is currently more likely than not that they will be realized. We recognized the benefit of certain recurring foreign tax credits in amounts similar to prior years in 2006.

Our 2005 effective income tax rate was positively impacted by valuation allowance reversals for certain deferred tax assets whose realization became more likely than not as well as the recognition of certain nonrecurring foreign tax credits we were able to substantiate in 2005. The impact of these items was partially offset by tax expense associated with our 2005 decision to repatriate approximately \$390 million in qualified foreign earnings. These earnings, as well as \$110 million for which a determination was made to repatriate in 2004, were eligible for a dividends received deduction in accordance with the American Jobs Creation Act of 2004.

Our 2004 effective income tax rate was positively impacted by the reversal of tax reserves in connection with our regular U.S. audit cycle, partially offset by the recognition of valuation allowances for certain deferred tax assets whose realization was no longer considered more likely than not.

Adjustments to reserves and prior years include the effects of the reconciliation of income tax amounts recorded in our Consolidated Statements of Income to amounts reflected on our tax returns, including any adjustments to the Consolidated Balance Sheets. Adjustments to reserves and prior years also includes changes in tax reserves established for potential exposure we may incur if a taxing authority takes a position on a matter contrary to our position. We evaluate these reserves, including interest thereon, on a quarterly basis to insure that they have been appropriately adjusted for events, including audit settlements that we believe may impact our exposure.

## Consolidated Cash Flows

**Net cash provided by operating activities** was \$1,302 million compared to \$1,238 million in 2005. The increase was driven by a higher net income, lower pension contributions and a 2006 partial receipt of the settlement related to the 2005 mainland China supplier ingredient issue. These factors were offset by higher income tax and interest payments in 2006.

In 2005, net cash provided by operating activities was \$1,238 million compared to \$1,186 million in 2004. The increase was driven primarily by an increase in net income, including the non-cash impact of the adoption of SFAS 123R, and lower income tax payments in 2005, partially offset by the impact of excess tax benefits from share-based compensation classified in financing activities in 2005 pursuant to the adoption of SFAS 123R.

**Net cash used in investing activities** was \$476 million versus \$345 million in 2005. The increase was driven by the current year acquisitions of the remaining interest in our Pizza Hut U.K. unconsolidated affiliate and the Rostik's brand and associated intellectual properties in Russia. The lapping of proceeds related to the 2005 sale of our fifty percent interest in our former Poland/Czech Republic unconsolidated affiliate also contributed to the increase. These factors were partially offset by an increase in proceeds from refranchising in 2006.

In 2005, net cash used in investing activities was \$345 million versus \$541 million in 2004. The decrease was primarily driven by lower acquisitions of restaurants from franchisees and capital spending, higher proceeds from the sale of property, plant and equipment versus 2004 and the proceeds from the sale of our fifty percent interest in our former Poland/Czech Republic unconsolidated affiliate.

**Net cash used in financing activities** was \$673 million versus \$832 million in 2005. The decrease was driven by an increase in net borrowings and lower share repurchases, partially offset by a reduction in the excess tax benefits from share-based compensation and higher dividend payments.

In 2005, net cash used in financing activities was \$832 million versus \$779 million in 2004. The increase was driven primarily by higher share repurchases, partially offset by net debt borrowings in 2005 versus net debt repayments in 2004 and the impact of excess tax benefits from share-based compensation classified in financing activities in 2005 pursuant to the adoption of SFAS 123R.

## Liquidity and Capital Resources

Operating in the QSR industry allows us to generate substantial cash flows from the operations of our company stores and from our franchise operations, which require a limited YUM investment. In each of the last five fiscal years, net cash provided by operating activities has exceeded \$1 billion. We expect these levels of net cash provided by operating activities to continue in the foreseeable future. Our discretionary spending includes capital spending for new restaurants, acquisitions of restaurants from franchisees, repurchases of shares of our common stock and dividends paid to our shareholders. Unforeseen downturns in our business could adversely impact our cash flows from operations from the levels historically realized. However, we believe our ability to reduce discretionary spending and our borrowing capacity would allow us to meet our cash requirements in 2007 and beyond.

### Discretionary Spending

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During 2006, we invested \$614 million in our businesses, including approximately \$331 million in the U.S., \$118 million for the International Division and \$165 million for the China Division. We also acquired the remaining fifty percent ownership interest of our Pizza Hut United Kingdom unconsolidated affiliate for \$178 million in cash.

For the second straight year, we returned over \$1.1 billion to our shareholders through share repurchases and quarterly dividends. Under the authority of our Board of Directors, we repurchased 20.2 million shares of our Common Shares for \$983 million during 2006. In September 2006, the Board of Directors authorized share repurchases of up to \$500 million of the Company's outstanding common stock (excluding applicable transaction fees) to be purchased through September

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2007. At December 30, 2006, we had remaining capacity to repurchase up to \$469 million of our outstanding common stock (excluding applicable transaction fees) under the September 2006 authorization.

During the year ended December 30, 2006, we paid cash dividends of \$144 million. Additionally, on November 17, 2006 and December 5, 2006, our Board of Directors approved cash dividends of \$0.15 and \$0.30, respectively, per share of common stock to be distributed on February 2, 2007 and March 30, 2007, respectively, to shareholders of record at the close of business on January 12, 2007 and March 9, 2007, respectively.

For 2007, we estimate that capital spending will be approximately \$650 million. We also estimate that refranchising proceeds, prior to taxes, will total approximately \$200 million in 2007. We also expect to provide returns to our shareholders through both significant share repurchases and dividends. We are targeting a 3% to 4% reduction of our diluted share count in 2007.

### Borrowing Capacity

Our primary bank credit agreement comprises a \$1.0 billion senior unsecured Revolving Credit Facility (the Credit Facility ) which matures in September 2009. The Credit Facility is unconditionally guaranteed by our principal domestic subsidiaries and contains financial covenants relating to maintenance of leverage and fixed charge coverage ratios. The Credit Facility also contains affirmative and negative covenants including, among other things, limitations on certain additional indebtedness, guarantees of indebtedness, level of cash dividends, aggregate non-U.S. investment and certain other transactions specified in the agreement. We were in compliance with all debt covenants at December 30, 2006.

Under the terms of the Credit Facility, we may borrow up to the maximum borrowing limit, less outstanding letters of credit. At December 30, 2006, our unused Credit Facility totaled \$778 million, net of outstanding letters of credit of \$222 million. There were no borrowings outstanding under the Credit Facility at December 30, 2006. The interest rate for borrowings under the Credit Facility ranges from 0.35% to 1.625% over the London Interbank Offered Rate ( LIBOR ) or 0.00% to 0.20% over an Alternate Base Rate, which is the greater of the Prime Rate or the Federal Funds Effective Rate plus 0.50%. The exact spread over LIBOR or the Alternate Base Rate, as applicable, depends on our performance under specified financial criteria. Interest on any outstanding borrowings under the Credit Facility is payable at least quarterly.

In November 2005, we executed a five-year revolving credit facility totaling \$350 million (the International Credit Facility or ICF ) on behalf of three of our wholly owned international subsidiaries. The ICF is unconditionally guaranteed by YUM and by YUM's principal domestic subsidiaries and contains covenants substantially identical to those of the Credit Facility. We were in compliance with all debt covenants at the end of 2006.

There were borrowings of \$174 million and available credit of \$176 million outstanding under the ICF at the end of 2006. The interest rate for borrowings under the ICF ranges from 0.20% to 1.20% over LIBOR or 0.00% to 0.20% over a Canadian Alternate Base Rate, which is the greater of the Citibank, N.A., Canadian Branch's publicly announced reference rate or the Canadian Dollar Offered Rate plus 0.50%. The exact spread over LIBOR or the Canadian Alternate Base Rate, as applicable, depends upon YUM's performance under specified financial criteria. Interest on any outstanding borrowings under the ICF is payable at least quarterly.

In 2006, we executed two short-term borrowing arrangements (the Term Loans ) on behalf of the International Division. There were borrowings of \$183 million outstanding at the end of 2006 under the Term Loans, both of which expired and were repaid in the first quarter of 2007.

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The majority of our remaining long-term debt primarily comprises Senior Unsecured Notes with varying maturity dates from 2008 through 2016 and interest rates ranging from 6.25% to 8.88%. The Senior Unsecured Notes represent senior, unsecured obligations and rank equally in right of payment with all of our existing and future unsecured unsubordinated indebtedness. Amounts outstanding under Senior Unsecured Notes were \$1.6 billion at December 30, 2006. This amount

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includes \$300 million aggregate principal amount of 6.25% Senior Unsecured Notes that were issued in April 2006 due April 15, 2016. We used \$200 million of these proceeds to repay our 8.5% Senior Unsecured Notes that matured in April 2006 and the remainder for general corporate purposes.

**Contractual Obligations** In addition to any discretionary spending we may choose to make, our significant contractual obligations and payments as of December 30, 2006 included:

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt obligations <sup>(a)</sup>	\$ 2,744	\$ 360	\$ 506	\$ 1,021	\$ 857
Capital leases <sup>(b)</sup>	303	20	40	38	205
Operating leases <sup>(b)</sup>	3,606	438	757	618	1,793
Purchase obligations <sup>(c)</sup>	265	198	47	6	14
Other long-term liabilities reflected on our Consolidated Balance Sheet under GAAP	13		5	3	5
<b>Total contractual obligations</b>	<b>\$ 6,931</b>	<b>\$ 1,016</b>	<b>\$ 1,355</b>	<b>\$ 1,686</b>	<b>\$ 2,874</b>

- (a) 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. Excludes a fair value adjustment of \$13 million deducted from debt related to interest rate swaps that hedge the fair value of a portion of our debt. See Note 12.
- (b) These obligations, which are shown on a nominal basis, relate to approximately 5,800 restaurants. See Note 13.
- (c) Purchase obligations include agreements to purchase goods or services that are enforceable and legally binding on us and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. We have excluded agreements that are cancelable without penalty. Purchase obligations relate primarily to information technology, marketing, commodity agreements, purchases of property, plant and equipment as well as consulting, maintenance and other agreements.

