HERSHEY CO
Form 10-Q
October 28, 2016

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

FORM 10-Q

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

For the quarterly period ended October 2, 2016

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 1-183

THE HERSHEY COMPANY
(Exact name of registrant as specified in its charter)

Delaware	23-0691590
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 Crystal A Drive, Hershey, PA
17033
(Address of principal executive offices)
(Zip Code)
717-534-4200
(Registrant’s telephone number, including area code)
Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ ¨

	Smaller reporting company
(Do not check if a smaller reporting company)	

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

Indicate the number of shares outstanding of each of the registrant’s classes of common stock as of the latest practicable date.
Common Stock, one dollar par value—151,609,649 shares, as of October 21, 2016.
Class B Common Stock, one dollar par value—60,619,777 shares, as of October 21, 2016.

THE HERSHEY COMPANY
Quarterly Report on Form 10-Q
For the Period Ended October 2, 2016

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Item 1. Financial Statements.
THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended		Nine Months Ended	
	October 2, 2016	October 4, 2015	October 2, 2016	October 4, 2015
Net sales	$2,003,454	$1,960,779	$5,469,937	$5,477,404
Costs and expenses:				
Cost of sales	1,152,606	1,068,715	3,054,315	2,949,089
Selling, marketing and administrative	474,494	500,306	1,408,759	1,469,861
Goodwill impairment	—	30,991	—	280,802
Business realignment charges	2,330	57,753	30,568	82,972
Total costs and expenses	1,629,430	1,657,765	4,493,642	4,782,724
Operating profit	374,024	303,014	976,295	694,680
Interest expense, net	24,387	46,967	66,730	85,046
Other (income) expense, net	21,800	9,409	8,703	4,328
Income before income taxes	327,837	246,638	900,862	605,306
Provision for income taxes	100,434	91,867	297,671	305,739
Net income	$227,403	$154,771	$603,191	$299,567
Net income per share—basic:				
Common stock	$1.09	$0.73	$2.88	$1.40
Class B common stock	$0.99	$0.66	$2.63	$1.27
Net income per share—diluted:				
Common stock	$1.06	$0.70	$2.80	$1.35
Class B common stock	$0.99	$0.66	$2.62	$1.28
Dividends paid per share:				
Common stock	$0.618	$0.583	$1.784	$1.653
Class B common stock	$0.562	$0.530	$1.622	$1.502

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Three Months Ended		Nine Months Ended	
	October 2, 2016	October 4, 2015	October 2, 2016	October 4, 2015
Net income	$227,403	$154,771	$603,191	$299,567
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	(8,533)	(26,631)	5,053	(51,681)
Pension and post-retirement benefit plans	7,395	9,969	9,884	20,896
Cash flow hedges:				
Gains (losses) on cash flow hedging derivatives	1,144	(43,914)	(34,789)	21,023
Reclassification adjustments	(898)	(6,214)	(7,985)	(17,711)
Total other comprehensive income (loss), net of tax	(892)	(66,790)	(27,837)	(27,473)
Total comprehensive income	$226,511	$87,981	$575,354	$272,094
Comprehensive loss (income) attributable to noncontrolling interests	751	(820)	2,040	2,111
Comprehensive income attributable to The Hershey Company	$227,262	$87,161	$577,394	$274,205

