CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT ACCOUNTING ESTIMATES

Promotional expenditures

Our promotional activities are conducted either through the retail trade or directly with consumers and include activities such as in-store displays and events, feature price discounts, consumer coupons, contests and loyalty programs. The costs of these activities are generally recognized at the time the related revenue is recorded, which normally precedes the actual cash expenditure. The recognition of these costs therefore requires management judgment regarding the volume of promotional offers that will be redeemed by either the retail trade or consumer. These estimates are made using various techniques including historical data on performance of similar promotional programs. Differences between estimated expense and actual redemptions are normally insignificant and recognized as a change in management estimate in a subsequent period. On a full-year basis, these subsequent period adjustments have rarely represented more than 0.3% of our Company's net sales. However, our Company's total promotional expenditures (including amounts classified as a revenue reduction) represented approximately 40% of 2008 net sales; therefore, it is likely that our results would be materially different if different assumptions or conditions were to prevail.

Goodwill and other intangible assets

We follow Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," in evaluating impairment of intangibles. We perform this evaluation at least annually during the fourth quarter of each year in conjunction with our annual budgeting process. Under SFAS No. 142, goodwill impairment testing first requires a comparison between the carrying value and fair value of a reporting unit with associated goodwill. Carrying value is based on the assets and liabilities associated with the operations of that reporting unit, which often requires allocation of shared or corporate items among reporting units. The fair value of a reporting unit is based primarily on our assessment of profitability multiples likely to be achieved in a theoretical sale transaction. Similarly, impairment testing of other intangible assets requires a comparison of carrying value to fair value of that particular asset. Fair values of non-goodwill intangible assets are based primarily on projections of future cash flows to be generated from that asset. For instance, cash flows related to a particular trademark would be based on a projected royalty stream attributable to branded product sales. These estimates are made using various inputs including historical data, current and anticipated market conditions, management plans, and market comparables.

We also apply the principles of SFAS No. 142 in evaluating the useful life over which a non-goodwill intangible asset is expected to contribute directly or indirectly to the cash flows of the Company. An intangible asset with a finite useful life is amortized; an intangible asset with an indefinite useful life is not amortized, but is evaluated annually for impairment. Reaching a determination on useful life requires significant judgments and assumptions regarding the future effects of obsolescence, demand, competition, other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels), the level of required maintenance expenditures, and the expected lives of other related groups of assets.

At January 3, 2009, goodwill and other intangible assets amounted to $5.1 billion, consisting primarily of goodwill and trademarks associated with the 2001 acquisition of Keebler Foods Company. Within this total, approximately $1.4 billion of non-goodwilll intangible assets were classified as indefinite-lived, comprised principally of Keebler trademarks. We currently believe that the fair value of our goodwill and other intangible assets exceeds their carrying value and that those intangibles so classified will contribute indefinitely to the cash flows of the Company. However, if we had used materially different assumptions regarding the future performance of our North American snacks business or a different weighted-average cost of capital in the valuation, this could have resulted in significant impairment losses and/or amortization expense.

Retirement benefits

Our Company sponsors a number of U.S. and foreign defined benefit employee pension plans and also provides retiree health care and other welfare benefits in the United States and Canada. Plan funding strategies are influenced by tax regulations and asset return performance. A substantial majority of plan assets are invested in a globally diversified portfolio of equity securities with smaller holdings of debt securities and other investments. We follow SFAS No. 87 "Employers' Accounting for Pensions" and SFAS No. 106 "Employers' Accounting for Postretirement Benefits Other Than Pensions" (as amended by SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans") for the measurement and recognition of obligations and expense related to our retiree benefit plans. Embodied in both of these standards is the concept that the cost of benefits provided during retirement should be recognized over the employees' active working life. Inherent in this concept is the requirement to use various actuarial assumptions to predict and measure costs and obligations many years prior to the settlement date. Major actuarial assumptions that require significant management judgment and have a material impact on the measurement of our consolidated benefits expense and accumulated obligation include the long- term rates of

return on plan assets, the health care cost trend rates, and the interest rates used to discount the obligations for our major plans, which cover employees in the United States, United Kingdom, and Canada.