We have not included obligations under our pension and postretirement medical benefit plans in the contractual obligations table. Our most significant plan, the Yum Retirement Plan (the U.S. Plan), is a noncontributory defined benefit pension plan covering certain full-time U.S. salaried employees. Our funding policy with respect to the U.S. Plan is to contribute amounts necessary to satisfy minimum pension funding requirements plus such additional amounts from time to time as are determined to be appropriate to improve the U.S. Plan's funded status. The U.S. Plan's funded status is affected by many factors including discount rates and the performance of U.S. Plan assets. Based on current funding rules, we are not required to make minimum pension funding payments in 2007, but we may make discretionary contributions during the year based on our estimate of the U.S. Plan's expected September 30, 2007 funded status. During 2006, we made a \$23 million discretionary contribution to the U.S. Plan, none of which represented minimum funding requirements. At our September 30, 2006 measurement date, our pension plans in the U.S., which include the U.S. Plan and an unfunded supplemental executive plan, had a projected benefit obligation of \$864 million and plan assets of \$673 million.

The funding rules for our pension plans outside of the U.S. vary from country to country and depend on many factors including discount rates, performance of plan assets, local laws and tax regulations. Our most significant plans are in the U.K., including a plan for which we assumed full liability upon our purchase of the remaining fifty percent interest in our former Pizza Hut U.K. unconsolidated affiliate. During 2006, we made a discretionary contribution of approximately \$18 million to our KFC U.K. pension plan in anticipation of certain future funding requirements. Since our plan assets approximate our projected benefit obligation at year-end for this plan, we do not anticipate any significant further, near term funding. The projected benefit obligation of our Pizza Hut U.K. pension plan exceeds plan assets by approximately \$35 million. We anticipate taking steps to reduce this deficit in the near term, which could include a decision to partially





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or completely fund the deficit in 2007. However, given the level of cash flows from operations the Company anticipates generating in 2007, any funding decision would not materially impact our ability to maintain our planned levels of discretionary spending.

During 2006, Congress passed the Pension Protection Act of 2006 (the "Act") with the stated purpose of improving the funding of America's private pension plans. The Act introduces new funding requirements for defined benefit pension plans, introduces benefit limitations for certain under-funded plans and raises tax deduction limits for contributions. The Act applies to pension plan years beginning after December 31, 2007 and is applicable only to our U.S. Plan. We have preliminarily reviewed the provisions of the Act to determine the impact on the Company. Required funding under the Act will be dependent upon many factors including our U.S. Plan's future funded status as well as discretionary contributions we may choose to make. Based upon this preliminary review as well as the current funded status of the U.S. Plan relative to our level of annual operating cash flows, we do not believe that required contributions under the Act would materially impact our operating cash flows in any one given year.

Our postretirement plan is not required to be funded in advance, but is pay as you go. We made postretirement benefit payments of \$4 million in 2006. See Note 15 for further details about our pension and post-retirement plans.

We have excluded from the contractual obligations table payments we may make for: workers' compensation, employment practices liability, general liability, automobile liability and property losses (collectively property and casualty losses) for which we are self-insured; employee healthcare and long-term disability claims for which we are self-insured; and income taxes and associated interest we may pay upon audit by tax authorities of tax returns previously filed. The majority of our recorded liability for self-insured employee health, long-term disability and property and casualty losses represents estimated reserves for incurred claims that have yet to be filed or settled. We provide reserves for potential tax and associated interest exposures when we consider it probable that a taxing authority may take a sustainable position on a matter contrary to our position.

### **Off-Balance Sheet Arrangements**

We had provided approximately \$16 million of partial guarantees of two franchisee loan pools related primarily to the Company's historical refranchising programs and, to a lesser extent, franchisee development of new restaurants at December 30, 2006. In support of these guarantees, we posted letters of credit of \$4 million. We also provided a standby letter of credit of \$18 million, under which we could potentially be required to fund a portion of one of the franchisee loan pools. The total loans outstanding under these loan pools were approximately \$75 million at December 30, 2006.

Any funding under the guarantees or letters of credit would be secured by the franchisee loans and any related collateral. We believe that we have appropriately provided for our estimated probable exposures under these contingent liabilities. These provisions were primarily charged to net refranchising loss (gain). New loans added to the loan pools in 2006 were not significant.

Our unconsolidated affiliates have approximately \$29 million of short-term debt outstanding as of December 30, 2006, none of which is guaranteed by YUM.

### **Accounting Pronouncements Adopted in the Fourth Quarter of 2006**

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In the fourth quarter of 2006, we adopted Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement for the purpose of a materiality assessment. SAB 108 requires that registrants quantify a current year misstatement using an approach that considers both the impact of prior year misstatements that remain on the balance sheet and those that were recorded in the current year income statement. Historically, we quantified prior year misstatements and assessed materiality based on a current year income statement approach. The transition provisions of SAB 108 permitted the Company to adjust for the cumulative effect of uncorrected prior year misstatements that were not material to any prior periods under our historical income statement approach but that were material under the guidance in

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SAB 108 through retained earnings at the beginning of 2006. See Note 2 for further discussion on the impact of adopting SAB 108.

In the fourth quarter of 2006, we adopted the recognition and disclosure provisions of 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) (SFAS 158). SFAS 158 required the Company to recognize the funded status of its pension and post-retirement plans in the December 30, 2006 Consolidated Balance Sheet, with a corresponding adjustment to accumulated other comprehensive income, net of tax. Gains or losses and prior service costs or credits that arise in future years will be recognized as a component of other comprehensive income to the extent they have not been recognized as a component of net periodic benefit cost. The impact of adopting SFAS 158 has been included in the Company's December 30, 2006 Consolidated Balance Sheet. See Notes 2 and 15 for further discussion of the impact of adopting SFAS 158.

SFAS 158 also requires measurement of the funded status of pension and postretirement plans as of the date of a Company's fiscal year end effective in the year ended 2008. Certain of our plans currently have measurement dates that do not coincide with our fiscal year end and thus we will be required to change their measurement dates in 2008.

### **New Accounting Pronouncements Not Yet Adopted**

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, (FIN 48) an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 is effective for fiscal years beginning after December 15, 2006, the year beginning December 31, 2006 for the Company. FIN 48 requires that a position taken or expected to be taken in a tax return be recognized in the financial statements when it is more likely than not (i.e. a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Upon adoption, the cumulative effect of applying the recognition and measurement provisions of FIN 48, if any, shall be reflected as an adjustment to the opening balance of retained earnings. We do not currently anticipate that the adjustment to the opening balance of retained earnings we will record upon adoption of FIN 48 will materially impact our financial condition.

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

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

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities*, (SFAS 159). SFAS 159 provides companies with an option to report selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007, the year beginning December 30, 2007 for the Company. We are currently reviewing the provisions of SFAS 159 to determine any impact for the Company.



## Critical Accounting Policies and Estimates

Our reported results are impacted by the application of certain accounting policies that require us to make subjective or complex judgments. These judgments involve estimations of the effect of matters that are inherently uncertain and may significantly impact our quarterly or annual results of operations or financial condition. Changes in the estimates and judgments could significantly affect our results of operations, financial condition and cash flows in future years. A description of what we consider to be our most significant critical accounting policies follows.

### Impairment or Disposal of Long-Lived Assets

We evaluate our long-lived assets for impairment at the individual restaurant level except when there is an expectation that we will rebrand restaurants as a group. Restaurants held and used are evaluated for impairment on a semi-annual basis or whenever events or circumstances indicate that the carrying amount of a restaurant may not be recoverable (including a decision to close a restaurant or an offer to rebrand a restaurant or group of restaurants for less than the carrying value).

Our semi-annual impairment test includes those restaurants that have experienced two consecutive years of operating losses. Our semi-annual impairment evaluations require an estimation of cash flows over the remaining useful life of the primary asset of the restaurant, which can be for a period of over 20 years, and any terminal value. We limit assumptions about important factors such as sales growth and margin improvement to those that are supportable based upon our plans for the unit and actual results at comparable restaurants.

If the long-lived assets of a restaurant subject to our semi-annual test are not recoverable based upon forecasted, undiscounted cash flows, we write the assets down to their fair value. This fair value is determined by discounting the forecasted cash flows, including terminal value, of the restaurant at an appropriate rate. The discount rate used is our weighted average cost of capital plus a risk premium where deemed appropriate.

We often rebrand restaurants in groups and, therefore, perform such impairment evaluations at the group level. Forecasted cash flows in such instances consist of estimated holding period cash flows and the expected sales proceeds less applicable transaction costs. Expected sales proceeds are based on the most relevant of historical sales multiples or bids from buyers, and have historically been reasonably accurate estimations of the proceeds ultimately received.

See Note 2 for a further discussion of our policy regarding the impairment or disposal of long-lived assets.

### Impairment of Investments in Unconsolidated Affiliates

We record impairment charges related to an investment in an unconsolidated affiliate whenever events or circumstances indicate that a decrease in the fair value of an investment has occurred which is other than temporary. In addition, we evaluate our investments in unconsolidated affiliates for impairment when they have experienced two consecutive years of operating losses. The fair values of our investments in each of our unconsolidated affiliates are currently significantly in excess of their carrying values.

See Note 2 for a further discussion of our policy regarding the impairment of investments in unconsolidated affiliates.

Impairment of Goodwill and Indefinite-Lived Intangible Assets

We evaluate goodwill and indefinite-lived intangible assets for impairment on an annual basis or more often if an event occurs or circumstances change that indicates impairment might exist. Goodwill is evaluated for impairment through the comparison of fair value of our reporting units to their carrying values. Our reporting units are our operating segments in the U.S. and our business management units internationally (typically individual countries). Fair value is the price a willing buyer would pay for the reporting unit, and is generally estimated by discounting expected future cash flows from the reporting unit over twenty years plus an expected terminal value. The discount rate used in determining fair value is our weighted average cost of capital plus a risk premium where deemed appropriate.

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We have recorded intangible assets as a result of business acquisitions. These include trademark/brand intangible assets for KFC, LJS and A&W. We believe the value of a trademark/brand is derived from the royalty we avoid, in the case of Company stores, or receive, in the case of franchise stores, due to our ownership of the trademark/brand. We have determined that the KFC trademark/brand has an indefinite life and therefore it is not being amortized. Our impairment test for the KFC trademark/brand consists of a comparison of the fair value of the asset with its carrying amount. Future sales are the most important assumption in determining the fair value of the KFC trademark/brand.

