

Notes to Consolidated Financial Statements

NOTE 1 ACCOUNTING POLICIES

Basis of presentation

The consolidated financial statements include the accounts of Kellogg Company and its majority-owned subsidiaries ("Kellogg" or the "Company"). Intercompany balances and transactions are eliminated.

The Company's fiscal year normally ends on the Saturday closest to December 31 and as a result, a 53rd week is added approximately every sixth year. The Company's 2007 and 2006 fiscal years each contained 52 weeks and ended on December 29 and December 30, respectively. The Company's 2008 fiscal year ended on January 3, 2009, and included a 53rd week. While quarters normally consist of 13-week periods, the fourth quarter of fiscal 2008 included a 14th week.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent 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 those estimates.

Cash and cash equivalents

Highly liquid investments with original maturities of three months or less are considered to be cash equivalents.

Accounts receivable

Accounts receivable consist principally of trade receivables, which are recorded at the invoiced amount, net of allowances for doubtful accounts and prompt payment discounts. Trade receivables do not bear interest. Terms and collection patterns vary around the world and by channel. In the United States, the Company generally has required payment for goods sold eleven or sixteen days subsequent to the date of invoice as 2% 10/net 11 or 1% 15/net 16, and days sales outstanding has averaged approximately 19 days during the periods presented. The allowance for doubtful accounts represents management's estimate of the amount of probable credit losses in existing accounts receivable, as determined from a review of past due balances and other specific account data. Account balances are written off against the allowance when management determines the receivable is uncollectible. The Company does not have any off-balance sheet credit exposure related to its customers. Refer to Note 18 for an analysis of the Company's

accounts receivable and allowance for doubtful account balances during the periods presented.

Inventories

Inventories are valued at the lower of cost of market. Cost is determined on an average cost basis.

Property

The Company's property consists mainly of plants and equipment used for manufacturing activities. These assets are recorded at cost and depreciated over estimated useful lives using straight-line methods for financial reporting and accelerated methods, where permitted, for tax reporting. Major property categories are depreciated over various periods as follows (in years): manufacturing machinery and equipment 5-20; computer and other office equipment 3-5; building components 15-30; building structures 50. Cost includes an amount of interest associated with significant capital projects. Plant and equipment are reviewed for impairment when conditions indicate that the carrying value may not be recoverable. Such conditions include an extended period of idleness or a plan of disposal. Assets to be abandoned at a future date are depreciated over the remaining period of use. Assets to be sold are written down to realizable value at the time the assets are being actively marketed for sale and the disposal is expected to occur within one year. As of year-end 2007 and 2008, the carrying value of assets held for sale was insignificant.

Goodwill and other intangible assets

The Company's goodwill and intangible assets are comprised primarily of amounts related to the 2001 acquisition of Keebler Foods Company ("Keebler"). Management expects the Keebler trademarks to contribute indefinitely to the cash flows of the Company. Accordingly, these intangible assets, have been classified as an indefinite-lived intangible. Goodwill and indefinite-lived intangibles are not amortized, but are tested at least annually for impairment. Goodwill impairment testing first requires a comparison between the carrying value and fair value of a reporting unit, which for the Company is generally equivalent to a North American product group or an International market. If carrying value exceeds fair value, goodwill is considered impaired and is reduced to the implied fair value. Impairment testing for indefinite-lived intangible assets requires a comparison between the fair value and carrying value of the intangible asset. If carrying value exceeds fair value, the intangible asset is considered impaired and is reduced to fair value. The Company uses various market valuation techniques to determine the fair value of intangible assets. Refer to Note 2 for further information on goodwill and other intangible assets.

Revenue recognition and measurement

The Company recognizes sales upon delivery of its products to customers net of applicable provisions for discounts, returns, allowances, and various government withholding taxes. Methodologies for determining these provisions are dependent on local customer pricing and promotional practices, which range from contractually fixed percentage price reductions to reimbursement based on actual occurrence or performance. Where applicable, future reimbursements are estimated based on a combination of historical patterns and future expectations regarding specific in-market product performance. The Company classifies promotional payments to its customers, the cost of consumer coupons, and other cash redemption offers in net sales. The cost of promotional package inserts is recorded in cost of goods sold. Other types of consumer promotional expenditures are normally recorded in selling, general and administrative (SGA) expense.

Advertising

The costs of advertising are expensed as incurred and are classified within SGA expense.

Research and development

The costs of research and development (R&D) are expensed as incurred and are classified within SGA expense. R&D includes expenditures for new product and process innovation, as well as significant technological improvements to existing products and processes. Total annual expenditures for R&D are disclosed in Note 18 and are principally comprised of internal salaries, wages, consulting, and supplies attributable to time spent on R&D activities. Other costs include depreciation and maintenance of research facilities and equipment, including assets at manufacturing locations that are temporarily engaged in pilot plant activities.

Stock-based compensation

The Company uses stock-based compensation, including stock options, restricted stock and executive performance shares, to provide long-term performance incentives for its global workforce. Refer to Note 8 for further information on these programs and the amount of compensation expense recognized during the periods presented.

The Company classifies pre-tax stock compensation expense principally in SGA expense within its corporate operations. Expense attributable to awards of equity instruments is accrued in capital in excess of par value within the Consolidated Balance Sheet.

Certain of the Company's stock-based compensation plans contain provisions that accelerate vesting of awards upon retirement, disability, or death of eligible employees and directors. A stock-based award is considered vested for expense attribution purposes when the employee's retention of the award is no

longer contingent on providing subsequent service. Accordingly, the Company recognizes compensation cost immediately for awards granted to retirement-eligible individuals or over the period from the grant date to the date retirement eligibility is achieved, if less than the stated vesting period.

Corporate income tax benefits realized upon exercise or vesting of an award in excess of that previously recognized in earnings ("windfall tax benefit") is presented in the Consolidated Statement of Cash Flows as a financing activity, classified as "other." Realized windfall tax benefits are credited to capital in excess of par value in the Consolidated Balance Sheet. Realized shortfall tax benefits (amounts which are less than that previously recognized in earnings) are first offset against the cumulative balance of windfall tax benefits, if any, and then charged directly to income tax expense. The Company currently has sufficient cumulative windfall tax benefits to absorb arising shortfalls, such that earnings were not affected during the periods presented. Correspondingly, the Company includes the impact of pro forma deferred tax assets (i.e., the "as if" windfall or shortfall) for purposes of determining assumed proceeds in the treasury stock calculation of diluted earnings per share.

Employee postretirement and postemployment benefits

The Company sponsors a number of U.S. and foreign plans to provide pension, health care, and other welfare benefits to retired employees, as well as salary continuance, severance, and long-term disability to former or inactive employees. Refer to Notes 9 and 10 for further information on these benefits and the amount of expense recognized during the periods presented.

In order to improve the reporting of pension and other postretirement benefit plans in the financial statements, in September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," which was effective for the Company at the end of its 2006 fiscal year. Prior periods were not restated. The standard requires plan sponsors to measure the net over- or under-funded position of a defined postretirement benefit plan as of the sponsor's fiscal year end and to display that position as an asset or liability on the balance sheet. Any unrecognized prior service cost, experience gains/losses, or transition obligation is reported as a component of other comprehensive income, net of tax, in shareholders' equity. In contrast, under pre-existing guidance, these unrecognized amounts were disclosed in financial statement footnotes.

Uncertain tax positions

In July 2006, the FASB issued Interpretation No. 48 "Accounting for Uncertainty in Income Taxes"

(FIN No. 48) to clarify what criteria must be met prior to recognition of the financial statement benefit, in accordance with SFAS No. 109, "Accounting for Income Taxes," of a position taken in a tax return. The provisions of the final interpretation apply broadly to all tax positions taken by an enterprise, including the decision not to report income in a tax return or the decision to classify a transaction as tax exempt. The prescribed approach is based on a two-step benefit recognition model. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not, based on the technical merits and without consideration of detection risk, that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the appropriate amount of the benefit to recognize. The amount of benefit to recognize is measured as the largest amount of tax benefit that is greater than 50 percent likely of being ultimately realized upon settlement. The tax position must be derecognized when it is no longer more likely than not of being sustained. The interpretation also provides guidance on recognition and classification of related penalties and interest, classification of liabilities, and disclosures of unrecognized tax benefits. The change in net assets, if any, as a result of applying the provisions of this interpretation is considered a change in accounting principle with the cumulative effect of the change treated as an offsetting adjustment to the opening balance of retained earnings in the period of transition.

The Company adopted FIN No. 48 as of the beginning of its 2007 fiscal year. Prior to adoption, the Company's pre-existing policy was to establish reserves for uncertain tax positions that reflected the probable outcome of known tax contingencies. As compared to the Company's historical approach, the application of FIN No. 48 resulted in a net decrease to accrued income tax and related interest liabilities of approximately \$2 million, with an offsetting increase to retained earnings.

Interest recognized in accordance with FIN No. 48 may be classified in the financial statements as either income taxes or interest expense, based on the accounting policy election of the enterprise. Similarly, penalties may be classified as income taxes or another expense. The Company has historically classified income tax-related interest and penalties as interest expense and SGA expense, respectively, and continues to do so under FIN No. 48.