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	October 2, 2016 (unaudited)	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$333,333	$346,529
Accounts receivable—trade, net	759,619	599,073
Inventories	843,519	750,970
Prepaid expenses and other	194,046	152,026
Total current assets	2,130,517	1,848,598
Property, plant and equipment, net	2,159,589	2,240,460
Goodwill	816,133	684,252
Other intangibles	510,291	379,305
Other assets	169,753	155,366
Deferred income taxes	59,130	36,390
Total assets	$5,845,413	$5,344,371
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$458,028	$474,266
Accrued liabilities	683,012	856,967
Accrued income taxes	13,588	23,243
Short-term debt	612,383	363,513
Current portion of long-term debt	250,024	499,923
Total current liabilities	2,017,035	2,217,912
Long-term debt	2,362,466	1,557,091
Other long-term liabilities	478,707	468,718
Deferred income taxes	45,133	53,188
Total liabilities	4,903,341	4,296,909
Stockholders' equity:		
The Hershey Company stockholders' equity		
Preferred stock, shares issued: none at October 2, 2016 and December 31, 2015, respectively	—	—
Common stock, shares issued: 299,281,967 at October 2, 2016 and December 31, 2015, respectively	299,281	299,281
Class B common stock, shares issued: 60,619,777 at October 2, 2016 and December 31, 2015, respectively	60,620	60,620
Additional paid-in capital	852,675	783,877
Retained earnings	6,129,088	5,897,603
Treasury—common stock shares, at cost: 146,305,207 at October 2, 2016 and 143,124,384 at December 31, 2015	(6,049,397)	(5,672,359)
Accumulated other comprehensive loss	(396,822)	(371,025)
The Hershey Company stockholders' equity	895,445	997,997
Noncontrolling interests in subsidiaries	46,627	49,465
Total stockholders' equity	942,072	1,047,462
Total liabilities and stockholders' equity	$5,845,413	$5,344,371

See Notes to Unaudited Consolidated Financial Statements.

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

	Nine Months Ended October 2, 2016	Nine Months Ended October 4, 2015
Operating Activities		
Net income	$603,191	$299,567
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	241,901	182,855
Stock-based compensation expense	40,699	39,989
Excess tax benefits from stock-based compensation	(20,978)	(22,966)
Deferred income taxes	(12,703)	(10,385)
Goodwill impairment	—	280,802
Contributions to pension and other benefits plans	(42,566)	(45,187)
Loss on early extinguishment of debt	—	28,326
Write-down of equity investments	35,862	13,895
Gain on settlement of SGM liability (see Note 2)	(26,650)	—
Changes in assets and liabilities, net of effects from business acquisitions and divestitures:		
Accounts receivable—trade, net	(157,142)	(186,156)
Inventories	(83,221)	(2,064)
Accounts payable and accrued liabilities	(159,871)	(55,890)
Other assets and liabilities	4,017	72,299
Net cash provided by operating activities	422,539	595,085
Investing Activities		
Capital additions (including software)	(168,225)	(237,893)
Proceeds from sales of property, plant and equipment	3,032	1,184
Proceeds from sale of business	—	32,408
Equity investments in tax credit qualifying partnerships	(35,395)	(3,775)
Business acquisitions, net of cash and cash equivalents acquired	(285,374)	(218,654)
Sale of short-term investments	—	95,316
Net cash used in investing activities	(485,962)	(331,414)
Financing Activities		
Net increase in short-term debt	250,573	336,851
Long-term borrowings	792,923	599,031
Repayment of long-term debt	(250,000)	(351,042)
Payment of SGM liability (see Note 2)	(35,762)	—
Cash dividends paid	(371,706)	(353,070)
Exercise of stock options	95,336	63,623
Excess tax benefits from stock-based compensation	20,978	22,966
Purchase of noncontrolling interest	—	(38,270)
Repurchase of common stock	(452,580)	(567,480)
Net cash provided by (used in) financing activities	49,762	(287,391)
Effect of exchange rate changes on cash and cash equivalents	465	(7,221)
Decrease in cash and cash equivalents	(13,196)	(30,941)
Cash and cash equivalents, beginning of period	346,529	374,854
Cash and cash equivalents, end of period	$333,333	$343,913
Supplemental Disclosure		

Interest paid (excluding loss on early extinguishment of debt in 2015)	$72,925	$71,124
Income taxes paid	306,580	256,610

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(in thousands)
(unaudited)