In determining the fair value of our reporting units and the KFC trademark/brand, we limit assumptions about important factors such as sales growth, margin and other factors impacting the fair value calculation to those that are supportable based upon our plans. For 2006, there was no impairment of goodwill or the KFC trademark/brand.

We have certain intangible assets, such as the LJS and A&W trademark/brand intangible assets, franchise contract rights, reacquired franchise rights and favorable operating leases, which are amortized over their expected useful lives. We base the expected useful lives of our trademark/brand intangible assets on a number of factors including the competitive environment, our future development plans for the applicable Concept and the level of franchisee commitment to the Concept. We generally base the expected useful lives of our franchise contract rights on their respective contractual terms including renewals when appropriate. We base the expected useful lives of reacquired franchise rights over a period for which we believe it is reasonable that we will operate a Company restaurant in the trade area. We base the expected useful lives of our favorable operating leases on the remaining lease term.

Our amortizable intangible assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of the intangible asset may not be recoverable. An intangible asset that is deemed impaired is written down to its estimated fair value, which is based on discounted cash flows. For purposes of our impairment analysis, we update the cash flows that were initially used to value the amortizable intangible asset to reflect our current estimates and assumptions over the asset's future remaining life.

See Note 2 for a further discussion of our policies regarding goodwill and intangible assets.

### Allowances for Franchise and License Receivables/Lease Guarantees

We reserve a franchisee's or licensee's entire receivable balance based upon pre-defined aging criteria and upon the occurrence of other events that indicate that we may not collect the balance due. As a result of reserving using this methodology, we have an immaterial amount of receivables that are past due that have not been reserved for at December 30, 2006.

We have also issued certain guarantees as a result of assigning our interest in obligations under operating leases, primarily as a condition to the refranchising of certain Company restaurants. Such guarantees are subject to the requirements of SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" (SFAS 145). We recognize a liability for the fair value of such lease guarantees under SFAS 145 upon refranchising and upon any subsequent renewals of such leases when we remain contingently liable. The fair value of a guarantee is the estimated amount at which the liability could be settled in a current transaction between willing parties.

If payment on the guarantee becomes probable and estimable, we record a liability for our exposure under these lease assignments and guarantees. At December 30, 2006, we have recorded an immaterial liability for our exposure which we consider to be probable and estimable. The potential total exposure under such leases is significant, with \$336 million representing the present value, discounted at our pre-tax cost of



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debt, of the minimum payments of the assigned leases at December 30, 2006. Current franchisees are the primary lessees under the vast majority of these leases. We generally have cross-default provisions with these franchisees that would put them in default of their franchise agreement in the event of non-payment under the lease. We believe these cross-default provisions significantly reduce the risk that we will be required to make payments under these leases and, historically, we have not been required to make such payments in significant amounts.

See Note 2 for a further discussion of our policies regarding franchise and license operations.

See Note 22 for a further discussion of our lease guarantees.

#### Self-Insured Property and Casualty Losses

We record our best estimate of the remaining cost to settle incurred self-insured property and casualty losses. The estimate is based on the results of an independent actuarial study and considers historical claim frequency and severity as well as changes in factors such as our business environment, benefit levels, medical costs and the regulatory environment that could impact overall self-insurance costs. Additionally, a risk margin to cover unforeseen events that may occur over the several years it takes for claims to settle is included in our reserve, increasing our confidence level that the recorded reserve is adequate.

See Note 22 for a further discussion of our insurance programs.

#### Pension Plans

Certain of our employees are covered under defined benefit pension plans. The most significant of these plans are in the U.S. In accordance with our fourth quarter 2006 adoption of the recognition provisions of SFAS 158, we have recorded the under-funded status of \$191 million for these U.S. plans as a pension liability in our Consolidated Balance Sheet as of December 30, 2006. These U.S. plans had projected benefit obligations ( PBO ) of \$864 million and fair values of plan assets of \$673 million.

The PBO reflects the actuarial present value of all benefits earned to date by employees and incorporates assumptions as to future compensation levels. Due to the relatively long time frame over which benefits earned to date are expected to be paid, our PBO s are highly sensitive to changes in discount rates. For our U.S. plans, we measured our PBO using a discount rate of 5.95% at September 30, 2006. This discount rate was determined with the assistance of our independent actuary. The primary basis for our discount rate determination is a model that consists of a hypothetical portfolio of ten or more high-quality corporate debt instruments with cash flows that mirror our expected benefit payment cash flows under the plans. In considering possible bond portfolios, the model allows the bond cash flows for a particular year to exceed the expected benefit cash flows for that year. Such excesses are assumed to be reinvested at appropriate one-year forward rates and used to meet the benefit cash flows in a future year. The weighted average yield of this hypothetical portfolio was used to arrive at an appropriate discount rate. We also insure that changes in the discount rate as compared to the prior year are consistent with the overall change in prevailing market rates. A 50 basis point increase in this discount rate would have decreased our U.S. plans PBO by approximately \$71 million at our measurement dates. Conversely, a 50 basis point decrease in this discount rate would have increased our U.S. plans PBO by approximately \$77 million at our measurement dates.

The pension expense we will record in 2007 is also impacted by the discount rate we selected at our measurement dates. We expect pension expense for our U.S. plans to decrease approximately \$7 million to \$59 million in 2007. The decrease is primarily driven by a decrease in recognized actuarial loss of \$6 million in 2007. A 50 basis point change in our weighted average discount rate assumption at our measurement date would impact our 2007 U.S. pension expense by approximately \$13 million.

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The assumption we make regarding our expected long-term rates of return on plan assets also impacts our pension expense. Our estimated long-term rate of return on U.S. plan assets represents the weighted-average of historical returns for each asset category, adjusted for an assessment of current market conditions. Our expected long-term rate of return on U.S. plan assets at September 30, 2006 was 8.0%. We believe this rate is appropriate given the composition of our plan assets and historical market returns thereon. A one percentage point increase or decrease in our expected long-term rate of return on plan assets assumption would decrease or increase, respectively, our 2007 U.S. pension plan expense by approximately \$6 million.

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The losses our U.S. plan assets have experienced, along with a decrease in discount rates over time, have largely contributed to an unrecognized actuarial loss of \$216 million in the U.S. plans. For purposes of determining 2006 expense, our funded status was such that we recognized \$30 million of previously unrecognized actuarial loss. We will recognize approximately \$24 million of unrecognized actuarial loss in 2007. Given no change to our current assumptions, actuarial loss recognition will remain at an amount near that to be recognized in 2007 over the next few years before it begins to gradually decline.

See Note 15 for further discussion of our pension and post-retirement plans.

### Stock Options and Stock Appreciation Rights Expense

Compensation expense for stock options and stock appreciation rights ( SARs ) is estimated on the grant date using a Black-Scholes option pricing model. Our specific weighted-average assumptions for the risk-free interest rate, expected term, expected volatility and expected dividend yield are documented in Note 16. Additionally, under SFAS 123R we are required to estimate pre-vesting forfeitures for purposes of determining compensation expense to be recognized. Future expense amounts for any particular quarterly or annual period could be affected by changes in our assumptions or changes in market conditions.

In connection with our adoption of SFAS 123R, we determined that it was appropriate to group our awards into two homogeneous groups when estimating expected term and pre-vesting forfeitures. These groups consist of grants made primarily to restaurant-level employees under our Restaurant General Manager Stock Option Plan (the RGM Plan ) and grants made to executives under our other stock option plans. Historically, approximately 20% of total options granted have been made under the RGM Plan.

Grants under the RGM Plan typically cliff vest after four years and grants made to executives under our other stock option plans typically have a graded vesting schedule and vest 25% per year over four years. We use a single weighted-average expected term for our awards that have a graded vesting schedule as permitted by SFAS 123R. We reevaluate our expected term assumptions using historical exercise and post-vesting employment termination behavior on a regular basis. Based on the results of this analysis, we have determined that six years is an appropriate expected term for awards to both restaurant level employees and to executives.

Prior to the adoption of SFAS 123R in 2005 we have traditionally based expected volatility on Company specific historical stock data over the expected term of the option. Subsequent to adoption, we revaluated expected volatility, including consideration of both historical volatility of our stock as well as implied volatility associated with our traded options. Based on this analysis, our weighted average volatility used in the determination of fair value for 2006 grants was 31%.

Prior to our adoption of SFAS 123R in 2005 we recorded reductions in expense due to pre-vesting forfeitures as they occurred. In connection with the adoption of SFAS 123R we have estimated forfeitures based on historical data. Based on such data, we believe that approximately 45% of all awards granted under the RGM Plan will be forfeited and approximately 20% of all awards granted to above-store executives will be forfeited.

### Income Tax Valuation Allowances and Tax Reserves

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At December 30, 2006, we have a valuation allowance of \$342 million primarily to reduce our net operating loss and tax credit carryforward benefit of \$331 million, as well our other deferred tax assets, to amounts that will more likely than not be realized. The net operating loss and tax credit carryforwards exist in federal, state and foreign jurisdictions and have varying carryforward periods and restrictions on usage. The estimation of future taxable income in these jurisdictions and our resulting ability to utilize net operating loss and tax credit carryforwards can significantly change based on future events, including our determinations as to the feasibility of certain tax planning strategies. Thus, recorded valuation allowances may be subject to material future changes.

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As a matter of course, we are regularly audited by federal, state and foreign tax authorities. We provide reserves for potential exposures when we consider it probable that a taxing authority may take a sustainable position on a matter contrary to our position. We evaluate these reserves, including interest thereon, on a quarterly basis to insure that they have been appropriately adjusted for events, including audit settlements, that may impact our ultimate payment for such exposures.

See Note 20 for a further discussion of our income taxes and Note 22 for further discussion of certain proposed Internal Revenue Service adjustments.

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

The Company is exposed to financial market risks associated with interest rates, foreign currency exchange rates and commodity prices. In the normal course of business and in accordance with our policies, we manage these risks through a variety of strategies, which may include the use of derivative financial and commodity instruments to hedge our underlying exposures. Our policies prohibit the use of derivative instruments for trading purposes, and we have procedures in place to monitor and control their use.

#### Interest Rate Risk

We have a market risk exposure to changes in interest rates, principally in the United States. We attempt to minimize this risk and lower our overall borrowing costs through the utilization of derivative financial instruments, primarily interest rate swaps. These swaps are entered into with financial institutions and have reset dates and critical terms that match those of the underlying debt. Accordingly, any change in market value associated with interest rate swaps is offset by the opposite market impact on the related debt.