Fair value measurements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" to define fair value, establish a framework for measuring fair value, and expand disclosures about fair value measurements. The Company adopted the provisions of SFAS No. 157 applicable to financial assets and liabilities, as well as

for other assets and liabilities that are carried at fair value on a recurring basis, as of the beginning of its 2008 fiscal year. The FASB provided for a deferral of the implementation of this standard for non-financial assets and non-financial liabilities, except for those recognized at fair value in the financial statements at least annually. Adoption of the initial provisions of SFAS No. 157 did not have an impact on the measurement of the Company's financial assets and liabilities but did result in additional disclosures contained in Note 13 herein.

New accounting pronouncements

Business combinations and noncontrolling interests. In December 2007, the FASB issued SFAS No. 141 (Revised 2007) "Business Combinations" and SFAS No. 160 "Noncontrolling Interests in Consolidated Financial Statements," which are effective for fiscal years beginning after December 15, 2008. These new standards represent the completion of the FASB's first major joint project with the International Accounting Standards Board and are intended to improve, simplify, and converge internationally the accounting for business combinations and the reporting of noncontrolling interests (formerly minority interests) in consolidated financial statements. Kellogg Company will adopt these standards at the beginning of its 2009 fiscal year. The effect of adoption will be prospectively applied to transactions completed after the end of the Company's 2008 fiscal year, although the new presentation and disclosure requirements for pre-existing noncontrolling interests will be retrospectively applied to all prior-period financial information presented.

SFAS No. 141(R) retains the underlying fair value concepts of its predecessor (SFAS No. 141), but changes the method for applying the acquisition method in a number of significant respects including the requirement to expense transaction fees and expected restructuring costs as incurred, rather than including these amounts in the allocated purchase price; the requirement to recognize the fair value of contingent consideration at the acquisition date, rather than the expected amount when the contingency is resolved; the requirement to recognize the fair value of acquired in-process research and development assets at the acquisition date, rather than immediately expensing them; and the requirement to recognize a gain in relation to a bargain purchase price, rather than reducing the allocated basis of long-lived assets. Because this standard is applied prospectively, the effect of adoption on the Company's financial statements will depend primarily on specific transactions, if any, completed after 2008.

Under SFAS No. 160, consolidated financial statements will be presented as if the parent company investors (controlling interests) and other minority investors (noncontrolling interests) in partially-owned subsidiaries

have similar economic interests in a single entity. As a result, the investment in the noncontrolling interest, previously recorded on the balance sheet between liabilities and equity (the mezzanine), will be reported as equity in the parent company's consolidated financial statements subsequent to the adoption of SFAS No. 160. Furthermore, consolidated financial statements will include 100% of a controlled subsidiary's earnings, rather than only the parent company's share. Lastly, transactions between the parent company and noncontrolling interests will be reported in equity as transactions between shareholders, provided that these transactions do not create a change in control. Previously, acquisitions of additional interests in a controlled subsidiary generally resulted in remeasurement of assets and liabilities acquired; dispositions of interests generally resulted in a gain or loss. The Company does not expect the adoption of SFAS No. 160 to have a material impact on its financial statements.

Disclosures about derivative instruments. In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities," an amendment of SFAS No. 133. SFAS No. 161 requires companies to disclose their objectives and strategies for using derivative instruments, whether or not their derivatives are designated as hedging instruments. The pronouncement requires disclosure of the fair value of derivative instruments by primary underlying risk exposures (e.g. interest rate, credit, foreign exchange rate, combination of interest rate and foreign exchange rate, or overall price). It also requires detailed disclosures about the income statement impact of derivative instruments by designation as fair-value hedges, cash-flow hedges, or hedges of the foreign-currency exposure of a net investment in a foreign operation. SFAS No. 161 requires disclosure of information that will enable financial statement users to understand the level of derivative activity entered into by the company (e.g., total number of interest-rate swaps or total notional or quantity or percentage of forecasted commodity purchases that are being hedged). The principles of SFAS No. 161 may be applied on a prospective basis and are effective for financial statements issued for fiscal years beginning after November 15, 2008. For the Company, SFAS No. 161 will be effective at the beginning of its 2009 fiscal year and will result in additional disclosures in notes to the Company's consolidated financial statements.

Fair value. In February 2008, the FASB issued Staff Position (FSP) FAS 157-2, "Effective Date of FASB Statement No. 157," which delays by one year the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for those that are recognized or disclosed at fair value in the financial statements at least annually. Assets and liabilities subject to this deferral include goodwill, intangible assets, long-lived assets measured at fair value for

impairment assessments, and nonfinancial assets and liabilities initially measured at fair value in a business combination. For the Company, FSP FAS 157-2 will be effective at the beginning of its 2009 fiscal year. Management does not expect the adoption of the remaining provisions to have a material impact on the measurement of the Company's non-financial assets and liabilities.

Disclosures about postretirement benefit plan assets. In December 2008, the FASB issued FSP FAS 132(R)-1, "Employers' Disclosures about Postretirement Benefit Plan Assets," which provides additional guidance on employers' disclosures about the plan assets of defined benefit pension or other postretirement plans. The disclosures required by FSP FAS 132(R)-1 include a description of how investment allocation decisions are made, major categories of plan assets, valuation techniques used to measure the fair value of plan assets, the impact of measurements using significant unobservable inputs and concentrations of risk within plan assets. The disclosures about plan assets required by this FSP shall be provided for fiscal years ending after December 15, 2009. For the Company, FSP FAS 132(R)-1 will be effective for fiscal year end 2009 and will result in additional disclosures related to the assets of defined benefit pension plans in notes to the Company's consolidated financial statements.

NOTE 2 ACQUISITIONS, OTHER INVESTMENTS, GOODWILL AND OTHER INTANGIBLE ASSETS

Acquisitions

The Company made acquisitions in order to expand its presence geographically and increase its manufacturing capacity.

Assets, liabilities, and results of operations of the acquired businesses have been included in the Company's consolidated financial statements beginning on the date of acquisition; such amounts were insignificant to the Company's consolidated financial position and results of operations. In addition, the pro forma effect of these acquisitions on the Company's results of operations, as though these business combinations had been completed at the beginning of 2008 or 2007, would have been immaterial when considered individually or in the aggregate.

At January 3, 2009, the valuation of assets acquired and liabilities assumed in connection with these acquisitions is considered complete.

Specialty Cereals. In September 2008, the Company acquired Specialty Cereals of Sydney, Australia, a manufacturer and distributor of natural ready-to-eat cereals. The Company paid \$37 million cash in connection with the transaction, including approximately \$5 million to the seller's lenders to settle

debt of the acquired entity. Assets acquired consisted primarily of property, plant and equipment of \$19 million and goodwill of \$18 million (which will not be deductible for income tax purposes). This acquisition is included in the Asia Pacific operating segment.

IndyBake Products/Brownie Products. In August 2008, the Company acquired certain assets and liabilities of the business of IndyBake Products and Brownie Products (collectively, "IndyBake"), located in Indiana and Illinois. IndyBake, a contract manufacturing business that produces cracker, cookie and frozen dough products, had been a partner to Kellogg for many years as a snacks contract manufacturer.

The Company paid approximately \$42 million in cash in connection with the transaction, including approximately \$8 million to the seller's lenders. Assets acquired consisted primarily of property, plant and equipment of \$12 million and goodwill of \$25 million (which will be deductible for income tax purposes). Other assets acquired amounted to \$5 million, net of other liabilities acquired. This acquisition is included in the North America operating segment.

Navigable Foods. In June 2008, the Company acquired a majority interest in the business of Zhenghang Food Company Ltd. ("Navigable Foods") for approximately \$36 million (net of cash received). Navigable Foods, a manufacturer of cookies and crackers in the northern and northeastern regions of China, included approximately 1,800 employees, two manufacturing facilities and a sales and distribution network.

During 2008, the Company paid a total of \$31 million in connection with the acquisition, including approximately \$22 million to lenders and other third parties to settle debt and other obligations of the acquired entity. Assets acquired consisted primarily of property, plant and equipment of \$23 million and goodwill of \$19 million (which will be deductible for income tax purposes). Other liabilities acquired amounted to \$6 million, net of other assets acquired. At January 3, 2009, additional purchase price payable in June 2011 amounted to \$5 million and was recorded on the Company's Consolidated Balance Sheet in other liabilities. This acquisition is included in the Asia Pacific operating segment.

The Company recorded noncontrolling interest of \$6 million in connection with the acquisition, and obtained the option to purchase the noncontrolling interest beginning June 30, 2011. The noncontrolling interest holder also obtained the option to cause the Company to purchase its remaining interest. The options, which have similar terms, include an exercise price that is expected to approximate fair value on the date of exercise.

United Bakers. In January 2008, subsidiaries of the Company acquired substantially all of the equity

interests in OJSC Kreker (doing business as "United Bakers") and consolidated subsidiaries. United Bakers is a leading producer of cereal, cookie, and cracker products in Russia, with approximately 4,000 employees, six manufacturing facilities, and a broad distribution network.