	Preferred Stock	Common Stock	Class B Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Common Stock	Accumulated Other Comprehensive Loss	Noncontrolling Interests in Subsidiaries	Total Stockholders' Equity
Balance, December 31, 2015	$ —	$299,281	$60,620	$783,877	$5,897,603	$(5,672,359)	$(371,025)	$49,465	$1,047,462
Net income					603,191				603,191
Other comprehensive loss							(25,797)	(2,040)	(27,837)
Dividends:									
Common Stock, $1.784 per share					(273,380)				(273,380)
Class B Common Stock, $1.622 per share					(98,326)				(98,326)
Stock-based compensation				39,621					39,621
Exercise of stock options and incentive-based transactions				29,177		75,542			104,719
Repurchase of common stock						(452,580)			(452,580)
Net loss attributable to noncontrolling interests								(798)	(798)
Balance, October 2, 2016	$ —	$299,281	$60,620	$852,675	$6,129,088	$(6,049,397)	$(396,822)	$46,627	$942,072

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited consolidated financial statements provided in this report include the accounts of The Hershey Company (the "Company," "Hershey," "we" or "us") and our majority-owned subsidiaries and entities in which we have a controlling financial interest after the elimination of intercompany accounts and transactions. We have a controlling financial interest if we own a majority of the outstanding voting common stock and the noncontrolling shareholders do not have substantive participating rights, or we have significant control over an entity through contractual or economic interests in which we are the primary beneficiary.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial reporting and with the rules and regulations for reporting on Form 10-Q. Accordingly, they do not contain certain information and disclosures required by GAAP for comprehensive financial statements. Our significant interim accounting policies include the recognition of a pro-rata share of certain estimated annual amounts primarily for raw material purchase price variances, advertising expense, incentive compensation expenses and the effective income tax rate. We have included all adjustments (consisting only of normal recurring accruals) that we believe are considered necessary for a fair presentation.

Operating results for the quarter ended October 2, 2016 may not be indicative of the results that may be expected for the year ending December 31, 2016 because of seasonal effects on our business. These financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2015 (our "2015 Annual Report on Form 10-K"), which provides a more complete understanding of our accounting policies, financial position, operating results and other matters.

Reclassifications

Certain prior period amounts presented in the Consolidated Statements of Cash Flows have been reclassified to conform to the current year presentation.

Recent Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This ASU is part of the FASB's simplification initiative. The areas for simplification in this ASU involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods, with early adoption permitted. We are currently evaluating the impact that the adoption of ASU 2016-09 will have on our consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This ASU will require lessees to recognize a right-of-use asset and lease liability for all leases with terms of more than 12 months. Recognition, measurement and presentation of expenses will depend on classification as a finance or operating lease. This ASU also requires certain quantitative and qualitative disclosures. Accounting guidance for lessors is largely unchanged. The amendments should be applied on a modified retrospective basis. ASU 2016-02 is effective for us beginning January 1, 2019. We are beginning to evaluate the impact that the adoption of ASU 2016-02 will have on our consolidated financial statements and related disclosures.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU No. 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard was originally effective for us on January 1, 2017; however, in July 2015 the FASB decided to defer the effective date by one year. Early application is not permitted, but reporting entities may choose to adopt the standard as of the original effective date. The standard permits the use of either the retrospective or

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(amounts in thousands, except share data or if otherwise indicated)

cumulative effect transition method. We are currently evaluating the effect that ASU No. 2014-09 will have on our consolidated financial statements and related disclosures, our transition date and transition method.

No other new accounting pronouncement issued or effective during the fiscal year had or is expected to have a material impact on our consolidated financial statements or disclosures.

2. BUSINESS ACQUISITIONS AND DIVESTITURES

Acquisitions of businesses are accounted for as purchases and, accordingly, the results of operations of the businesses acquired have been included in the consolidated financial statements since the respective dates of the acquisitions. The purchase price for each of the acquisitions is allocated to the assets acquired and liabilities assumed.