At December 30, 2006 and December 31, 2005, a hypothetical 100 basis point increase in short-term interest rates would result, over the following twelve-month period, in a reduction of approximately \$8 million and \$7 million, respectively, in income before income taxes. The estimated reductions are based upon the level of variable rate debt and assume no changes in the volume or composition of debt. In addition, the fair value of our derivative financial instruments at December 30, 2006 and December 31, 2005 would decrease approximately \$32 million and \$39 million, respectively. The fair value of our Senior Unsecured Notes at December 30, 2006 and December 31, 2005 would decrease approximately \$69 million and \$59 million, respectively. Fair value was determined by discounting the projected cash flows.

#### Foreign Currency Exchange Rate Risk

The combined International Division and China Division operating profits constitute approximately 48% of our operating profit in 2006, excluding unallocated income (expenses). In addition, the Company's net asset exposure (defined as foreign currency assets less foreign currency liabilities) totaled approximately \$1.4 billion as of December 30, 2006. Operating in international markets exposes the Company to movements in foreign currency exchange rates. The Company's primary exposures result from our operations in Asia-Pacific, Europe and the Americas. Changes in foreign currency exchange rates would impact the translation of our investments in foreign operations, the fair value of our foreign currency denominated financial instruments and our reported foreign currency denominated earnings and cash flows. For the fiscal year ended December 30, 2006, operating profit would have decreased \$78 million if all foreign currencies had uniformly weakened 10% relative to the U.S. dollar. The estimated reduction assumes no changes in sales volumes or local currency sales or input prices.

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We attempt to minimize the exposure related to our investments in foreign operations by financing those investments with local currency debt when practical. In addition, we attempt to minimize the exposure related to foreign currency denominated financial instruments by purchasing goods and services from third parties in local currencies when practical. Consequently, foreign currency denominated financial instruments consist primarily of intercompany short-term receivables and payables. At times, we utilize forward contracts to reduce our exposure related to these intercompany short-term receivables and payables. The notional amount and maturity dates of these contracts match those of the underlying receivables or payables such that our foreign currency exchange risk related to these instruments is eliminated.

### Commodity Price Risk

We are subject to volatility in food costs as a result of market risk associated with commodity prices. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. We manage our exposure to this risk primarily through pricing agreements as well as, on a limited basis, commodity future and option contracts. Commodity future and option contracts entered into for the fiscal years ended December 30, 2006, and December 31, 2005, did not significantly impact our financial position, results of operations or cash flows.

### **Cautionary Statements**

From time to time, in both written reports and oral statements, we present forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The statements include those identified by such words as may, will, expect, project, anticipate, believe, plan and other similar terminology. These forward-looking reflect our current expectations regarding future events and operating and financial performance and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to the Company and those specific to the industry, and could differ materially from expectations. Accordingly, you are cautioned not to place undue reliance on forward-looking statements.

Company risks and uncertainties include, but are not limited to, changes in effective tax rates; potential unfavorable variances between estimated and actual liabilities; our ability to secure distribution of products and equipment to our restaurants on favorable economic terms and our ability to ensure adequate supply of restaurant products and equipment in our stores; unexpected disruptions in our supply chain; effects and outcomes of any pending or future legal claims involving the Company; the effectiveness of operating initiatives and marketing and advertising and promotional efforts; our ability to continue to recruit and motivate qualified restaurant personnel; the ongoing financial viability of our franchisees and licensees; the success of our refranchising strategy; the success of our strategies for international development and operations; volatility of actuarially determined losses and loss estimates; and adoption of new or changes in accounting policies and practices including pronouncements promulgated by standard setting bodies.

Industry risks and uncertainties include, but are not limited to, economic and political conditions in the countries and territories where we operate, including effects of war and terrorist activities; new legislation and governmental regulations or changes in laws and regulations and the consequent impact on our business; new product and concept development by us and/or our food industry competitors; changes in commodity, labor, and other operating costs; changes in competition in the food industry; publicity which may impact our business and/or industry; severe weather conditions; volatility of commodity costs; increases in minimum wage and other operating costs; availability and cost of land and construction; consumer preferences or perceptions concerning the products of the Company and/or our competitors, spending patterns and demographic trends; political or economic instability in local markets and changes in currency exchange and interest rates; and the impact that any widespread illness or general health concern may have on our business and/or the economy of the countries in which we operate.

**Item 8. Financial Statements and Supplementary Data.**

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**Financial Statement Schedules**

No schedules are required because either the required information is not present or not present in amounts sufficient to require submission of the schedule, or because the information required is included in the above listed financial statements or notes thereto.



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### Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

YUM! Brands, Inc.:

We have audited the accompanying consolidated balance sheets of YUM! Brands, Inc. and Subsidiaries ( YUM ) as of December 30, 2006 and December 31, 2005, and the related consolidated statements of income, cash flows and shareholders' equity and comprehensive income for each of the years in the three-year period ended December 30, 2006. These consolidated financial statements are the responsibility of YUM's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of YUM as of December 30, 2006 and December 31, 2005, and the results of its operations and its cash flows for each of the years in the three-year period ended December 30, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of YUM's internal control over financial reporting as of December 30, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 28, 2007 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

As discussed in Notes 2 and 16 to the consolidated financial statements, YUM adopted the provisions of the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 123R (Revised 2004), Share-Based Payment, and changed its method for accounting for share-based payments in 2005.

As discussed in Note 2 to the consolidated financial statements, YUM changed its method of quantifying errors in 2006. Also, as discussed in Notes 2 and 15 to the consolidated financial statements, YUM adopted the provisions of the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132 (R), in 2006.

/s/ KPMG LLP

Louisville, Kentucky

February 28, 2007

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### Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

YUM! Brands, Inc.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, appearing under Item 9A, that YUM! Brands, Inc. and Subsidiaries ( "YUM" ) maintained effective internal control over financial reporting as of December 30, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). YUM's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that YUM maintained effective internal control over financial reporting as of December 30, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, YUM maintained, in all material respects, effective internal control over financial reporting as of December 30, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of YUM as of December 30, 2006 and December 31, 2005, and the related consolidated statements of income, cash flows and shareholders' equity and comprehensive income for each of the years in the three-year period ended December 30, 2006, and our report dated February 28, 2007, expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Louisville, Kentucky

February 28, 2007

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**Consolidated Statements of Income**

YUM! Brands, Inc. and Subsidiaries

Fiscal years ended December 30, 2006, December 31, 2005 and December 25, 2004

(in millions, except per share data)

	2006	2005	2004
<b>Revenues</b>			
Company sales	\$ 8,365	\$ 8,225	\$ 7,992
Franchise and license fees	1,196	1,124	1,019
Total revenues	9,561	9,349	9,011
<b>Costs and Expenses, Net</b>			
Company restaurants			
Food and paper	2,549	2,584	2,538
Payroll and employee benefits	2,142	2,171	2,112
Occupancy and other operating expenses	2,403	2,315	2,183
	7,094	7,070	6,833
General and administrative expenses	1,187	1,158	1,056
Franchise and license expenses	35	33	26
Closures and impairment expenses	59	62	38
Refranchising (gain) loss	(24 )	(43 )	(12 )
Other (income) expense	(51 )	(80 )	(55 )
Wrench litigation (income) expense		(2 )	(14 )
AmeriServe and other charges (credits)	(1 )	(2 )	(16 )
Total costs and expenses, net	8,299	8,196	7,856
<b>Operating Profit</b>	1,262	1,153	1,155
Interest expense, net	154	127	129
<b>Income before Income Taxes</b>	1,108	1,026	1,026
Income tax provision	284	264	286
<b>Net Income</b>	\$ 824	\$ 762	\$ 740
<b>Basic Earnings Per Common Share</b>	\$ 3.02	\$ 2.66	\$ 2.54
<b>Diluted Earnings Per Common Share</b>	\$ 2.92	\$ 2.55	\$ 2.42
<b>Dividends Declared Per Common Share</b>	\$ 0.865	\$ 0.445	\$ 0.30

See accompanying Notes to Consolidated Financial Statements.

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Consolidated Statements of Cash Flows

YUM! Brands, Inc. and Subsidiaries

Fiscal years ended December 30, 2006, December 31, 2005 and December 25, 2004

(in millions)

	2006	2005	2004
<b>Cash Flows Operating Activities</b>			
Net income	\$ 824	\$ 762	\$ 740
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	479	469	448
Closures and impairment expenses	59	62	38
Refranchising (gain) loss	(24 )	(43 )	(12 )
Contributions to defined benefit pension plans	(43 )	(74 )	(55 )
Deferred income taxes	(30 )	(101 )	142
Equity income from investments in unconsolidated affiliates	(51 )	(51 )	(54 )
Distributions of income received from unconsolidated affiliates	32	44	55
Excess tax benefits from share-based compensation	(62 )	(87 )	
Share-based compensation expense	65	62	3
Other non-cash charges and credits, net	101	78	83
Changes in operating working capital, excluding effects of acquisitions and dispositions:			
Accounts and notes receivable	24	(1 )	(39 )
Inventories	(3 )	(4 )	(7 )
Prepaid expenses and other current assets	(33 )	78	(5 )
Accounts payable and other current liabilities	(46 )	(10 )	(20 )
Income taxes payable	10	54	(131 )
Net change in operating working capital	(48 )	117	(202 )
<b>Net Cash Provided by Operating Activities</b>	<b>1,302</b>	<b>1,238</b>	<b>1,186</b>
<b>Cash Flows Investing Activities</b>			
Capital spending	(614 )	(609 )	(645 )
Proceeds from refranchising of restaurants	257	145	140
Acquisition of remaining interest in unconsolidated affiliate, net of cash assumed	(178 )		
Acquisition of restaurants from franchisees	(7 )	(2 )	(38 )
Short-term investments	39	12	(36 )
Sales of property, plant and equipment	57	81	52
Other, net	(30 )	28	(14 )
<b>Net Cash Used in Investing Activities</b>	<b>(476 )</b>	<b>(345 )</b>	<b>(541 )</b>
<b>Cash Flows Financing Activities</b>			
Proceeds from issuance of long-term debt	300		
Repayments of long-term debt	(211 )	(14 )	(371 )
Short-term borrowings by original maturity			
More than three months proceeds	236		
More than three months payments	(54 )		
Three months or less, net	4	(34 )	
Revolving credit facilities, three months or less, net	(23 )	160	19
Repurchase shares of common stock	(983 )	(1,056 )	(569 )
Excess tax benefit from share-based compensation	62	87	
Employee stock option proceeds	142	148	200
Dividends paid on common shares	(144 )	(123 )	(58 )
Other, net	(2 )		
<b>Net Cash Used in Financing Activities</b>	<b>(673 )</b>	<b>(832 )</b>	<b>(779 )</b>
<b>Effect of Exchange Rate on Cash and Cash Equivalents</b>	<b>8</b>	<b>1</b>	<b>4</b>
<b>Net (Decrease) Increase in Cash and Cash Equivalents</b>	<b>161</b>	<b>62</b>	<b>(130 )</b>
<b>Net Increase in Cash and Cash Equivalents of Mainland China for December 2004</b>		<b>34</b>	
<b>Cash and Cash Equivalents Beginning of Year</b>	<b>158</b>	<b>62</b>	<b>192</b>
<b>Cash and Cash Equivalents End of Year</b>	<b>\$ 319</b>	<b>\$ 158</b>	<b>\$ 62</b>

See accompanying Notes to Consolidated Financial Statements.