The Company paid \$110 million cash (net of \$5 million cash acquired), including approximately \$67 million to settle debt and other assumed obligations of the acquired entities. Of the total cash paid, \$5 million was spent in 2007 for transaction fees and advances. This acquisition is included in the Europe operating segment.

The purchase agreement between the Company and the seller provides for the payment of a currently undeterminable amount of contingent consideration at the end of three years, which will be calculated based on the growth of sales and earnings before income taxes, depreciation and amortization. Such payment will be recognized as additional purchase price when the contingency is resolved.

The purchase price allocation for United Bakers was as follows:

(millions)	Asset/(liability)
Cash	\$ 5
Property, net	60
Goodwill (a)	77
Working capital, net (b)	(11)
Long-term debt	(3)
Deferred income taxes	(8)
Other	(5)
Total	\$115

(a) Goodwill is not expected to be tax deductible.

(b) Inventory, receivables and other current assets less current liabilities.

Bear Naked, Inc. and Wholesome & Hearty Foods Company. In late 2007, the Company completed two separate business acquisitions for a total of approximately \$123 million in cash, including related transaction costs. A subsidiary of the Company acquired 100% of the equity interests in Bear Naked, Inc., a leading seller of premium-branded natural granola products. Also, the Company acquired certain assets and liabilities of the Wholesome & Hearty Foods Company, a U.S. manufacturer of veggie foods marketed under the Gardenburger® brand. The combined purchase price allocation was as follows (in millions): Goodwill—\$68; indefinite-lived trademark intangibles—\$33; trademark intangibles with a 10-year expected useful life—\$5; equipment—\$7; working capital and other individually immaterial items—\$10. The amount of tax-deductible goodwill is currently expected to approximate the carrying value recognized for financial reporting purposes. These acquisitions are included in the North America operating segment.

Other investments

In early 2006, a subsidiary of the Company formed a joint venture with a third-party company domiciled in Turkey, for the purpose of selling co-branded products in the surrounding region. During 2007, the Company contributed approximately \$4 million in cash to its Turkish joint venture, in which it owns a 50% equity interest. No additional contributions were made during 2008. The Company's net investment as of January 3, 2009 was approximately \$6 million. This joint venture is included in the Europe operating segment and is accounted for using the equity method of accounting. Accordingly, the Company records its share of the earnings or loss from this arrangement as well as other direct transactions with or on behalf of the joint venture entity such as product sales and certain administrative expenses.

Goodwill and other intangible assets

For 2007, the Company recorded in selling, general, and administrative expense impairment losses of \$7 million to write off the remaining carrying value of several individually insignificant trademarks, which were abandoned during the year. Associated gross carrying amounts of \$16 million and the related accumulated amortization were retired from the Company's balance sheet.

For the periods presented, the Company's intangible assets consisted of the following:

Intangible assets subject to amortization				
(millions)	Gross carrying amount		Accumulated amortization	
	2008	2007	2008	2007
Trademarks	\$19	\$19	\$14	\$13
Other	41	29	28	28
Total	\$60	\$48	\$42	\$41
			2008	2007
Amortization expense (a)			\$1	\$8

(a) The currently estimated aggregate amortization expense for each of the five succeeding fiscal years is approximately \$2 million per year.

Intangible assets not subject to amortization		
(millions)	Total carrying amount	
	2008	2007
Trademarks	\$1,443	\$1,443

Changes in the carrying amount of goodwill

(millions)	North America	Europe	Latin America	Asia Pacific (a)	Consolidated
December 30, 2006	\$3,446	\$ —	\$ —	\$ 2	\$3,448
Acquisitions	67	—	—	—	67
December 29, 2007	\$3,513	\$ —	\$ —	\$ 2	\$3,515
Purchase accounting adjustments	1	—	—	—	1
Acquisitions	25	77	—	37	139
Currency translation adjustment	—	(16)	—	(2)	(18)
January 3, 2009	\$3,539	\$ 61	\$ —	\$37	\$3,637

(a) Includes Australia, Asia and South Africa.

NOTE 3 EXIT OR DISPOSAL ACTIVITIES

The Company views its continued spending on cost-reduction initiatives as part of its ongoing operating principles to provide greater visibility in achieving its long-term profit growth targets. Initiatives undertaken are currently expected to recover cash implementation costs within a five-year period of completion. Each cost-reduction initiative is normally up to three years in duration. Upon completion (or as each major stage is completed in the case of multi-year programs), the project begins to deliver cash savings and/or reduced depreciation.

Cost summary

The Company recorded \$27 million of costs in 2008 associated with exit or disposal activities comprised of \$7 million of asset write offs, \$17 million of severance and other cash costs and \$3 million related to pension costs. \$23 million of the 2008 charges were recorded in cost of goods sold within the Europe operating segment, with the balance recorded in selling, general and administrative (SGA) expense in the Latin America operating segment.

For 2007, the Company recorded charges of \$100 million, comprised of \$7 million of asset write-offs, \$72 million for severance and other exit costs including route franchise settlements, \$15 million for other cash expenditures, and \$6 million for a multiemployer pension plan withdrawal liability. \$23 million of the total 2007 charges were recorded in cost of goods sold within the Europe operating segment results, with \$77 million recorded in SGA expense within the North America operating results.

For 2006, the Company recorded charges of \$82 million, comprised of \$20 million of asset write-offs, \$30 million for severance and other exit costs, \$9 million for other cash expenditures, \$4 million for a multiemployer pension plan withdrawal liability, and \$19 million for pension and other postretirement plan curtailment losses and special termination benefits. \$74 million was recorded in cost of goods sold within

operating segment results, with \$8 million recorded in SGA expense within corporate results. The Company's operating segments were impacted as follows (in millions): North America—\$46; Europe—\$28.

Exit cost reserves at January 3, 2009 were \$2 million related to severance payments. Exit cost reserves were \$5 million at December 29, 2007, consisting of \$2 million for severance and \$3 million for lease termination payments.

Specific initiatives

During the fourth quarter of 2008, the Company executed a cost-reduction initiative in Latin America that resulted in the elimination of approximately 120 salaried positions. The cost of the program was \$4 million and was recorded in Latin America's SGA expense. The charge related primarily to severance benefits which were paid by the end of the year. There were no reserves as of January 3, 2009 related to this program.

The Company commenced a multi-year European manufacturing optimization plan in 2006 to improve utilization of its facility in Manchester, England and to better align production in Europe. The project resulted in an elimination of approximately 220 hourly and salaried positions from the Manchester facility through voluntary early retirement and severance programs. The pension trust funding requirements of these early retirements exceeded the recognized benefit expense by \$5 million which was funded in 2006. During this program certain manufacturing equipment was removed from service.

All of the costs for the European manufacturing optimization plan have been recorded in cost of goods sold within the Company's Europe operating segment. The following tables present total project costs and a reconciliation of employee severance reserves for this initiative. All other cash costs were paid in the period incurred. The project was completed in 2008.

Project costs to date (millions)	Employee severance	Other cash costs (a)	Asset write-offs	Retirement benefits (b)	Total
Year ended December 30, 2006	\$12	\$ 2	\$ 5	\$ 9	\$28
Year ended December 29, 2007	7	8	4	—	19
Year ended January 3, 2009	5	3	(3)	3	8
Total project costs	\$24	\$13	\$ 6	\$12	\$55

(a) Primarily includes expenditures for equipment removal and relocation, and temporary contracted services to facilitate employee transitions.

(b) Pension plan curtailment losses and special termination benefits recognized under SFAS No. 88 "Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits."

Employee severance reserves to date (millions)	Beginning of period	Accruals	Payments	End of period
Year ended December 29, 2007	\$12	\$7	\$(19)	\$—
Year ended January 3, 2009	\$—	\$5	\$(3)	\$2

In October 2007, management committed to reorganize certain production processes at the Company's plants in Valls, Spain and Bremen, Germany.

Commencement of this plan followed consultation with union representatives at the Bremen facility regarding the elimination of approximately 120 employee positions. This reorganization plan improved manufacturing and distribution efficiency across the Company's continental European operations, and has been completed as of the end of the Company's 2008 fiscal year.

All of the costs for European production process realignment have been recorded in cost of goods sold within the Company's Europe operating segment.

The following tables present total project costs and a reconciliation of employee severance reserves for this initiative. All other cash costs were paid in the period incurred.

Project costs to date (millions)	Employee severance	Other cash costs (a)	Asset write-offs	Total
Year ended December 29, 2007	\$2	\$1	\$ 1	\$ 4
Year ended January 3, 2009	4	1	10	15
Total project costs	\$6	\$2	\$11	\$19

(a) Primarily includes expenditures for equipment removal and relocation, and temporary contracted services to facilitate employee transitions.