To conduct our annual review of the long-term rate of return on plan assets, we model expected returns over a 20-year investment horizon with respect to the specific investment mix of each of our major plans. The return assumptions used reflect a combination of rigorous historical performance analysis and forward-looking views of the financial markets including consideration of current yields on long-term bonds, price-earnings ratios of the major stock market indices, and long-term inflation. Our U.S. plan model, corresponding to approximately 70% of our trust assets globally, currently incorporates a long-term inflation assumption of 2.5% and an active management premium of 1% (net of fees) validated by historical analysis. Although we review our expected long-term rates of return annually, our benefit trust investment performance for one particular year does not, by itself, significantly influence our evaluation. Our expected rates of return are generally not revised, provided these rates continue to fall within a "more likely than not" corridor of between the 25th and 75th percentile of expected long-term returns, as determined by our modeling process. Our assumed rate of return for U.S. plans in 2008 of 8.9% equated to approximately the 50th percentile expectation of our 2008 model. Similar methods are used for various foreign plans with invested assets, reflecting local economic conditions. Foreign trust investments represent approximately 30% of our global benefit plan assets.

Based on consolidated benefit plan assets at January 3, 2009, a 100 basis point reduction in the assumed rate of return would increase 2009 benefits expense by approximately $31 million. Correspondingly, a 100 basis point shortfall between the assumed and actual rate of return on plan assets for 2008 would result in a similar amount of arising experience loss. Any arising asset-related experience gain or loss is recognized in the calculated value of plan assets over a five-year period. Once recognized, experience gains and losses are amortized using a declining-balance method over the average remaining service period of active plan participants, which for U.S. plans is presently about 13 years. Under this recognition method, a 100 basis point shortfall in actual versus assumed performance of all of our plan assets in 2008 would reduce pre-tax earnings by approximately $1 million in 2010, increasing to approximately $5 million in 2014. For each of the three fiscal years, our actual return on plan assets exceeded/(was less than) the recognized assumed return by the following amounts (in millions): 2008–$(1,528); 2007–$(99); 2006–$257.

To conduct our annual review of health care cost trend rates, we model our actual claims cost data over a five-year historical period, including an analysis of pre-65 versus post-65 age groups and other important demographic components of our covered retiree population. This data is adjusted to eliminate the impact of plan changes and other factors that would tend to distort the underlying cost inflation trends. Our initial health care cost trend rate is reviewed annually and adjusted as necessary to remain consistent with recent historical experience and our expectations regarding short-term future trends. In comparison to our actual five-year compound annual claims cost growth rate of approximately 5%, our initial trend rate for 2009 of 7.5% reflects the expected future impact of faster-growing claims experience for certain demographic groups within our total employee population. Our initial rate is trended downward by 0.5% per year, until the ultimate trend rate of 4.5% is reached. The ultimate trend rate is adjusted annually, as necessary, to approximate the current economic view on the rate of long-term inflation plus an appropriate health care cost premium. Based on consolidated obligations at January 3, 2009, a 100 basis point increase in the assumed health care cost trend rates would increase 2009 benefits expense by approximately $15 million. A 100 basis point excess of 2009 actual health care claims cost over that calculated from the assumed trend rate would result in an arising experience loss of approximately $9 million. Any arising health care claims cost-related experience gain or loss is recognized in the calculated amount of claims experience over a four-year period. Once recognized, experience gains and losses are amortized using a straight-line method over 15 years, resulting in at least the minimum amortization prescribed by SFAS No. 106. The net experience gain arising from recognition of 2008 claims experience was approximately $4 million.

To conduct our annual review of discount rates, we use several published market indices with appropriate duration weighting to assess prevailing rates on high quality debt securities, with a primary focus on the *Citigroup Pension Liability Index*® for our U.S. plans. To test the appropriateness of these indices, we periodically conduct a matching exercise between the expected settlement cash flows of our plans and the bond maturities, consisting principally of AA-rated (or the equivalent in foreign jurisdictions) non-callable issues with at least $25 million principal outstanding. The model does not assume any reinvestment rates and assumes that bond investments mature just in time to pay benefits as they become due. For those years where no suitable bonds are available, the portfolio utilizes a linear interpolation approach to impute a hypothetical bond whose maturity matches the cash flows required in those years. During 2008, we refined our methodology for setting our discount rate by inputting the cash flows for our pension, postretirement and postemployment plans into the spot yield curve underlying the *Citigroup* index. The measurement dates for our defined benefit plans are consistent with our fiscal year end. Accordingly, we select discount rates to measure our benefit obligations

that are consistent with market indices during December of each year.