**Consolidated Balance Sheets**

YUM! Brands, Inc. and Subsidiaries

December 30, 2006 and December 31, 2005

(in millions)

	2006	2005
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 319	\$ 158
Short-term investments	6	43
Accounts and notes receivable, less allowance: \$18 in 2006 and \$23 in 2005	220	236
Inventories	93	85
Prepaid expenses and other current assets	132	75
Deferred income taxes	57	181
Advertising cooperative assets, restricted	74	77
<b>Total Current Assets</b>	<b>901</b>	<b>855</b>
Property, plant and equipment, net	3,631	3,356
Goodwill	662	538
Intangible assets, net	347	330
Investments in unconsolidated affiliates	138	173
Other assets	369	320
Deferred income taxes	305	225
<b>Total Assets</b>	<b>\$ 6,353</b>	<b>\$ 5,797</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable and other current liabilities	\$ 1,386	\$ 1,256
Income taxes payable	37	79
Short-term borrowings	227	211
Advertising cooperative liabilities	74	77
<b>Total Current Liabilities</b>	<b>1,724</b>	<b>1,623</b>
Long-term debt	2,045	1,649
Other liabilities and deferred credits	1,147	1,076
<b>Total Liabilities</b>	<b>4,916</b>	<b>4,348</b>
<b>Shareholders' Equity</b>		
Preferred stock, no par value, 250 shares authorized; no shares issued		
Common stock, no par value, 750 shares authorized; 265 shares and 278 shares issued in 2006 and 2005, respectively		
Retained earnings	1,593	1,619
Accumulated other comprehensive loss	(156 )	(170 )
<b>Total Shareholders' Equity</b>	<b>1,437</b>	<b>1,449</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 6,353</b>	<b>\$ 5,797</b>

See accompanying Notes to Consolidated Financial Statements.

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## Consolidated Statements of Shareholders' Equity and Comprehensive Income

YUM! Brands, Inc. and Subsidiaries

Fiscal years ended December 30, 2006, December 31, 2005 and December 25, 2004

(in millions, except per share data)

	Issued Common Stock		Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount			
<b>Balance at December 27, 2003</b>	292	\$ 916	\$ 414	\$ (210)	\$ 1,120
Net income			740		740
Foreign currency translation adjustment arising during the period				73	73
Minimum pension liability adjustment (net of tax impact of \$3 million)				6	6
Comprehensive Income					819
Dividends declared on common shares (\$0.30 per common share)			(87)		(87)
Repurchase of shares of common stock	(14)	(569)			(569)
Employee stock option exercises (includes tax impact of \$102 million)	12	302			302
Compensation-related events		10			10
<b>Balance at December 25, 2004</b>	290	\$ 659	\$ 1,067	\$ (131)	\$ 1,595
Net income			762		762
Foreign currency translation adjustment arising during the period				(31)	(31)
Foreign currency translation adjustment included in net income				6	6
Minimum pension liability adjustment (net of tax impact of \$8 million)				(15)	(15)
Net unrealized gain on derivative instruments (net of tax impact of \$1 million)				1	1
Comprehensive Income					723
Dividends declared on common shares (\$0.445 per common share)			(129)		(129)
China December 2004 net income			6		6
Repurchase of shares of common stock	(21)	(969)	(87)		(1,056)
Employee stock option exercises (includes tax impact of \$94 million)	9	242			242
Compensation-related events		68			68
<b>Balance at December 31, 2005</b>	278	\$	\$ 1,619	\$ (170)	\$ 1,449
Adjustment to initially apply SAB No. 108			100		100
Net income			824		824
Foreign currency translation adjustment arising during the period (includes tax impact of \$13 million)				59	59
Minimum pension liability adjustment (net of tax impact of \$11 million)				17	17
Net unrealized gain on derivative instruments (net of tax impact of \$3 million)				5	5
Comprehensive Income					905
Adjustment to initially apply SFAS No. 158 (net of tax impact of \$37 million)				(67)	(67)
Dividends declared on common shares (\$0.865 per common share)			(234)		(234)
Repurchase of shares of common stock	(20)	(284)	(716)		(1,000)
Employee stock option exercises (includes tax impact of \$68 million)	7	210			210
Compensation-related events		74			74
<b>Balance at December 30, 2006</b>	265	\$	\$ 1,593	\$ (156)	\$ 1,437

See accompanying Notes to Consolidated Financial Statements.



## Notes to Consolidated Financial Statements

(Tabular amounts in millions, except share data)

### Note 1 Description of Business

YUM! Brands, Inc. and Subsidiaries (collectively referred to as "YUM" or the "Company") comprises the worldwide operations of KFC, Pizza Hut, Taco Bell and since May 7, 2002, Long John Silver's ("LJS") and A&W All-American Food Restaurants ("A&W") (collectively the "Concepts"), which were added when we acquired Yorkshire Global Restaurants, Inc. ("YGR"). YUM is the world's largest quick service restaurant company based on the number of system units, with more than 34,000 units of which approximately 42% are located outside the U.S. in more than 100 countries and territories. YUM was created as an independent, publicly-owned company on October 6, 1997 (the "Spin-off Date") via a tax-free distribution by our former parent, PepsiCo, Inc. ("PepsiCo"), of our Common Stock (the "Spin-off") to its shareholders. References to YUM throughout these Consolidated Financial Statements are made using the first person notations of "we," "us" or "our."

Through our widely-recognized Concepts, we develop, operate, franchise and license a system of both traditional and non-traditional quick service restaurants. Each Concept has proprietary menu items and emphasizes the preparation of food with high quality ingredients as well as unique recipes and special seasonings to provide appealing, tasty and attractive food at competitive prices. Our traditional restaurants feature dine-in, carryout and, in some instances, drive-thru or delivery service. Non-traditional units, which are principally licensed outlets, include express units and kiosks which have a more limited menu and operate in non-traditional locations like airports, gasoline service stations, convenience stores, stadiums, amusement parks and colleges, where a full-scale traditional outlet would not be practical or efficient. We also operate multibrand units, where two or more of our Concepts are operated in a single unit. In addition, we continue to pursue the multibrand combination of Pizza Hut and WingStreet, a flavored chicken wings concept we have developed.

In 2005, we began reporting information for our international business in two separate operating segments as a result of changes to our management reporting structure. The China Division includes mainland China ("China"), Thailand and KFC Taiwan, and the International Division includes the remainder of our international operations. While this reporting change did not impact our consolidated results, segment information for 2004 was restated to be consistent with the current period presentation.

Beginning in 2005, we also changed the China business reporting calendar to more closely align the timing of the reporting of its results of operations with our U.S. business. Previously our China business, like the rest of our international businesses, closed one month (or one period for certain of our international businesses) earlier than YUM's period end date to facilitate consolidated reporting. To maintain comparability of our consolidated results of operations, amounts related to our China business for December 2004 have not been reflected in our Consolidated Statements of Income and net income for the China business for the one month period ended December 31, 2004 was recognized as an adjustment directly to consolidated retained earnings in the year ended December 31, 2005. Our consolidated results of operations for the years ended December 30, 2006 and December 31, 2005 both include the results of operations of the China business for the months of January through December. Our consolidated results of operations for the year ended December 25, 2004 continue to include the results of operations of the China business for the months of December 2003 through November 2004 as previously reported.

For the month of December 2004 the China business had revenues of \$79 million and net income of \$6 million. As mentioned previously, neither of these amounts is included in our Consolidated Statement of Income for the year ended December 31, 2005 and the net income figure was credited directly to retained earnings in the first quarter of 2005. Net income for the month of December 2004 was negatively impacted by costs incurred in preparation of opening a significant number of new stores in early 2005 as well as increased advertising expense, all of which was recorded in December's results of operations. Additionally, the net increase in cash for the China business in December 2004 has been presented as a single line item on our Consolidated Statement of Cash Flows for the year ended December 31, 2005. The \$34 million net increase in cash was primarily attributable to short-term



borrowings for working capital purposes, a majority of which were repaid prior to the end of the China business first quarter of 2006.

## Note 2 - Summary of Significant Accounting Policies

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

**Principles of Consolidation and Basis of Preparation.** Intercompany accounts and transactions have been eliminated. Certain investments in businesses that operate our Concepts are accounted for by the equity method. Our lack of majority voting rights precludes us from controlling these affiliates, and thus we do not consolidate these affiliates. Our share of the net income or loss of those unconsolidated affiliates is included in other (income) expense.

We participate in various advertising cooperatives with our franchisees and licensees established to collect and administer funds contributed for use in advertising and promotional programs designed to increase sales and enhance the reputation of the Company and its franchise owners. Contributions to the advertising cooperatives are required for both company operated and franchise restaurants and are generally based on a percent of restaurant sales. In certain of these cooperatives we possess majority voting rights, and thus control and consolidate the cooperatives. We report all assets and liabilities of these advertising cooperatives that we consolidate as advertising cooperative assets, restricted and advertising cooperative liabilities in the Consolidated Balance Sheet. The advertising cooperative assets, consisting primarily of cash received from franchisees and accounts receivable from franchisees, can only be used for selected purposes and are considered restricted. The advertising cooperative liabilities represent the corresponding obligation arising from the receipt of the contributions to purchase advertising and promotional programs. As the contributions to these cooperatives are designated and segregated for advertising, we act as an agent for the franchisees and licensees with regard to these contributions. Thus, in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 45, Accounting for Franchise Fee Revenue, we do not reflect franchisee and licensee contributions to these cooperatives in our Consolidated Statements of Income or Consolidated Statements of Cash Flows.