2016 Activity

Ripple Brand Collective, LLC

On April 26, 2016, we completed the acquisition of all of the outstanding shares of Ripple Brand Collective, LLC, a privately held company based in Congers, New York that owns the barkTHINS mass premium chocolate snacking brand. The barkTHINS brand is largely sold in the United States in take-home resealable packages and is available in the club channel, as well as select natural and conventional grocers. The business enables us to expand our mass premium offerings and is expected to generate 2016 annual net sales of approximately $65 million to $75 million.

The purchase consideration was allocated to assets acquired and liabilities assumed based on their respective fair values as follows:

Goodwill	$127,455
Trademarks	91,200
Other intangible assets	60,900
Other assets, primarily current assets, net of cash acquired totaling $674	13,030
Current liabilities	(7,211)
Net assets acquired	$285,374

The purchase price allocation presented above is preliminary. We are in the process of refining the valuation of acquired assets and liabilities and expect to finalize the purchase price allocation by the end of 2016.

Goodwill is calculated as the excess of the purchase price over the fair value of the net assets acquired. The goodwill resulting from the acquisition is attributable primarily to the value of leveraging our brand building expertise, consumer insights, supply chain capabilities and retail relationships to accelerate growth and access to barkTHINS products.

Acquired trademarks were assigned estimated useful lives of 27 years, while other intangibles, including customer relationships and covenants not to compete, were assigned estimated useful lives ranging from 2 to 14 years.

The recorded goodwill, trademarks and other intangibles are expected to be deductible for tax purposes.

Shanghai Golden Monkey (“SGM”)

On February 3, 2016, we completed the purchase of the remaining 20% of the outstanding shares of SGM for cash consideration totaling $35,762, pursuant to a new agreement entered into during the fourth quarter of 2015 with the SGM selling shareholders which revised the originally-agreed purchase price for these shares. For accounting purposes, we treated the acquisition as if we had acquired 100% at the initial acquisition date in 2014 and financed the payment for the remaining 20% of the outstanding shares. Therefore, the cash settlement of the liability for the purchase of these remaining shares is reflected within the financing section of the Unaudited Consolidated Statements of Cash Flows.

(amounts in thousands, except share data or if otherwise indicated)

The final settlement also resulted in an extinguishment gain of $26,650 representing the net carrying amount of the recorded liability in excess of the cash paid to settle the obligation for the remaining 20% of the outstanding shares. This gain is recorded within non-operating other (income) expense, net within the Unaudited Consolidated Statements of Income.

2015 Acquisition

KRAVE Pure Foods

In March 2015, we completed the acquisition of all of the outstanding shares of KRAVE Pure Foods, Inc. ("Krave"), manufacturer of KRAVE jerky, a leading all-natural snack brand of premium jerky products. The transaction was undertaken to allow Hershey to tap into the rapidly growing meat snacks category and further expand into the broader snacks space. Krave is headquartered in Sonoma, California and generated 2014 annual sales of approximately $35 million.

Total purchase consideration included cash consideration of $220,016, as well as agreement to pay additional cash consideration of up to $20,000 to the Krave shareholders if certain defined targets related to net sales and gross profit margin are met or exceeded during the twelve-month periods ending December 31, 2015 or March 31, 2016. The fair value of the contingent cash consideration was appropriately classified as a liability of $16,800 as of the acquisition date. Based on revised targets in a subsequent agreement with the Krave shareholders, the fair value was reduced over the second and third quarters of 2015 to $10,000, with the adjustment to fair value recorded within selling, marketing and administrative expenses. The remaining $10,000 was paid in December 2015.

The purchase consideration was allocated to assets acquired and liabilities assumed based on their respective fair values as follows:

Goodwill	$147,089
Trademarks	112,000
Other intangible assets	17,000
Other assets, primarily current assets, net of cash acquired totaling $1,362	9,465
Current liabilities	(2,756)
Non-current deferred tax liabilities	(47,344)
Net assets acquired	$235,454

The goodwill resulting from the acquisition is attributable primarily to the value of leveraging our brand building expertise, consumer insights, supply chain capabilities and retail relationships to accelerate growth and access to KRAVE products. The recorded goodwill is not expected to be deductible for tax purposes. The purchase price allocation for Krave was concluded in the third quarter of 2015.