Employee severance reserves to date (millions)	Beginning of period	Accruals	Payments	End of period
Year ended December 29, 2007	\$—	\$2	\$—	\$ 2
Year ended January 3, 2009	\$ 2	\$4	\$(6)	\$—

In July 2007, management commenced a plan to reorganize the Company's direct store-door delivery (DSD) operations in the southeastern United States. This DSD reorganization plan was intended to integrate the Company's southeastern sales and distribution regions with the rest of its U.S. DSD operations, resulting in greater efficiency across the nationwide network. The Company exited approximately 517 distribution route franchise agreements with independent contractors. The plan also resulted in the involuntary termination or relocation of approximately 300 employee positions. Total project costs incurred were \$77 million, principally consisting of cash expenditures for route franchise settlements and to a lesser extent, for employee separation, relocation, and reorganization. Exit cost reserves were \$3 million as of December 29, 2007 and were paid in 2008. This initiative is complete.

During 2006, the Company commenced several initiatives to enhance the productivity and efficiency of its U.S. cereal manufacturing network, primarily through technological and sourcing improvements in warehousing and packaging operations. In conjunction with these initiatives, the Company offered voluntary separation incentives, which resulted in the retirement of approximately 80 hourly employees by early 2007. During 2006, the Company incurred approximately \$15 million of total up-front costs, comprised of approximately 20% asset write-offs and 80% cash

costs, including \$10 million of pension and other postretirement plan curtailment losses. These initiatives were complete by the end of 2007.

Also during 2006, the Company undertook an initiative to improve customer focus and selling efficiency within a particular Latin American market, leading to a shift from a third-party distributor to a direct sales force model. As a result of this initiative, the Company paid \$8 million in cash during 2006 to exit the existing distribution arrangement.

During 2008 the Company finalized its pension plan withdrawal liability related to its North America snacks bakery consolidation which was executed in 2005 and 2006. The final liability was \$20 million, \$16 million of which was recognized in 2005 and \$4 million in 2006; and was paid in the third quarter of 2008.

NOTE 4 OTHER INCOME (EXPENSE), NET

Other income (expense), net includes non-operating items such as interest income, charitable donations, and gains and losses from foreign currency exchange and commodity derivatives.

Other income (expense), net includes charges for contributions to the Kellogg's Corporate Citizenship Fund, a private trust established for charitable giving, as follows (in millions): 2008—\$4; 2007—\$12; 2006—\$3. Interest income was (in millions): 2008—\$20; 2007—\$23; 2006—\$11. Net foreign currency exchange gains (losses) were (in millions): 2008—\$5; 2007—\$(8); 2006—\$(2). Income (expense) recognized for premiums on commodity options was (in millions): 2008—\$(12); 2007—\$(7); 2006—\$0. Gains (losses) on Company Owned Life Insurance ("COLI"), due to changes in cash surrender value, were (in millions): 2008—\$(12); 2007—\$9; 2006—\$12.

NOTE 5 EQUITY

During the year ended December 30, 2006, the Company revised the classification of \$101 million of prior net losses realized upon reissuance of treasury shares from capital in excess of par value to retained earnings on the Consolidated Balance Sheet. Such reissuances occurred in connection with employee and director stock option exercises and other share-based settlements. The revision did not have an effect on the Company's results of operations, total shareholders' equity, or cash flows.

Earnings per share

Basic net earnings per share is determined by dividing net earnings by the weighted-average number of common shares outstanding during the period. Diluted net earnings per share is similarly determined, except

that the denominator is increased to include the number of additional common shares that would have been outstanding if all dilutive potential common shares had been issued. Dilutive potential common shares are comprised principally of employee stock options issued by the Company. Basic net earnings per share is reconciled to diluted net earnings per share in the following table. The total number of anti-dilutive potential common shares excluded from the reconciliation for each period was (in millions): 2008—5.8; 2007—0.8; 2006—0.7.

(millions, except per share data)	Net earnings	Average shares outstanding	Net earnings per share
2008			
Basic	\$1,148	382	\$3.01
Dilutive potential common shares	—	3	(.02)
Diluted	\$1,148	385	\$2.99
2007			
Basic	\$1,103	396	\$2.79
Dilutive potential common shares	—	4	(.03)
Diluted	\$1,103	400	\$2.76
2006			
Basic	\$1,004	397	\$2.53
Dilutive potential common shares	—	3	(.02)
Diluted	\$1,004	400	\$2.51

Stock transactions

The Company issues shares to employees and directors under various equity-based compensation and stock purchase programs, as further discussed in Note 8. The number of shares issued during the periods presented was (in millions): 2008—5; 2007—4; 2006—7. Additionally, during 2006, the Company established *Kellogg Direct™*, a direct stock purchase and dividend reinvestment plan for U.S. shareholders. The total number of shares issued for that purpose was less than one million in 2008, 2007 and 2006.

To offset these issuances and for general corporate purposes, the Company's Board of Directors has authorized management to repurchase specified amounts of the Company's common stock in each of the periods presented. In each of the years 2008, 2007 and 2006, the Company spent \$650 million to repurchase the following number of shares (in millions); 2008—13; 2007—12; and 2006—15. The 2006 activity consisted principally of a February 2006 private transaction with the W. K. Kellogg Foundation Trust to repurchase approximately 13 million shares for \$550 million.

On July 25, 2008, the Board of Directors authorized the repurchase of \$500 million of Kellogg common stock during 2008 and 2009 for general corporate purposes and to offset issuances for employee benefit programs. No purchases were made under this program. This authorization was canceled on

February 4, 2009 and replaced with a \$650 million authorization for 2009.

Comprehensive income

Comprehensive income includes net earnings and all other changes in equity during a period except those resulting from investments by or distributions to shareholders. Other comprehensive income for the periods presented consists of foreign currency translation adjustments pursuant to SFAS No. 52 "Foreign Currency Translation," unrealized gains and losses on cash flow hedges pursuant to SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," and beginning in 2007 includes adjustments for net experience losses and prior service cost pursuant to SFAS No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." The Company adopted SFAS No. 158 as of the end of its 2006 fiscal year.

During 2008, the assets of the Company's postretirement and postemployment benefit plans suffered losses of over \$1 billion due to the asset allocation of 70% in the equity market. These losses are recognized in other comprehensive income and for pension plans is recognized in the calculated value of plan assets over a five-year period and once recognized, are amortized using a declining-balance method over the average remaining service period of active plan participants.

(millions)	Pre-tax amount	Tax (expense) benefit	After-tax amount
2008			
Net earnings			\$ 1,148
Other comprehensive income:			
Foreign currency translation adjustments	\$ (431)	\$ —	(431)
Cash flow hedges:			
Unrealized loss on cash flow hedges	(33)	12	(21)
Reclassification to net earnings	5	(2)	3
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience loss	(1,402)	497	(905)
Prior service cost	3	(1)	2
Reclassification to net earnings:			
Net experience loss	49	(17)	32
Prior service cost	9	(3)	6
	\$(1,800)	\$ 486	(1,314)
Total comprehensive income (loss)			\$ (166)
2007			
Net earnings			\$ 1,103
Other comprehensive income:			
Foreign currency translation adjustments	\$ 4	\$ —	4
Cash flow hedges:			
Unrealized gain on cash flow hedges	34	(11)	23
Reclassification to net earnings	5	(1)	4
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience gain	187	(68)	119
Prior service cost	7	(4)	3
Reclassification to net earnings:			
Net experience loss	89	(30)	59
Prior service cost	10	(3)	7
	\$ 336	\$(117)	219
Total comprehensive income			\$ 1,322
2006			
Net earnings			\$ 1,004
Other comprehensive income:			
Foreign currency translation adjustments	\$ 10	\$ —	10
Cash flow hedges:			
Unrealized loss on cash flow hedges	(12)	4	(8)
Reclassification to net earnings	12	(4)	8
Minimum pension liability adjustments	172	(60)	112
	\$ 182	\$ (60)	122
Total comprehensive income			\$ 1,126

Accumulated other comprehensive income (loss) at year end consisted of the following:

(millions)	2008	2007
Foreign currency translation adjustments	\$ (836)	\$(405)
Cash flow hedges — unrealized net loss	(24)	(6)
Postretirement and postemployment benefits:		
Net experience loss	(1,235)	(362)
Prior service cost	(46)	(54)
Total accumulated other comprehensive income (loss)	\$(2,141)	\$(827)

NOTE 6 LEASES AND OTHER COMMITMENTS

The Company's leases are generally for equipment and warehouse space. Rent expense on all operating leases was (in millions): 2008-\$145; 2007-\$135; 2006-\$123. The Company was subject to a residual value guarantee on one operating lease of approximately \$13 million, which was scheduled to expire in July 2007. During the first quarter of 2007, the Company recognized a liability in connection with this guarantee of approximately \$5 million, which was recorded in cost of goods sold within the Company's North America operating segment. During the second quarter of 2007, the Company terminated the lease agreement and purchased the facility for approximately \$16 million, which discharged the residual value guarantee obligation. During 2008, 2007 and 2006, the Company entered into approximately \$3 million, \$5 million and \$2 million, respectively, in capital lease agreements to finance the purchase of equipment.