In 2004, we adopted Financial Accounting Standards Board ( FASB ) Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 ( FIN 46R ). FIN 46R addresses the consolidation of an entity whose equity holders either (a) have not provided sufficient equity at risk to allow the entity to finance its own activities or (b) do not possess certain characteristics of a controlling financial interest. FIN 46R requires the consolidation of such an entity, known as a variable interest entity ( VIE ), by the primary beneficiary of the entity. The primary beneficiary is the entity, if any, that is obligated to absorb a majority of the risk of loss from the VIE s activities, entitled to receive a majority of the VIE s residual returns, or both. FIN 46R excludes from its scope businesses (as defined by FIN 46R) unless certain conditions exist.

The principal entities in which we possess a variable interest include franchise entities, including our unconsolidated affiliates described above. We do not possess any ownership interests in franchise entities except for our investments in various unconsolidated affiliates accounted for under the equity method. Additionally, we generally do not provide financial support to franchise entities in a typical franchise relationship.

We also possess variable interests in certain purchasing cooperatives we have formed along with representatives of the franchisee groups of each of our Concepts. These purchasing cooperatives were formed for the purpose of purchasing certain restaurant products and equipment in the U.S. Our equity ownership in each cooperative is generally proportional to our percentage ownership of the U.S. system units for the Concept. We account for our investments in these purchasing cooperatives using the cost method, under which our recorded balances were not significant at December 30, 2006 or December 31, 2005.



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As a result of the adoption of FIN 46R, we have not consolidated any franchise entities, purchasing cooperatives or other entities.

**Fiscal Year.** Our fiscal year ends on the last Saturday in December and, as a result, a 53rd week is added every five or six years. Fiscal year 2005 included 53 weeks. The first three quarters of each fiscal year consist of 12 weeks and the fourth quarter consists of 16 weeks in fiscal years with 52 weeks and 17 weeks in fiscal years with 53 weeks. In fiscal year 2005, the 53rd week added \$96 million to total revenues and \$23 million to total operating profit in our Consolidated Statement of Income. Our subsidiaries operate on similar fiscal calendars with period or month end dates suited to their businesses. The subsidiaries' period end dates are within one week of YUM's period end date with the exception of all of our international businesses except China. The international businesses except China close one period or one month earlier to facilitate consolidated reporting.

**Reclassifications.** We have reclassified certain items in the accompanying Consolidated Financial Statements and Notes thereto for prior periods to be comparable with the classification for the fiscal year ended December 30, 2006. These reclassifications had no effect on previously reported net income.

The most significant reclassification we made was related to the presentation of deferred taxes on our Consolidated Balance Sheet at December 31, 2005. Previously, deferred tax assets and liabilities were netted for all tax jurisdictions outside of the U.S. Due to the implementation of new tax accounting software, we netted our deferred tax assets and liabilities at the individual tax jurisdiction level outside the U.S. at December 30, 2006. We reclassified certain amounts on our Consolidated Balance Sheet at December 31, 2005 to be consistent with this presentation which resulted in an increase to both current deferred income tax assets and liabilities of \$18 million and an increase to both long term deferred income tax assets and liabilities of \$87 million.

**Franchise and License Operations.** We execute franchise or license agreements for each unit which set out the terms of our arrangement with the franchisee or licensee. Our franchise and license agreements typically require the franchisee or licensee to pay an initial, non-refundable fee and continuing fees based upon a percentage of sales. Subject to our approval and their payment of a renewal fee, a franchisee may generally renew the franchise agreement upon its expiration.

We incur expenses that benefit both our franchise and license communities and their representative organizations and our Company operated restaurants. These expenses, along with other costs of servicing of franchise and license agreements are charged to general and administrative ( G&A ) expenses as incurred. Certain direct costs of our franchise and license operations are charged to franchise and license expenses. These costs include provisions for estimated uncollectible fees, franchise and license marketing funding, amortization expense for franchise related intangible assets and certain other direct incremental franchise and license support costs.

We monitor the financial condition of our franchisees and licensees and record provisions for estimated losses on receivables when we believe that our franchisees or licensees are unable to make their required payments. While we use the best information available in making our determination, the ultimate recovery of recorded receivables is also dependent upon future economic events and other conditions that may be beyond our control. Net provisions for uncollectible franchise and license receivables of \$2 million, \$3 million and \$1 million were included in franchise and license expense in 2006, 2005 and 2004, respectively.

**Revenue Recognition.** Our revenues consist of sales by Company operated restaurants and fees from our franchisees and licensees. Revenues from Company operated restaurants are recognized when payment is tendered at the time of sale. We recognize initial fees received from a franchisee or licensee as revenue when we have performed substantially all initial services required by the franchise or license agreement, which is generally upon the opening of a store. We recognize continuing fees based upon a percentage of franchisee and licensee sales as earned. We

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recognize renewal fees when a renewal agreement with a franchisee or licensee becomes effective. We include initial fees collected upon the sale of a restaurant to a franchisee in refranchising (gain) loss.

**Direct Marketing Costs.** We charge direct marketing costs to expense ratably in relation to revenues over the year in which incurred and, in the case of advertising production costs, in the year the advertisement is first shown. Deferred direct marketing costs, which are classified as prepaid expenses, consist of media and related advertising production costs which will generally be used for the first time in the next fiscal year and have historically not been significant. To the extent we participate in advertising cooperatives, we expense our contributions as incurred. Our advertising expenses were \$492 million, \$497 million and \$458 million in 2006, 2005 and 2004, respectively. We report substantially all of our direct marketing costs in occupancy and other operating expenses.

**Research and Development Expenses.** Research and development expenses, which we expense as incurred, are reported in G&A expenses. Research and development expenses were \$33 million, \$33 million and \$26 million in 2006, 2005 and 2004, respectively.

**Impairment or Disposal of Long-Lived Assets.** In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ( SFAS 144 ), we review our long-lived assets related to each restaurant to be held and used in the business, including any allocated intangible assets subject to amortization, semi-annually for impairment, or whenever events or changes in circumstances indicate that the carrying amount of a restaurant may not be recoverable. We evaluate restaurants using a two-year history of operating losses as our primary indicator of potential impairment. Based on the best information available, we write down an impaired restaurant to its estimated fair market value, which becomes its new cost basis. We generally measure estimated fair market value by discounting estimated future cash flows. In addition, when we decide to close a restaurant it is reviewed for impairment and depreciable lives are adjusted based on the expected disposal date. The impairment evaluation is based on the estimated cash flows from continuing use through the expected disposal date plus the expected terminal value.

We account for exit or disposal activities, including store closures, in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* ( SFAS 146 ). Store closure costs include costs of disposing of the assets as well as other facility-related expenses from previously closed stores. These store closure costs are generally expensed as incurred. Additionally, at the date we cease using a property under an operating lease, we record a liability for the net present value of any remaining lease obligations, net of estimated sublease income, if any. Any subsequent adjustments to that liability as a result of lease termination or changes in estimates of sublease income are recorded in store closure costs. To the extent we sell assets, primarily land, associated with a closed store, any gain or loss upon that sale is also recorded in store closure costs (income).

Refranchising (gain) loss includes the gains or losses from the sales of our restaurants to new and existing franchisees and the related initial franchise fees, reduced by transaction costs. In executing our refranchising initiatives, we most often offer groups of restaurants. We classify restaurants as held for sale and suspend depreciation and amortization when (a) we make a decision to refranchise; (b) the stores can be immediately removed from operations; (c) we have begun an active program to locate a buyer; (d) significant changes to the plan of sale are not likely; and (e) the sale is probable within one year. We recognize estimated losses on refranchisings when the restaurants are classified as held for sale. We also recognize as refranchising loss impairment associated with stores we have offered to refranchise for a price less than their carrying value, but do not believe have met the criteria to be classified as held for sale. We recognize gains on restaurant refranchisings when the sale transaction closes, the franchisee has a minimum amount of the purchase price in at-risk equity, and we are satisfied that the franchisee can meet its financial obligations. If the criteria for gain recognition are not met, we defer the gain to the extent we have a remaining financial exposure in connection with the sales transaction. Deferred gains are recognized when the gain recognition criteria are met or as our financial exposure is reduced. When we make a decision to retain a store, or group of stores, previously held for sale, we revalue the store at the lower of its (a) net book value at our original sale decision date less normal depreciation and amortization that would have been recorded during the period held for sale or (b) its current fair market value. This value becomes the store's new cost basis. We record any difference between the store's carrying amount and its new cost basis to refranchising gain (loss).

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Considerable management judgment is necessary to estimate future cash flows, including cash flows from continuing use, terminal value, sublease income and refranchising proceeds. Accordingly, actual results could vary significantly from our estimates.

**Impairment of Investments in Unconsolidated Affiliates.** We record impairment charges related to an investment in an unconsolidated affiliate whenever events or circumstances indicate that a decrease in the fair value of an investment has occurred which is other than temporary. In addition, we evaluate our investments in unconsolidated affiliates for impairment when they have experienced two consecutive years of operating losses. We recorded no impairment associated with our investments in unconsolidated affiliates during the years ended December 30, 2006, December 31, 2005 and December 25, 2004.

Considerable management judgment is necessary to estimate future cash flows. Accordingly, actual results could vary significantly from our estimates.

**Guarantees.** We account for certain guarantees in accordance with FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*, an interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34 ( *FIN 45* ). *FIN 45* elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. *FIN 45* also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of certain obligations undertaken.

We have also issued guarantees as a result of assigning our interest in obligations under operating leases as a condition to the refranchising of certain Company restaurants. Such guarantees are subject to the requirements of SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections* ( *SFAS 145* ). We recognize a liability for the fair value of such lease guarantees under SFAS 145 upon refranchising and upon any subsequent renewals of such leases when we remain contingently liable. The related expense in both instances is included in refranchising gain (loss).