Acquired trademarks were assigned estimated useful lives of 22 years, while other intangibles, including customer relationships and covenants not to compete, were assigned estimated useful lives ranging from 5 to 16 years.

2015 Divestiture

In December 2014, we entered into an agreement to sell the Mauna Loa Macadamia Nut Corporation ("Mauna Loa"). The transaction closed in the first quarter of 2015, resulting in proceeds, net of selling expenses and an estimated working capital adjustment, of approximately $32,400. As a result of the expected sale, in 2014, we recorded an estimated loss on the anticipated sale of $22,256 to reflect the disposal entity at fair value, less an estimate of the selling costs. This amount included impairment charges totaling $18,531 to write down goodwill and the indefinite-lived trademark intangible asset, based on the valuation of these assets as implied by the agreed-upon sales price. The sale of Mauna Loa resulted in the recording of an additional loss on sale of $2,667 in the first quarter of 2015, based on updates to the selling expenses and tax benefits. The loss on the sale is reflected within business realignment charges in the Unaudited Consolidated Statements of Income.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

3. GOODWILL AND INTANGIBLE ASSETS

The changes in the carrying value of goodwill by reportable segment for the nine months ended October 2, 2016 are as follows:

	North America	International and Other	Total
Balance at December 31, 2015	$662,083	$ 22,169	$684,252
Acquired during the period (see Note 2)	127,455	—	127,455
Foreign currency translation	5,709	(1,283)	4,426
Balance at October 2, 2016	$795,247	$ 20,886	$816,133

The following table provides the gross carrying amount and accumulated amortization for each major class of intangible asset:

	October 2, 2016	December 31, 2015
Intangible assets not subject to amortization:		
Trademarks	43,072	43,775
Intangible assets subject to amortization:		
Trademarks, customer relationships, patents and other finite-lived intangibles	538,753	390,900
Less: accumulated amortization	(71,534)	(55,370)
Total other intangible assets	$510,291	$379,305

Total amortization expense for the three months ended October 2, 2016 and October 4, 2015 was $7,666 and $5,340, respectively. Total amortization expense for the nine months ended October 2, 2016 and October 4, 2015 was $18,811 and $16,469, respectively.

4. SHORT AND LONG-TERM DEBT

Short-term Debt

As a source of short-term financing, we utilize cash on hand and commercial paper or bank loans with an original maturity of three months or less. We maintain a $1.0 billion unsecured revolving credit facility, which currently expires in November 2020. This agreement also includes an option to increase borrowings by an additional $400,000 with the consent of the lenders. On June 16, 2016, we entered into an additional unsecured revolving credit facility that provided for borrowings up to $500,000. We terminated this facility, which was scheduled to expire on June 15, 2017, effective October 24, 2016.

The credit agreement contains (and the credit agreement terminated effective October 24, 2016) certain financial and other covenants, customary representations, warranties and events of default. As of October 2, 2016, we were in compliance with all covenants pertaining to the credit agreements, and we had no significant compensating balance agreements that legally restricted these funds. For more information, refer to the Consolidated Financial Statements included in our 2015 Annual Report on Form 10-K.

In addition to the revolving credit facility, we maintain lines of credit with domestic and international commercial banks. We had short-term foreign bank loans against these lines of credit for $217,017 and $313,520 at October 2, 2016 and December 31, 2015, respectively. Commitment fees relating to our revolving credit facility and lines of credit are not material.