Based on consolidated obligations at January 3, 2009, a 25 basis point decline in the weighted-average discount rate used for benefit plan measurement purposes would increase 2009 benefits expense by approximately $13 million. All obligation-related experience gains and losses are amortized using a straight-line method over the average remaining service period of active plan participants.

Despite the previously-described rigorous policies for selecting major actuarial assumptions, we periodically experience material differences between assumed and actual experience. As of January 3, 2009, we had consolidated unamortized prior service cost and net experience losses of approximately $1.9 billion, as compared to approximately $0.6 billion at December 29, 2007. The year-over-year increase in net unamortized amounts was attributable primarily to poor asset performance during 2008. Of the total unamortized amounts at January 3, 2009, approximately $1.5 billion was related to asset losses during 2008, with the remainder largely related to discount rate reductions and net unfavorable health care claims experience (including upward revisions in the assumed trend rate) prior to 2008. For 2009, we currently expect total amortization of prior service cost and net experience losses to be approximately $11 million higher than the actual 2008 amount of approximately $58 million. Total employee benefit expense for 2009 is expected to be slightly higher than 2008 due to increased amortization of experience losses which is offset by assumed asset returns on our 2008 contributions. Based on our current actuarial assumptions, we expect 2010 pension expense to increase significantly primarily due to the amortization of net experience losses.

During 2008 we made contributions in the amount of $354 million to Kellogg's global tax-qualified pension programs. This amount was mostly discretionary. We anticipate having to make additional contributions in future years to make up for the poor performance of global equity markets during 2008. Additionally we contributed $97 million to our retiree medical programs; most of this contribution was also discretionary and largely used to fund benefit obligations related to our union retiree healthcare benefits.

Assuming actual future experience is consistent with our current assumptions, annual amortization of accumulated prior service cost and net experience losses during each of the next several years would increase versus the 2008 amount.

Income taxes

Our consolidated effective income tax rate is influenced by tax planning opportunities available to us in the various jurisdictions in which we operate. Judgment is required in evaluating our tax positions to determine how much benefit should be recognized in our income tax expense. We establish tax reserves in accordance with FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" (FIN No. 48) which we adopted at the beginning of 2007. FIN No. 48 is based on a benefit recognition model, which we believe could result in a greater amount of benefit (and a lower amount of reserve) being initially recognized in certain circumstances. Prior to the adoption of FIN No. 48, our policy was to establish reserves that reflected the probable outcome of known tax contingencies. Favorable resolution was recognized as a reduction to our effective tax rate in the period of resolution. The initial application of FIN No. 48 resulted in a net decrease to the Company's consolidated accrued income tax and related interest liabilities of approximately $2 million, with an offsetting increase to retained earnings.

The Company evaluates a tax position in two-steps in accordance with FIN No. 48. The first step is to determine whether it is more-likely-than not that a tax position will be sustained upon examination based upon the technical merit of the position. In weighing the technical merits of the position, we consider the facts and circumstances of the position; we assume the reviewing tax authority has full knowledge of the position; and we consider the weight of authoritative guidance. The second step is measurement; a tax position that meets the more-likely-than not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. While reviewing the ranges of probable outcomes, the Company records the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. The tax position will be derecognized when it is no longer more-likely-than not of being sustained.

For the periods presented, our income tax and related interest reserves have averaged approximately $175 million. Reserve adjustments for individual issues have rarely exceeded 1% of earnings before income taxes annually. Significant tax reserve adjustments impacting our effective tax rate would be separately presented in the rate reconciliation table of Note 11 within Notes to Consolidated Financial Statements.

The current portion of our tax reserves is presented in the balance sheet within accrued income taxes and the amount expected to be settled after one year is recorded in other liabilities. Likewise, the current portion of related interest reserves are presented in the balance sheet within accrued other current liabilities, with the amount expected to be settled after one year recorded in other liabilities.

New accounting pronouncements

New accounting pronouncements are discussed in Note 1 within Notes to Consolidated Financial Statements.