**Cash and Cash Equivalents.** Cash equivalents represent funds we have temporarily invested (with original maturities not exceeding three months) as part of managing our day-to-day operating cash receipts and disbursements.

**Inventories.** We value our inventories at the lower of cost (computed on the first-in, first-out method) or net realizable value.

**Property, Plant and Equipment.** We state property, plant and equipment at cost less accumulated depreciation and amortization and valuation allowances. We calculate depreciation and amortization on a straight-line basis over the estimated useful lives of the assets as follows: 5 to 25 years for buildings and improvements, 3 to 20 years for machinery and equipment and 3 to 7 years for capitalized software costs. As discussed above, we suspend depreciation and amortization on assets related to restaurants that are held for sale.

**Leases and Leasehold Improvements.** We account for our leases in accordance with SFAS No. 13, *Accounting for Leases* and other related authoritative guidance. When determining the lease term, we often include option periods for which failure to renew the lease imposes a penalty on the Company in such an amount that a renewal appears, at the inception of the lease, to be reasonably assured. The primary penalty to which we are subject is the economic detriment associated with the existence of leasehold improvements which might be impaired if we choose not to continue the use of the leased property.



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In 2004, we recorded an adjustment to correct instances where our leasehold improvements were not being depreciated over the shorter of their useful lives or the term of the lease, including options in some instances, over which we were recording rent expense, including escalations, on a straight line basis. The cumulative adjustment, primarily through increased U.S. depreciation expense, totaled \$11.5 million (\$7 million after tax). The portion of this adjustment that related to 2004 was approximately \$3 million. As the portion of the adjustment recorded that

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was a correction of errors of amounts reported in our prior period financial statements was not material to any of those prior period financial statements, the entire adjustment was recorded in the 2004 Consolidated Financial Statements and no adjustment was made to any prior period financial statements.

We record rent expense for leases that contain scheduled rent increases on a straight-line basis over the lease term, including any option periods considered in the determination of that lease term. Contingent rentals are generally based on sales levels in excess of stipulated amounts, and thus are not considered minimum lease payments and are included in rent expense as they accrue. We generally do not receive leasehold improvement incentives upon opening a store that is subject to a lease.

Prior to fiscal year 2006, we capitalized rent while we were constructing a restaurant even if such construction period was subject to a rent holiday. Such capitalized rent was then expensed on a straight-line basis over the remaining term of the lease upon opening of the restaurant. Effective January 1, 2006 as required by FASB Staff Position No. 13-1, *Accounting for Rental Costs Incurred during a Construction Period* ( FSP 13-1 ), we began expensing rent associated with leased land or buildings for construction periods whether rent was paid or we were subject to a rent holiday. The adoption of FSP 13-1 did not significantly impact our results of operations in 2006 and we do not anticipate significant future impact.

**Internal Development Costs and Abandoned Site Costs.** We capitalize direct costs associated with the site acquisition and construction of a Company unit on that site, including direct internal payroll and payroll-related costs. Only those site-specific costs incurred subsequent to the time that the site acquisition is considered probable are capitalized. If we subsequently make a determination that a site for which internal development costs have been capitalized will not be acquired or developed, any previously capitalized internal development costs are expensed and included in G&A expenses.

**Goodwill and Intangible Assets.** The Company accounts for acquisitions of restaurants from franchisees and other acquisitions of businesses that may occur from time to time in accordance with SFAS No. 141, *Business Combinations* ( SFAS 141 ). Goodwill in such acquisitions represents the excess of the cost of a business acquired over the net of the amounts assigned to assets acquired, including identifiable intangible assets, and liabilities assumed. SFAS 141 specifies criteria to be used in determining whether intangible assets acquired in a business combination must be recognized and reported separately from goodwill. We base amounts assigned to goodwill and other identifiable intangible assets on independent appraisals or internal estimates.

The Company accounts for recorded goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* ( SFAS 142 ). In accordance with SFAS 142, we do not amortize goodwill and indefinite-lived intangible assets. We evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, we amortize the intangible asset prospectively over its estimated remaining useful life. Amortizable intangible assets are amortized on a straight-line basis.

In accordance with the requirements of SFAS 142, goodwill has been assigned to reporting units for purposes of impairment testing. Our reporting units are our operating segments in the U.S. (see Note 21) and our business management units internationally (typically individual countries). We evaluate goodwill and indefinite lived assets for impairment on an annual basis or more often if an event occurs or circumstances change that indicate impairments might exist. Goodwill impairment tests consist of a comparison of each reporting unit's fair value with its carrying value. The fair value of a reporting unit is an estimate of the amount for which the unit as a whole could be sold in a current transaction between willing parties. We generally estimate fair value based on discounted cash flows. If the carrying value of a reporting unit exceeds its fair value, goodwill is written down to its implied fair value. We have selected the beginning of our fourth quarter as the date on which to perform our ongoing annual impairment test for goodwill. For 2006, 2005 and 2004, there was no impairment of goodwill identified during our annual impairment testing.



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For indefinite-lived intangible assets, our impairment test consists of a comparison of the fair value of an intangible asset with its carrying amount. Fair value is an estimate of the price a willing buyer would pay for the intangible asset and is generally estimated by discounting the expected future cash flows associated with the intangible asset. We also perform our annual test for impairment of our indefinite-lived intangible assets at the beginning of our fourth quarter. No impairment of indefinite-lived intangible assets was recorded in 2006, 2005 or 2004.

Our amortizable intangible assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of the intangible asset may not be recoverable. An intangible asset that is deemed impaired is written down to its estimated fair value, which is based on discounted cash flows. For purposes of our impairment analysis, we update the cash flows that were initially used to value the amortizable intangible asset to reflect our current estimates and assumptions over the asset's future remaining life.

**Share-Based Employee Compensation.** In the fourth quarter 2005, the Company adopted SFAS No. 123 (Revised 2004), Share-Based Payment ( SFAS 123R ), which replaced SFAS No. 123 Accounting for Stock-Based Compensation ( SFAS 123 ), superseded APB 25, Accounting for Stock Issued to Employees and related interpretations and amended SFAS No. 95, Statement of Cash Flows. The provisions of SFAS 123R are similar to those of SFAS 123, however, SFAS 123R requires all new, modified and unvested share-based payments to employees, including grants of employee stock options and stock appreciation rights ( SARs ), be recognized in the financial statements as compensation cost over the service period based on their fair value on the date of grant. Compensation cost is recognized over the service period on a straight-line basis for the fair value of awards that actually vest.

We adopted SFAS 123R using the modified retrospective application transition method effective September 4, 2005, the beginning of our 2005 fourth quarter. As permitted by SFAS 123R, we applied the modified retrospective application transition method to the beginning of the fiscal year of adoption (our fiscal year 2005). As such, the results for the first three fiscal quarters of 2005 were required to be adjusted to recognize the compensation cost previously reported in the pro forma footnote disclosures under the provisions of SFAS 123. However, years prior to 2005 were not restated.

The adoption of SFAS 123R resulted in a decrease in operating profit, the associated income tax benefits and a decrease in net income as shown below. Additionally, cash flows from operating activities decreased \$62 million and \$87 million in 2006 and 2005, respectively, and cash flows from financing activities increased \$62 million and \$87 million in 2006 and 2005, respectively.

	2006	2005
Payroll and employee benefits	\$ 9	\$ 10
General and administrative expense	51	48
Operating profit	60	58
Income tax benefit	(21)	(20)
Net income impact	\$ 39	\$ 38

Prior to 2005, all share-based payments were accounted for under the recognition and measurement principles of APB 25 and its related interpretations. Accordingly, no expense was reflected in the Consolidated Statements of Income for stock options, as all stock options granted had an exercise price equal to the market value of our underlying common stock on the date of grant. The following table illustrates the pro forma effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to all share-based payments for 2004.

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	2004
Net Income, as reported	\$ 740
Add: Compensation expense included in reported net income, net of related tax	3
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(40 )
Net income, pro forma	703
Basic Earnings per Common Share	
As reported	\$ 2.54
Pro forma	2.42
Diluted Earnings per Common Share	
As reported	\$ 2.42
Pro forma	2.30

**Derivative Financial Instruments.** We do not use derivative instruments for trading purposes and we have procedures in place to monitor and control their use. Our use of derivative instruments has included interest rate swaps and collars, treasury locks and foreign currency forward contracts. These derivative contracts are entered into with financial institutions.

We account for these derivative financial instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( SFAS 133 ) as amended by SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* ( SFAS 149 ). SFAS 133 requires that all derivative instruments be recorded on the Consolidated Balance Sheet at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument is dependent upon whether the derivative has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative instrument as well as the offsetting gain or loss on the hedged item attributable to the hedged risk are recognized in the results of operations. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income (loss) and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Any ineffective portion of the gain or loss on the derivative instrument is recorded in the results of operations immediately. For derivative instruments not designated as hedging instruments, the gain or loss is recognized in the results of operations immediately. See Note 14 for a discussion of our use of derivative instruments, management of credit risk inherent in derivative instruments and fair value information.

**Common Stock Share Repurchases.** From time to time, we repurchase shares of our Common Stock under share repurchase programs authorized by our Board of Directors. Shares repurchased constitute authorized, but unissued shares under the North Carolina laws under which we are incorporated. Additionally, our Common Stock has no par or stated value. Accordingly, we record the full value of share repurchases against Common Stock except when to do so would result in a negative balance in our Common Stock account. In such instances, on a period basis, we record the cost of any further share repurchases as a reduction in retained earnings. Due to the large number of share repurchases and the increase in our Common Stock market value over the past several years, our Common Stock balance is frequently zero at the end of any period. Accordingly, \$716 million and \$87 million in share repurchases were recorded as a reduction in retained earnings in 2006 and 2005, respectively. We have no legal restrictions on the payment of dividends. See Note 19 for additional information.

**Pension and Post-Retirement Medical Benefits.** In the fourth quarter of 2006, we adopted the recognition and disclosure provisions of 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) ( SFAS 158 ). SFAS 158

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amends SFAS No. 87, Employers Accounting for Pensions ( SFAS 87 ), SFAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Plans and for Termination Benefits ( SFAS 88 ), SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions ( SFAS 106 ) and SFAS No. 132(R), Employers Disclosures about Pensions and Other Postretirement Benefits.