At January 3, 2009, future minimum annual lease commitments under noncancelable operating and capital leases were as follows:

(millions)	Operating leases	Capital leases
2009	\$135	\$ 1
2010	119	1
2011	99	1
2012	75	1
2013	56	0
2014 and beyond	143	2
Total minimum payments	\$627	\$ 6
Amount representing interest		(1)
Obligations under capital leases		5
Obligations due within one year		(1)
Long-term obligations under capital leases		\$ 4

One of the Company's subsidiaries was guarantor on loans to independent contractors for the purchase of DSD route franchises. In July 2007, the Company exited these agreements. Refer to Note 3 for further information.

The Company has provided various standard indemnifications in agreements to sell and purchase business assets and lease facilities over the past several years, related primarily to pre-existing tax, environmental, and employee benefit obligations. Certain of these indemnifications are limited by agreement in either amount and/or term and others are unlimited. The Company has also provided various "hold harmless" provisions within certain service type agreements. Because the Company is not currently aware of any actual exposures associated with these indemnifications, management is unable to estimate the maximum potential future payments to be made. At January 3, 2009, the Company had not recorded any liability related to these indemnifications.

NOTE 7 DEBT

Notes payable at year end consisted of commercial paper borrowings in the United States and Canada, and to a lesser extent, bank loans of foreign subsidiaries at competitive market rates, as follows:

(dollars in millions)	2008		2007	
	Principal amount	Effective interest rate	Principal amount	Effective interest rate
U.S. commercial paper	\$1,272	4.1%	\$1,434	5.3%
Canadian commercial paper	38	2.8%	5	4.3%
Other	77		50	
	\$1,387		\$1,489	

Long-term debt at year end consisted primarily of issuances of fixed rate U.S. Dollar Notes, as follows:

(millions)	2008	2007
(a) 6.6% U.S. Dollar Notes due 2011	\$1,426	\$1,425
(a) 7.45% U.S. Dollar Debentures due 2031	1,089	1,088
(b) 2.875% U.S. Dollar Notes due 2008	—	465
(c) 5.125% U.S. Dollar Notes due 2012	749	750
(d) 4.25% U.S. Dollar Notes due 2013	792	—
Other	13	8
	4,069	3,736
Less current maturities	(1)	(466)
Balance at year end	\$4,068	\$3,270

- (a) In March 2001, the Company issued \$4.6 billion of long-term debt instruments, primarily to finance the acquisition of Keebler Foods Company. The preceding table reflects the remaining principal amounts outstanding as of year-end 2008 and 2007. The effective interest rates on these Notes, reflecting issuance discount and swap settlement, were as follows: due 2011-7.08%; due 2031-7.62%. Initially, these instruments were privately placed, or sold outside the United States, in reliance on exemptions from registration under the Securities Act of 1933, as amended (the "1933 Act"). The Company then exchanged new debt securities for these initial debt instruments, with the new debt securities being substantially identical in all respects to the initial debt instruments, except for being registered under the 1933 Act. These debt securities contain standard events of default and covenants. The Notes due 2011 and the Debentures due 2031 may be redeemed in whole or in part by the Company at any time at prices determined under a formula (but not less than 100% of the principal amount plus unpaid interest to the redemption date). In December 2007, the Company redeemed \$72 million of the Notes due 2011.
- (b) In June 2003, the Company issued \$500 million of five-year 2.875% fixed rate U.S. Dollar Notes, using the proceeds from these Notes to replace maturing long-term debt. These Notes were issued under an existing shelf registration statement. The effective interest rate on these Notes, reflecting issuance discount and swap settlement, was 3.35%. The Notes contained customary covenants that limited the ability of the Company and its restricted subsidiaries (as defined) to incur certain liens or enter into certain sale and lease-back transactions. In December 2005, the Company redeemed \$35 million of these Notes, and in June 2008 the Company repaid the remainder of the notes.
- (c) In December 2007, the Company issued \$750 million of five-year 5.125% fixed rate U.S. Dollar Notes, using the proceeds from these Notes to replace a portion of its U.S. commercial paper. These Notes were issued under an existing shelf registration statement. The effective interest rate on these Notes, reflecting issuance discount and swap settlement, is 5.12%. The Notes contain customary covenants that limit the ability of the Company and its restricted subsidiaries (as defined) to incur certain liens or enter into certain sale and lease-back transactions. The customary covenants also contain a change of control provision.

(d) On March 6, 2008, the Company issued \$750 million of five-year 4.25% fixed rate U.S. Dollar Notes, using the proceeds from these Notes to retire a portion of its U.S. commercial paper. These Notes were issued under an existing shelf registration statement. The Notes contain customary covenants that limit the ability of the Company and its restricted subsidiaries (as defined) to incur certain liens or enter into certain sale and lease-back transactions. The customary covenants also contain a change of control provision. In conjunction with this debt issuance, the Company entered into interest rate swaps with notional amounts totaling \$750 million, which effectively converted this debt from a fixed rate to a floating rate obligation for the duration of the five-year term. These derivative instruments, which were designated as fair value hedges of the debt obligation, resulted in an effective interest rate of 3.09% as of January 3, 2009. The fair value adjustment for the interest rate swaps was \$43 million at January 3, 2009, and is recorded directly in the hedged debt balance.

In February 2007, the Company and two of its subsidiaries (the "Issuers") established a program under which the Issuers may issue euro-commercial paper notes up to a maximum aggregate amount outstanding at any time of \$750 million or its equivalent in alternative currencies. The notes may have maturities ranging up to 364 days and will be senior unsecured obligations of the applicable Issuer. Notes issued by subsidiary Issuers will be guaranteed by the Company. The notes may be issued at a discount or may bear fixed or floating rate interest or a coupon calculated by reference to an index or formula. As of January 3, 2009, no notes were outstanding under this program.

At January 3, 2009, the Company had \$2.2 billion of short-term lines of credit, virtually all of which were unused and available for borrowing on an unsecured basis. These lines were comprised principally of an unsecured Five-Year Credit Agreement, which the Company entered into during November 2006 and expires in 2011. The agreement allows the Company to borrow, on a revolving credit basis, up to \$2.0 billion, to obtain letters of credit in an aggregate amount up to \$75 million, and to provide a procedure for lenders to bid on short-term debt of the Company. The agreement contains customary covenants and warranties, including specified restrictions on indebtedness, liens, sale and leaseback transactions, and a specified interest coverage ratio. If an event of default occurs, then, to the extent permitted, the administrative agent may terminate the commitments under the credit facility, accelerate any outstanding loans, and demand the deposit of cash collateral equal to the lender's letter of credit exposure plus interest. The Company entered into a \$400 million unsecured 364-Day Credit Agreement effective January 31, 2007, containing customary covenants, warranties, and restrictions similar to those described herein for the Five-Year Credit Agreement. The facility was available for general corporate purposes, including commercial paper back-up. The \$400 million Credit Agreement expired at the end of January 2008 and the Company did not renew it.

Scheduled principal repayments on long-term debt are (in millions): 2009-\$1; 2010-\$1; 2011-\$1,428; 2012-\$751; 2013-\$752; 2014 and beyond-\$1,108.

Interest paid was (in millions): 2008-\$305; 2007-\$305; 2006-\$299. Interest expense capitalized as part of the construction cost of fixed assets was (in millions): 2008-\$6; 2007-\$5; 2006-\$3.

NOTE 8 STOCK COMPENSATION

The Company uses various equity-based compensation programs to provide long-term performance incentives for its global workforce. Currently, these incentives consist principally of stock options, and to a lesser extent, executive performance shares and restricted stock grants. The Company also sponsors a discounted stock purchase plan in the United States and matching-grant programs in several international locations. Additionally, the Company awards stock options and restricted stock to its outside directors. These awards are administered through several plans, as described within this Note.

The 2003 Long-Term Incentive Plan ("2003 Plan"), approved by shareholders in 2003, permits benefits to be awarded to employees and officers in the form of incentive and non-qualified stock options, performance units, restricted stock or restricted stock units, and stock appreciation rights. The 2003 Plan authorizes the issuance of a total of (a) 25 million shares plus (b) shares not issued under the 2001 Long-Term Incentive Plan, with no more than 5 million shares to be issued in satisfaction of performance units, performance-based restricted shares and other awards (excluding stock options and stock appreciation rights), and with additional annual limitations on awards or payments to individual participants. At January 3, 2009, there were 6.6 million remaining authorized, but unissued, shares under the 2003 Plan. During the periods presented, specific awards and terms of those awards granted under the 2003 Plan are described in the following sections of this Note.

The Non-Employee Director Stock Plan ("Director Plan") was approved by shareholders in 2000 and allows each eligible non-employee director to receive 2,100 shares of the Company's common stock annually and annual grants of options to purchase 5,000 shares of the Company's common stock. At January 3, 2009, there were 0.3 million remaining authorized, but unissued, shares under this plan. Shares other than options are placed in the Kellogg Company Grantor Trust for Non-Employee Directors (the "Grantor Trust"). Under the terms of the Grantor Trust, shares are available to a director only upon termination of service on the Board. Under this plan, awards were as follows: 2008-54,465 options and 19,964 shares; 2007-51,791 options and 21,702 shares; 2006-50,000 options and 17,000 shares. Options granted to directors under this plan are included in the option activity tables within this Note.