At October 2, 2016, we had outstanding commercial paper totaling $395,366, at a weighted average interest rate of 0.45%. At December 31, 2015, we had outstanding commercial paper totaling $49,993, at a weighted average interest rate of 0.40%.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

Long-term Debt
Long-term debt consisted of the following:

	October 2, 2016	December 31, 2015
5.45% Notes due 2016 (1)	$—	$250,000
1.50% Notes due 2016	250,000	250,000
1.60% Notes due 2018	300,000	300,000
4.125% Notes due 2020	350,000	350,000
8.8% Debentures due 2021	84,715	84,715
2.625% Notes due 2023	250,000	250,000
3.20% Notes due 2025	300,000	300,000
2.30% Notes due 2026 (2)	500,000	—
7.2% Debentures due 2027	193,639	193,639
3.375% Notes due 2046 (2)	300,000	—
Other obligations, net of debt issuance costs and unamortized debt discount	84,136	78,660
Total long-term debt	2,612,490	2,057,014
Less—current portion	250,024	499,923
Long-term portion	$2,362,466	$1,557,091

(1) In September 2016, we repaid $250,000 of 5.45% Notes due in 2016 upon their maturity.

(2) In August 2016, we issued $500,000 of 2.30% Notes due in 2026 and $300,000 of 3.375% Notes due in 2046 (the "Notes"). Proceeds from the issuance of the Notes, net of discounts and issuance costs, totaled $792,923. The Notes were issued under a shelf registration statement on Form S-3 filed in June 2015 that registered an indeterminate amount of debt securities.

Interest Expense
Net interest expense consisted of the following:

	Three Months Ended		Nine Months Ended	
	October 2, 2016	October 4, 2015	October 2, 2016	October 4, 2015
Interest expense	$25,882	$22,590	$72,404	$68,874
Less: Capitalized interest	(1,141)	(3,071)	(4,702)	(9,314)
Loss on extinguishment of debt	—	28,326	—	28,326
Interest expense	24,741	47,845	67,702	87,886
Interest income	(354)	(878)	(972)	(2,840)
Interest expense, net	$24,387	$46,967	$66,730	$85,046

5. DERIVATIVE INSTRUMENTS AND FAIR VALUE MEASUREMENTS

We are exposed to market risks arising principally from changes in foreign currency exchange rates, interest rates and commodity prices. We use certain derivative instruments to manage these risks. These include interest rate swaps to manage interest rate risk, foreign currency forward exchange contracts and options to manage foreign currency exchange rate risk, and commodities futures and options contracts to manage commodity market price risk exposures. In entering into these contracts, we have assumed the risk that might arise from the possible inability of counterparties to meet the terms of their contracts. We mitigate this risk by entering into exchanged-traded contracts with collateral posting requirements and/or by performing financial assessments prior to contract execution, conducting periodic evaluations of counterparty performance and maintaining a diverse portfolio of qualified counterparties. We do not expect any significant losses from counterparty defaults.

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Commodity Price Risk

We enter into commodities futures and options contracts and other commodity derivative instruments to reduce the effect of future price fluctuations associated with the purchase of raw materials, energy requirements and transportation services. We generally hedge commodity price risks for 3- to 24-month periods. Through 2015, we designated the majority of our commodity derivative instruments as cash flow hedges under the hedge accounting requirements. Under hedge accounting, we account for the effective portion of mark-to-market gains and losses on commodity derivative instruments in other comprehensive income, to be recognized in cost of sales in the same period that we record the hedged raw material requirements in cost of sales. The ineffective portion of gains and losses is recorded currently in cost of sales.

Effective July 6, 2015 for cocoa commodity derivatives and January 1, 2016 for other commodity derivatives, we discontinued the designation of any of our existing or new cocoa or other commodity derivatives for hedge accounting treatment. Since such dates, changes in the fair value of these derivatives have been recorded as incurred within cost of sales. Effective as of such dates, we also revised our definition of segment income to exclude gains and losses on commodity derivatives until the related inventory is sold. This change to our definition of segment income enables us to continue to align the derivative gains and losses with the underlying economic exposure being hedged and thereby eliminate the mark-to-market volatility within our reported segment income.