SFAS 158 required the Company to recognize the funded status of its pension and post-retirement plans in the December 30, 2006 Consolidated Balance Sheet, with a corresponding adjustment to accumulated other comprehensive income, net of tax. Gains or losses and prior service costs or credits that arise in future years will be recognized as a component of other comprehensive income to the extent they have not been recognized as a component of net periodic benefit cost pursuant to SFAS 87 or SFAS 106.

The incremental effects of adopting the provisions of SFAS 158 on the Company's Consolidated Balance Sheet at December 30, 2006 are presented as follows. The adoption of SFAS 158 had no impact on the Consolidated Statement of Income.

	Before Application of SFAS 158	Adjustments	After Application of SFAS 158
Intangible assets, net	\$350	\$(3 )	\$347
Deferred income taxes	268	37	305
Total assets	6,319	34	6,353
Accounts payable and other current liabilities	1,384	2	1,386
Other liabilities and deferred credits	1,048	99	1,147
Total liabilities	4,815	101	4,916
Accumulated other comprehensive loss	(89 )	(67 )	(156 )
Total stockholders' equity	1,504	(67 )	1,437

SFAS 158 also requires measurement of the funded status of pension and postretirement plans as of the date of a Company's fiscal year end effective in the year ended 2008. Certain of our plans currently have measurement dates that do not coincide with our fiscal year end and thus we will be required to change their measurement dates in 2008.

**Quantification of Misstatements.** In September 2006, the Securities and Exchange Commission (the SEC) issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement for the purpose of a materiality assessment. SAB 108 requires that registrants quantify a current year misstatement using an approach that considers both the impact of prior year misstatements that remain on the balance sheet and those that were recorded in the current year income statement. Historically, we quantified misstatements and assessed materiality based on a current year income statement approach. We were required to adopt SAB 108 in the fourth quarter of 2006.

The transition provisions of SAB 108 permit uncorrected prior year misstatements that were not material to any prior periods under our historical income statement approach but that would have been material under the dual approach of SAB 108 to be corrected in the carrying amounts of assets and liabilities at the beginning of 2006 with the offsetting adjustment to retained earnings for the cumulative effect of misstatements. We have adjusted certain balances in the accompanying Consolidated Financial Statements at the beginning of 2006 to correct the misstatements discussed below which we considered to be immaterial in prior periods under our historical approach. The impact of the January 1, 2006 cumulative effect adjustment, net of any income tax effect, was an increase to retained earnings as follows:

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Deferred Tax Liabilities Adjustments	\$ 79
Reversal of Unallocated Reserve	6
Non-GAAP Conventions	15
Net Increase to January 1, 2006 Retained Earnings	\$ 100

Deferred Taxes Our opening Consolidated Balance Sheet at Spin-off included significant deferred tax assets and liabilities. Over time we have determined that deferred tax liability amounts were recorded in excess of those necessary to reflect our temporary differences.

Unallocated Reserves A reserve was established in 1999 equal to certain out of year corrections recorded during that year such that there was no misstatement under our historical approach. No adjustments have been recorded to this reserve since its establishment and we do not believe the reserve is required.

Non-GAAP Accounting Conventions Prior to 2006, we used certain non-GAAP conventions to account for capitalized interest on restaurant construction projects, the leases of our Pizza Hut United Kingdom unconsolidated affiliate and certain state tax benefits. The net income statement impact on any given year from the use of these non-GAAP conventions was immaterial both individually and in the aggregate under our historical approach. Below is a summary of the accounting policies we adopted effective the beginning of 2006 and the impact of the cumulative effect adjustment under SAB 108, net of any income tax effect. The impact of these accounting policy changes was not significant to our results of operations in 2006.

Interest Capitalization SFAS No. 34, Capitalization of Interest Cost requires that interest be capitalized as part of an asset's acquisition cost. We traditionally have not capitalized interest on individual restaurant construction projects. We increased our 2006 beginning retained earnings balance by approximately \$12 million for the estimated capitalized interest on existing restaurants, net of accumulated depreciation.

Lease Accounting by our Pizza Hut United Kingdom Unconsolidated Affiliate Prior to our fourth quarter acquisition of the remaining fifty percent interest in our Pizza Hut United Kingdom unconsolidated affiliate, we accounted for our ownership under the equity method. The unconsolidated affiliate historically accounted for all of its leases as operating and we made no adjustments in recording equity income. We decreased our 2006 beginning retained earnings balance by approximately \$4 million to reflect our fifty percent share of the cumulative equity income impact of properly recording certain leases as capital.

Recognition of Certain State Tax Benefits We have historically recognized certain state tax benefits on a cash basis as they were recognized on the respective state tax returns instead of in the year the benefit originated. We increased our 2006 beginning retained earnings by approximately \$7 million to recognize these state tax benefits as deferred tax assets.

**New Accounting Pronouncements Not Yet Adopted.** In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (FIN 48) an interpretation of FASB Statement No. 109, Accounting for Income Taxes. FIN 48 is effective for fiscal years beginning after December 15, 2006, the year beginning December 31, 2006 for the Company. FIN 48 requires that a position taken or expected to be taken in a tax return be recognized in the financial statements when it is more likely than not (i.e. a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Upon adoption, the cumulative effect of applying the recognition and measurement provisions of FIN 48, if any, shall be reflected as an adjustment to the opening balance of retained earnings. We do not currently anticipate that the adjustment to the opening balance of retained earnings we will record upon adoption of FIN 48 will materially impact our financial condition.

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FIN 48 requires that subsequent to initial adoption a change in judgment that results in subsequent recognition, derecognition or change in a measurement of a tax position taken in a prior annual period (including any related



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interest and penalties) be recognized as a discrete item in the period in which the change occurs. Currently, we record such changes in judgment, including audit settlements, as a component of our annual effective rate. Thus, our reported quarterly income tax rate may become more volatile upon adoption of FIN 48. This change will not impact the manner in which we record income tax expense on an annual basis.

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

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

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities, ( SFAS 159 ). SFAS 159 provides companies with an option to report selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007, the year beginning December 30, 2007 for the Company. We are currently reviewing the provisions of SFAS 159 to determine any impact for the Company.

### Note 3 - Earnings Per Common Share ( EPS )

	2006	2005	2004
Net income	\$824	\$762	\$740
Weighted-average common shares outstanding (for basic calculation)	273	286	291
Effect of dilutive share-based employee compensation	9	12	14
Weighted-average common and dilutive potential common shares outstanding (for diluted calculation)	282	298	305
Basic EPS	\$3.02	\$2.66	\$2.54
Diluted EPS	\$2.92	\$2.55	\$2.42
Unexercised employee stock options and stock appreciation rights (in millions) excluded from the diluted EPS compensation <sup>(a)</sup>	0.1	0.5	0.4

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

**Note 4 Items Affecting Comparability of Net Income**Facility Actions

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

	2006	2005	2004
<b>U.S.</b>			
Refranchising net (gain) loss <sup>(a)(b)</sup>	\$ (20 )	\$ (40 )	\$ (14 )
Store closure costs (income)	(1 )	2	(3 )
Store impairment charges	38	44	17
Closure and impairment expenses	\$ 37	\$ 46	\$ 14
<b>International Division</b>			
Refranchising net (gain) loss <sup>(a)(b)</sup>	\$ (4 )	\$ (3 )	\$ 3
Store closure costs (income)	1	(1 )	1
Store impairment charges	15	10	19
Closure and impairment expenses	\$ 16	\$ 9	\$ 20
<b>China Division</b>			
Refranchising net (gain) loss <sup>(a)</sup>	\$	\$	\$ (1 )
Store closure costs (income)	(1 )	(1 )	(1 )
Store impairment charges	7	8	5
Closure and impairment expenses	\$ 6	\$ 7	\$ 4
<b>Worldwide</b>			
Refranchising net (gain) loss <sup>(a)(b)</sup>	\$ (24 )	\$ (43 )	\$ (12 )
Store closure costs (income)	(1 )		(3 )
Store impairment charges	60	62	41
Closure and impairment expenses	\$ 59	\$ 62	\$ 38

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

(b) Includes initial franchise fees in the U.S. of \$11 million in 2006, \$7 million in 2005 and \$2 million in 2004, and in the International Division of \$6 million in 2006, \$3 million in 2005 and \$8 million in 2004. See Note 7.

The following table summarizes the 2006 and 2005 activity related to reserves for remaining lease obligations for closed stores.

	Beginning Balance	Amounts Used	New Decisions	Estimate/Decision Changes	Other	Ending Balance
2005 Activity	\$ 43	(13 )	14			\$ 44
2006 Activity	\$ 44	(17 )	8	1		\$ 36



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Assets held for sale at December 30, 2006 and December 31, 2005 total \$13 million and \$11 million, respectively, of U.S. property, plant and equipment, primarily land, on which we previously operated restaurants and are included in prepaid expenses and other current assets on our Consolidated Balance Sheets.

### Wrench Litigation

In fiscal year 2003, we recorded a charge of \$42 million related to a lawsuit filed against Taco Bell Corp. (the Wrench litigation). Income of \$14 million was recorded for 2004 reflecting settlements associated with the Wrench litigation for amounts less than previously accrued as well as related insurance recoveries. We recorded income of \$2 million in 2005 from a settlement with an insurance carrier related to the Wrench litigation. We continue to pursue additional recoveries which, if any, will be recorded as realized.

### AmeriServe and Other Charges (Credits)

AmeriServe Food Distribution Inc. ( AmeriServe ) was the primary distributor of food and paper supplies to our U.S. stores when it filed for protection under Chapter 11 of the U.S. Bankruptcy Code on January 31, 2000. A plan of reorganization for AmeriServe (the POR ) was approved on November 28, 2000, which resulted in, among other things, the assumption of our distribution agreement, subject to certain amendments, by McLane Company, Inc. During the AmeriServe bankruptcy reorganization process, we took a number of actions to ensure continued supply to our system. Those actions resulted in significant expense for the Company, primarily recorded in 2000. Under the POR, we are entitled to proceeds from certain residual assets, preference claims and other legal recoveries of the estate.

Income of \$1 million, \$2 million and \$16 million was recorded as AmeriServe and other charges (credits) for 2006, 2005 and 2004, respectively. These amounts primarily resulted from cash recoveries related to the AmeriServe bankruptcy reorganization process.

### **Note 5 Supplemental Cash Flow Data**

2006

2005