The 2002 Employee Stock Purchase Plan was approved by shareholders in 2002 and permits eligible employees to purchase Company stock at a discounted price. This plan allows for a maximum of 2.5 million shares of Company stock to be issued at a purchase price equal to 95% of the fair market value of the stock on the last day of the quarterly purchase period. Total purchases through this plan for any employee are limited to a fair market value of \$25,000 during any calendar year. The Plan was amended in 2007. Prior to amendment, Company stock was issued at a purchase price equal to 85% of the fair market value of the stock on the first or last day of the quarterly purchase period. At January 3, 2009, there were 1.1 million remaining authorized, but unissued, shares under this plan. Shares were purchased by employees under this plan as follows (approximate number of shares): 2008–157,000; 2007–232,000; 2006–237,000. Options granted to employees to purchase discounted stock under this plan are included in the option activity tables within this Note.

Additionally, during 2002, a foreign subsidiary of the Company established a stock purchase plan for its employees. Subject to limitations, employee contributions to this plan are matched 1:1 by the Company. Under this plan, shares were granted by the Company to match an approximately equal number of shares purchased by employees as follows (approximate number of shares): 2008–78,000; 2007–75,000; 2006–80,000.

The Executive Stock Purchase Plan was established in 2002 to encourage and enable certain eligible employees of the Company to acquire Company stock, and to align more closely the interests of those individuals and the Company's shareholders. This plan allowed for a maximum of 500,000 shares of Company stock to be issued. Under this plan in 2006, approximately 4,000 shares were granted by the Company to executives in lieu of cash bonuses. No shares were granted under this plan in 2007. The plan expired in 2007 with approximately 460,000 authorized but unissued shares remaining unused.

Compensation expense for all types of equity-based programs and the related income tax benefit recognized were as follows:

(millions)	2008	2007	2006
Pre-tax compensation expense	\$74	\$81	\$96
Related income tax benefit	\$26	\$29	\$34

Pre-tax compensation expense for 2008 included \$4 million of expense related to the modification of certain stock options to eliminate the accelerated ownership feature ("AOF") and \$13 million representing cash compensation to holders of modified stock options to replace the value of the AOF, which is discussed in the section, "Stock options."

As of January 3, 2009, total stock-based compensation cost related to nonvested awards not yet recognized was approximately \$29 million and the weighted-average period over which this amount was expected to be recognized was approximately 1.4 years.

Cash flows realized upon exercise or vesting of stock-based awards in the periods presented are included in the following table. Tax benefits realized upon exercise or vesting of stock-based awards generally represent the tax benefit of the difference between the exercise price and the strike price of the option.

Cash used by the Company to settle equity instruments granted under stock-based awards was insignificant.

(millions)	2008	2007	2006
Total cash received from option exercises and similar instruments	\$175	\$163	\$218
Tax benefits realized upon exercise or vesting of stock-based awards:			
Windfall benefits classified as financing cash flow	\$ 12	\$ 15	\$ 22
Other amounts classified as operating cash flow	17	11	23
Total	\$ 29	\$ 26	\$ 45

Shares used to satisfy stock-based awards are normally issued out of treasury stock, although management is authorized to issue new shares to the extent permitted by respective plan provisions. Refer to Note 5 for information on shares issued during the periods presented to employees and directors under various long-term incentive plans and share repurchases under the Company's stock repurchase authorizations. The Company does not currently have a policy of repurchasing a specified number of shares issued under employee benefit programs during any particular time period.

Stock options

During the periods presented, non-qualified stock options were granted to eligible employees under the 2003 Plan with exercise prices equal to the fair market value of the Company's stock on the grant date, a contractual term of ten years, and a two-year graded vesting period. Grants to outside directors under the Director Plan included similar terms, but vested immediately.

Effective April 25, 2008, the Company eliminated the AOF from all outstanding stock options. Stock options that contained the AOF feature included the vested pre-2004 option awards and all reload options. Reload options are the stock options awarded to eligible employees and directors to replace previously owned Company stock used by those individuals to pay the exercise price, including related employment taxes, of vested pre-2004 options awards containing the AOF. The reload options were immediately vested with an expiration date which was the same as the original option grant. Apart from removing the AOF, the stock

options were not otherwise affected. Holders of the stock options received cash compensation to replace the value of the AOF.

The Company accounted for the elimination of the AOF as a modification in accordance with SFAS No. 123(R), "Share-Based Payment," which required the Company to record a modification charge equal to the difference between the value of the modified stock options on the date of modification and their values immediately prior to modification. Since the modified stock options were 100% vested and had relatively short remaining contractual terms of one to five years, the Company used a Black-Scholes model to value the awards for the purpose of calculating the modification charge. The total fair value of the modified stock options increased by \$4 million due to an increase in the expected term.

As a result of this action, pre-tax compensation expense for 2008 included \$4 million of expense related to the modification of stock options and \$13 million representing cash compensation paid to holders of the stock options to replace the value of the AOF. Approximately 900 employees were holders of the modified stock options.

Management estimates the fair value of each annual stock option award on the date of grant using a lattice-based option valuation model. Composite assumptions are presented in the following table. Weighted-average values are disclosed for certain inputs which incorporate a range of assumptions. Expected volatilities are based principally on historical volatility of the Company's stock, and to a lesser extent, on implied volatilities from traded options on the Company's stock. Historical volatility corresponds to the contractual term of the options granted. The Company uses historical data to estimate option exercise and employee termination within the valuation models; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted represents the period of time that options granted are expected to be outstanding; the weighted-average expected term for all employee groups is presented in the following table. The risk-free rate for periods within the contractual life of the options is based on the U.S. Treasury yield curve in effect at the time of grant.

Stock option valuation model assumptions for grants within the year ended:	2008	2007	2006
Weighted-average expected volatility	20.75%	17.46%	17.94%
Weighted-average expected term (years)	4.08	3.20	3.21
Weighted-average risk-free interest rate	2.66%	4.58%	4.65%
Dividend yield	2.40%	2.40%	2.40%
Weighted-average fair value of options granted	\$ 7.90	\$ 7.24	\$ 6.67

A summary of option activity for 2008 is presented in the following table:

Employee and director stock options	Shares (millions)	Weighted-average exercise price	Weighted-average remaining contractual term (yrs.)	Aggregate intrinsic value (millions)
Outstanding, beginning of year	26	\$44		
Granted	5	51		
Exercised	(5)	42		
Forfeitures and expirations	—	—		
Outstanding, end of year	26	\$45	5.8	\$55
Exercisable, end of year	20	\$44	3.8	\$55

Additionally, option activity for comparable prior-year periods is presented in the following table:

(millions, except per share data)	2007	2006
Outstanding, beginning of year	27	29
Granted	8	10
Exercised	(8)	(11)
Forfeitures and expirations	(1)	(1)
Outstanding, end of year	26	27
Exercisable, end of year	20	20
Weighted-average exercise price:		
Outstanding, beginning of year	\$41	\$ 38
Granted	51	46
Exercised	41	37
Forfeitures and expirations	44	43
Outstanding, end of year	\$44	\$ 41
Exercisable, end of year	\$42	\$ 40

The total intrinsic value of options exercised during the periods presented was (in millions): 2008—\$55; 2007—\$86; 2006—\$114.

Other stock-based awards

During the periods presented, other stock-based awards consisted principally of executive performance shares and restricted stock granted under the 2003 Plan.

In 2008, 2007 and 2006, the Company made performance share awards to a limited number of senior executive-level employees, which entitles these employees to receive a specified number of shares of the Company's common stock on the vesting date, provided cumulative three-year targets are achieved. The cumulative three-year targets involved operating profit for the 2008 grant, cash flow for the 2007 grant and net sales growth for the 2006 grant. Management estimates the fair value of performance share awards based on the market price of the underlying stock on the date of grant, reduced by the present value of estimated dividends foregone during the performance period. The 2008, 2007 and 2006 target grants (as revised for non-vested forfeitures and other adjustments) currently correspond to approximately 187,000, 185,000 and 241,000 shares, respectively, with a grant-date fair value of approximately \$47, \$46,

and \$41 per share. The actual number of shares issued on the vesting date could range from zero to 200% of target, depending on actual performance achieved. Based on the market price of the Company's common stock at year-end 2008, the maximum future value that could be awarded on the vesting date was (in millions): 2008 award—\$17; 2007 award—\$17; and 2006 award—\$22. The 2005 performance share award, payable in stock, was settled at 200% of target in February 2008 for a total dollar equivalent of \$28 million.