Foreign Exchange Price Risk

We are exposed to foreign currency exchange rate risk related to our international operations, including non-functional currency intercompany debt and other non-functional currency transactions of certain subsidiaries. Principal currencies hedged include the euro, Canadian dollar, Japanese yen, and Brazilian real. We typically utilize foreign currency forward exchange contracts and options to hedge these exposures for 3- to 12-month periods. The contracts are either designated as cash flow hedges or are undesignated. The net notional amount of foreign exchange contracts accounted for as cash flow hedges was $86,896 at October 2, 2016 and $10,752 at December 31, 2015. The effective portion of the changes in fair value on these contracts is recorded in other comprehensive income and reclassified into earnings in the same period in which the hedged transactions affect earnings. The net notional amount of foreign exchange contracts that are not designated as accounting hedges was $2,791 at October 2, 2016 and December 31, 2015, respectively. The change in fair value on these instruments is recorded directly in cost of sales or selling, marketing and administrative expense, depending on the nature of the underlying exposure.

Interest Rate Risk

In order to manage interest rate exposure, we enter into interest rate swap agreements to protect against unfavorable interest rate changes relating to forecasted debt transactions. These swaps are designated as cash flow hedges, with gains and losses deferred in other comprehensive income to be recognized as an adjustment to interest expense in the same period that the hedged interest payments affect earnings. We had one interest rate swap agreement in a cash flow hedging relationship with a notional amount of $500,000 at December 31, 2015. This interest rate swap agreement was settled in connection with the issuance of debt in August 2016, resulting in a payment of approximately $87,000, which is reflected as an operating outflow within the Consolidated Statement of Cash Flows.

We also manage our targeted mix of fixed and floating rate debt with debt issuances and by entering into fixed-to-floating interest rate swaps in order to mitigate fluctuations in earnings and cash flows that may result from interest rate volatility. These swaps are designated as fair value hedges, for which the gain or loss on the derivative and the offsetting loss or gain on the hedged item are recognized in current earnings as interest expense (income), net. The notional amount, interest payment and maturity date of these swaps generally match the principal, interest payment and maturity date of the related debt, and the swaps are valued using observable benchmark rates (Level 2 valuation). The notional amount of interest rate derivative instruments in fair value hedge relationships was $350,000 at October 2, 2016 and December 31, 2015, respectively.

Equity Price Risk

We are exposed to market price changes in certain broad market indices related to our deferred compensation obligations to our employees. We use equity swap contracts to hedge the portion of the exposure that is linked to market-level equity returns. These contracts are not designated as hedges for accounting purposes and are entered into for 3- to 12-month periods. The change in fair value of these derivatives is recorded in selling, marketing and

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(amounts in thousands, except share data or if otherwise indicated)

administrative expense, together with the change in the related liabilities. The notional amount of the contracts outstanding was $19,740 at October 2, 2016 and $22,230 at December 31, 2015.

Fair Value

Accounting guidance on fair value measurements requires that financial assets and liabilities be classified and disclosed in one of the following categories of the fair value hierarchy:

Level 1 – Based on unadjusted quoted prices for identical assets or liabilities in an active market.
Level 2 – Based on observable market-based inputs or unobservable inputs that are corroborated by market data.
Level 3 – Based on unobservable inputs that reflect the entity's own assumptions about the assumptions that a market participant would use in pricing the asset or liability.

We did not have any level 3 financial assets or liabilities, nor were there any transfers between levels during the periods presented.

The following table presents assets and liabilities that were measured at fair value in the Consolidated Balance Sheet on a recurring basis as of October 2, 2016 and December 31, 2015:

	October 2, 2016		December 31, 2015	
	Assets (1)	Liabilities (1)	Assets (1)	Liabilities (1)
Derivatives designated as cash flow hedging instruments:				
Commodities futures and options (2)	$ —	$ —	$ —	$ 479
Foreign exchange contracts (3)	944	2,419	367	475
Interest rate swap agreements (4)	—	—	—	40,299
	944	2,419	367	41,253
Derivatives designated as fair value hedging instruments:				
Interest rate swap agreements (4)				