The Company also periodically grants restricted stock and restricted stock units to eligible employees under the 2003 Plan. Restrictions with respect to sale or transferability generally lapse after three years and the grantee is normally entitled to receive shareholder dividends during the vesting period. Management estimates the fair value of restricted stock grants based on the market price of the underlying stock on the date of grant. A summary of restricted stock activity for the year ended January 3, 2009, is presented in the following table:

Employee restricted stock and restricted stock units	Shares (thousands)	Weighted-average grant-date fair value
Non-vested, beginning of year	374	\$47
Granted	162	52
Vested	(144)	44
Forfeited	(15)	49
Non-vested, end of year	377	\$48

Grants of restricted stock and restricted stock units for comparable prior-year periods were: 2007—55,000; 2006—190,000.

The total fair value of restricted stock and restricted stock units vesting in the periods presented was (in millions): 2008—\$7; 2007—\$6; 2006—\$8.

NOTE 9 PENSION BENEFITS

The Company sponsors a number of U.S. and foreign pension plans to provide retirement benefits for its employees. The majority of these plans are funded or unfunded defined benefit plans, although the Company does participate in a limited number of multiemployer or other defined contribution plans for certain employee groups. Defined benefits for salaried employees are generally based on salary and years of service, while union employee benefits are generally a negotiated amount for each year of service. The Company uses its fiscal year end as the measurement date for its defined benefit plans.

Obligations and funded status

The aggregate change in projected benefit obligation, plan assets, and funded status is presented in the

following tables. The Company adopted SFAS No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" as of the end of its 2006 fiscal year. The standard generally requires company plan sponsors to reflect the net over- or under-funded position of a defined postretirement benefit plan as an asset or liability on the balance sheet.

(millions)	2008	2007
Change in projected benefit obligation		
Beginning of year	\$3,314	\$3,309
Service cost	85	96
Interest cost	197	188
Plan participants' contributions	3	6
Amendments	11	(9)
Actuarial gain (loss)	(18)	(153)
Benefits paid	(211)	(198)
Curtailment and special termination benefits	11	12
Foreign currency adjustments	(271)	63
End of year	\$3,121	\$3,314

Change in plan assets		
Fair value beginning of year	\$3,613	\$3,426
Actual return on plan assets	(930)	206
Employer contributions	354	84
Plan participants' contributions	3	6
Benefits paid	(177)	(184)
Special termination benefits	3	9
Foreign currency adjustments	(292)	66
Fair value end of year	\$2,574	\$3,613
Funded status	\$ (547)	\$ 299

Amounts recognized in the Consolidated Balance

Sheet consist of		
Noncurrent assets	\$ 96	\$ 481
Current liabilities	(12)	(11)
Noncurrent liabilities	(631)	(171)
Net amount recognized	\$ (547)	\$ 299

Amounts recognized in accumulated other comprehensive income consist of

Net experience loss	\$1,432	\$ 377
Prior service cost	82	96
Net amount recognized	\$1,514	\$ 473

The accumulated benefit obligation for all defined benefit pension plans was \$2.85 billion and \$3.02 billion at January 3, 2009 and December 29, 2007, respectively. Information for pension plans with accumulated benefit obligations in excess of plan assets were:

(millions)	2008	2007
Projected benefit obligation	\$2,385	\$243
Accumulated benefit obligation	2,236	202
Fair value of plan assets	1,759	62

Expense

The components of pension expense are presented in the following table. Pension expense for defined contribution plans relates principally to multiemployer

plans in which the Company participates on behalf of certain unionized workforces in the United States.

(millions)	2008	2007	2006
Service cost	\$ 85	\$ 96	\$ 94
Interest cost	197	188	172
Expected return on plan assets	(300)	(282)	(257)
Amortization of unrecognized prior service cost	12	13	12
Recognized net loss	36	64	80
Curtailment and special termination benefits — net loss	12	4	17
Pension expense:			
Defined benefit plans	42	83	118
Defined contribution plans	22	25	19
Total	\$ 64	\$ 108	\$ 137

Any arising obligation-related experience gain or loss is amortized using a straight-line method over the average remaining service period of active plan participants. Any asset-related experience gain or loss is recognized as described in the "Assumptions" section. The estimated net experience loss and prior service cost for defined benefit pension plans that will be amortized from accumulated other comprehensive income into pension expense over the next fiscal year are approximately \$44 million and \$12 million, respectively.

Certain of the Company's subsidiaries sponsor 401(k) or similar savings plans for active employees. Expense related to these plans was (in millions): 2008—\$37; 2007—\$36; 2006—\$33. Company contributions to these savings plans approximate annual expense. Company contributions to multiemployer and other defined contribution pension plans approximate the amount of annual expense presented in the preceding table.

Assumptions

The worldwide weighted-average actuarial assumptions used to determine benefit obligations were:

	2008	2007	2006
Discount rate	6.2%	6.2%	5.7%
Long-term rate of compensation increase	4.2%	4.4%	4.4%

The worldwide weighted-average actuarial assumptions used to determine annual net periodic benefit cost were:

	2008	2007	2006
Discount rate	6.2%	5.7%	5.4%
Long-term rate of compensation increase	4.4%	4.4%	4.4%
Long-term rate of return on plan assets	8.9%	8.9%	8.9%

To determine the overall expected long-term rate of return on plan assets, the Company models expected returns over a 20-year investment horizon with respect to the specific investment mix of its 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. The U.S. model, which corresponds to approximately 70% of consolidated pension and other postretirement benefit plan assets, incorporates a long-term inflation assumption of 2.5% and an active management premium of 1% (net of fees) validated by historical analysis. Similar methods are used for various foreign plans with invested assets, reflecting local economic conditions. Although management reviews the Company's expected long-term rates of return annually, the benefit trust investment performance for one particular year does not, by itself, significantly influence this evaluation. The 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 the Company's modeling process. The expected rate of return for 2008 of 8.9% equated to approximately the 50th percentile expectation. Any future variance between the expected and actual rates of return on plan assets is recognized in the calculated value of plan assets over a five-year period and once recognized, experience gains and losses are amortized using a declining-balance method over the average remaining service period of active plan participants.

To conduct the annual review of discount rates, the Company uses 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 the U.S. plans. To test the appropriateness of these indices, the Company periodically conducts a matching exercise between the expected settlement cash flows of the 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, the Company refined the methodology for setting the discount rate by inputting the cash flows for the pension, postretirement and postemployment plans into the spot yield curve underlying the *Citigroup* index. The measurement dates for the defined benefit plans are consistent with the Company's fiscal year end. Accordingly, the Company selects discount rates to measure the benefit obligations that are consistent with market indices during December of each year.

Plan assets

The Company's year-end pension plan weighted-average asset allocations by asset category were:

	2008	2007
Equity securities	73%	74%
Debt securities	24%	23%
Other	3%	3%
Total	100%	100%

The Company's investment strategy for its major defined benefit plans is to maintain a diversified portfolio of asset classes with the primary goal of meeting long-term cash requirements as they become due. Assets are invested in a prudent manner to maintain the security of funds while maximizing returns within the Company's guidelines. The current weighted-average target asset allocation reflected by this strategy is: equity securities—74%; debt securities—24%; other—2%. Investment in Company common stock represented 1.8% and 1.5% of consolidated plan assets at January 3, 2009 and December 29, 2007, respectively. Plan funding strategies are influenced by tax regulations and funding requirements. The Company currently expects to contribute approximately \$85 million to its defined benefit pension plans during 2009.

Benefit payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in millions): 2009—\$174; 2010—\$180; 2011—\$194; 2012—\$188; 2013—\$193; 2014 to 2018—\$1,083.

NOTE 10 NONPENSION POSTRETIREMENT AND POSTEMPLOYMENT BENEFITS

Postretirement

The Company sponsors a number of plans to provide health care and other welfare benefits to retired employees in the United States and Canada, who have met certain age and service requirements. The majority of these plans are funded or unfunded defined benefit plans, although the Company does participate in a limited number of multiemployer or other defined contribution plans for certain employee groups. The Company contributes to voluntary employee benefit association (VEBA) trusts to fund certain U.S. retiree health and welfare benefit obligations. The Company uses its fiscal year end as the measurement date for these plans.

Obligations and funded status

The aggregate change in accumulated postretirement benefit obligation, plan assets, and funded status is presented in the following tables. The Company adopted SFAS No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" as of the end of its 2006 fiscal year. The

standard generally requires company plan sponsors to reflect the net over- or under-funded position of a defined postretirement benefit plan as an asset or liability on the balance sheet.

(millions)	2008	2007
Change in accumulated benefit obligation		
Beginning of year	\$1,075	\$1,208
Service cost	17	19
Interest cost	67	69
Actuarial loss (gain)	18	(174)
Benefits paid	(60)	(55)
Foreign currency adjustments	(9)	8
End of year	\$1,108	\$1,075
Change in plan assets		
Fair value beginning of year	\$ 754	\$ 764
Actual return on plan assets	(236)	36
Employer contributions	97	12
Benefits paid	(62)	(58)
Fair value end of year	\$ 553	\$ 754
Funded status	\$ (555)	\$ (321)
Amounts recognized in the Consolidated Balance Sheet consist of		
Current liabilities	\$ (2)	\$ (2)
Noncurrent liabilities	(553)	(319)
Net amount recognized	\$ (555)	\$ (321)
Amounts recognized in accumulated other comprehensive income consist of		
Net experience loss	\$ 429	\$ 123
Prior service credit	(14)	(16)
Net amount recognized	\$ 415	\$ 107

Expense

Components of postretirement benefit expense were:

(millions)	2008	2007	2006
Service cost	\$ 17	\$ 19	\$ 17
Interest cost	67	69	66
Expected return on plan assets	(63)	(59)	(58)
Amortization of unrecognized prior service credit	(3)	(3)	(3)
Recognized net loss	9	23	31
Curtailment and special termination benefits — net loss	—	—	6
Postretirement benefit expense:			
Defined benefit plans	27	49	59
Defined contribution plans	2	2	2
Total	\$ 29	\$ 51	\$ 61

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 and once recognized, is amortized using a straight-line method over 15 years, resulting in at least the minimum amortization prescribed by SFAS No. 106. Any asset-related experience gain or loss is recognized as described for pension plans on page 46. The estimated net experience loss for defined benefit plans that will be amortized from accumulated other comprehensive income into nonpension postretirement benefit expense over the next fiscal year is approximately \$13 million,

partially offset by amortization of prior service credit of \$3 million.

Net losses from curtailment and special termination benefits recognized in 2006 are related primarily to plant workforce reductions in the United States as further described in Note 3.

Assumptions

The weighted-average actuarial assumptions used to determine benefit obligations were:

	2008	2007	2006
Discount rate	6.1%	6.4%	5.9%

The weighted-average actuarial assumptions used to determine annual net periodic benefit cost were:

	2008	2007	2006
Discount rate	6.4%	5.9%	5.5%
Long-term rate of return on plan assets	8.9%	8.9%	8.9%

The Company determines the overall discount rate and expected long-term rate of return on VEBA trust obligations and assets in the same manner as that described for pension trusts in Note 9.

The assumed health care cost trend rate is 7.6% for 2009, decreasing gradually to 4.5% by the year 2015 and remaining at that level thereafter. These trend rates reflect the Company's recent historical experience and management's expectations regarding future trends. A one percentage point change in assumed health care cost trend rates would have the following effects:

(millions)	One percentage point increase	One percentage point decrease
Effect on total of service and interest cost components	\$ 8	\$ (9)
Effect on postretirement benefit obligation	\$106	\$(103)

Plan assets

The Company's year-end VEBA trust weighted-average asset allocations by asset category were:

	2008	2007
Equity securities	72%	75%
Debt securities	26%	25%
Other	2%	—
Total	100%	100%

The Company's asset investment strategy for its VEBA trusts is consistent with that described for its pension trusts in Note 9. The current target asset allocation is 75% equity securities and 25% debt securities. The Company currently expects to contribute approximately \$15 million to its VEBA trusts during 2009.

Postemployment

Under certain conditions, the Company provides benefits to former or inactive employees in the United States and several foreign locations, including salary continuance, severance, and long-term disability. The Company recognizes an obligation for any of these benefits that vest or accumulate with service. Postemployment benefits that do not vest or accumulate with service (such as severance based solely on annual pay rather than years of service) or costs arising from actions that offer benefits to employees in excess of those specified in the respective plans are charged to expense when incurred. The Company's postemployment benefit plans are unfunded. Actuarial assumptions used are generally consistent with those presented for pension benefits on page 46. The aggregate change in accumulated postemployment benefit obligation and the net amount recognized were:

(millions)	2008	2007
Change in accumulated benefit obligation		
Beginning of year	\$ 63	\$ 40
Service cost	5	6
Interest cost	4	2
Actuarial loss	1	22
Benefits paid	(7)	(8)
Foreign currency adjustments	(1)	1
End of year	\$ 65	\$ 63
Funded status	\$(65)	\$(63)

Amounts recognized in the Consolidated Balance Sheet consist of

Current liabilities	\$ (6)	\$ (7)
Noncurrent liabilities	(59)	(56)
Net amount recognized	\$(65)	\$(63)

Amounts recognized in accumulated other comprehensive income consist of

Net experience loss	\$ 34	\$ 36
Net amount recognized	\$ 34	\$ 36

Components of postemployment benefit expense were:

(millions)	2008	2007	2006
Service cost	\$ 5	\$ 6	\$ 4
Interest cost	4	2	2
Recognized net loss	4	2	3
Postemployment benefit expense	\$13	\$10	\$9

All gains and losses are recognized over the average remaining service period of active plan participants. The estimated net experience loss that will be amortized from accumulated other comprehensive income into postemployment benefit expense over the next fiscal year is approximately \$3 million.

Benefit payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

(millions)	Postretirement	Postemployment
2009	\$ 61	\$ 6
2010	65	7
2011	68	7
2012	69	7
2013	71	8
2014-2018	398	45

NOTE 11 INCOME TAXES

Earnings before income taxes and the provision for U.S. federal, state, and foreign taxes on these earnings were:

(millions)	2008	2007	2006
Earnings before income taxes			
United States	\$1,032	\$ 999	\$1,049
Foreign	601	548	423
	\$1,633	\$1,547	\$1,472
Income taxes			
Currently payable			
Federal	\$ 135	\$ 395	\$ 342
State	3	30	35
Foreign	190	88	134
	328	513	511
Deferred			
Federal	173	(74)	(10)
State	22	(3)	(4)
Foreign	(38)	8	(30)
	157	(69)	(44)
Total income taxes	\$ 485	\$ 444	\$ 467

The difference between the U.S. federal statutory tax rate and the Company's effective income tax rate was:

	2008	2007	2006
U.S. statutory income tax rate	35.0%	35.0%	35.0%
Foreign rates varying from 35%	-5.0	-4.0	-3.5
State income taxes, net of federal benefit	1.0	1.1	1.3
Foreign earnings repatriation	1.6	2.3	1.2
Tax audits	-1.5	—	-1.7
Net change in valuation allowances	—	- .5	.5
Statutory rate changes, deferred tax impact	-.1	-.6	—
International restructuring	—	-2.6	—
Other	-1.3	-2.0	-1.1
Effective income tax rate	29.7%	28.7%	31.7%

As presented in the preceding table, the Company's 2008 consolidated effective tax rate was 29.7%, as compared to 28.7% in 2007 and 31.7% in 2006. The 2008 effective tax rate reflects the favorable impact of various tax audit settlements. In conjunction with a planned international legal restructuring, management recorded a \$33 million tax charge in the second quarter and an additional \$9 million during the third and fourth quarters for a total charge of \$42 million on

\$1 billion of prior and current year unremitted foreign earnings and capital. During the year, the Company repatriated approximately \$710 million of earnings and capital which carried a cash tax charge of \$24 million. This amount was less than the charge recorded during the year due to the impact of favorable movements in foreign currency. This cost was further offset by foreign tax related items of \$16 million, reducing the net cost of repatriation to \$8 million. The Company has provided \$18 million of deferred taxes related to the remaining \$290 million of unremitted foreign earnings. These amounts are reflected in the foreign earnings repatriation line item. At January 3, 2009, accumulated foreign subsidiary earnings of approximately \$834 million were considered indefinitely invested in those businesses. Accordingly, U.S. income deferred taxes have not been provided on these earnings and it is not practical to estimate the deferred tax impact of those earnings.

2007's effective rate benefited from the favorable effect of discrete items in that year. In the first quarter of 2007, management implemented an international restructuring initiative which eliminated a foreign tax liability of approximately \$40 million. Accordingly, the reversal was recorded within the Company's consolidated provision for income taxes. The Company benefited from statutory rate reductions, primarily in the United Kingdom and in Germany which resulted in an \$11 million reduction to income tax expense. During 2007, the Company repatriated approximately \$327 million of current year foreign earnings, for a gross U.S. tax cost of \$35 million. This cost was offset by foreign tax credit related items of \$31 million, reducing the net cost of repatriation to \$4 million.

The Company's 2006 consolidated effective tax rate included two significant, but partially-offsetting, discrete adjustments. The Company reduced its reserves for uncertain tax positions by \$25 million, related principally to the closure of several domestic tax audits. In addition, the Company revised its repatriation plan for certain foreign earnings, giving rise to an incremental net tax cost of \$18 million.

Generally, the changes in valuation allowances on deferred tax assets and corresponding impacts on the effective income tax rate result from management's assessment of the Company's ability to utilize certain future tax deductions, operating losses and tax credit carryforwards prior to expiration. For 2007, the .5% rate reduction presented in the preceding table primarily reflects the reversal of a valuation allowance against U.S. foreign tax credits which were utilized in conjunction with the aforementioned 2007 foreign earnings repatriation. Total tax benefits of carryforwards at year-end 2008 and 2007 were approximately \$27 million and \$17 million, respectively, with related valuation allowances at year-end 2008 and 2007 of approximately \$20 and \$17 million. Of the total carryforwards at year-end 2008 approximately

\$2 million expire in 2009 with the remainder principally expiring after five years.

The following table provides an analysis of the Company's deferred tax assets and liabilities as of year-end 2008 and 2007. The significant increase in the "employee benefits" caption of the Company's noncurrent deferred tax asset during 2008 is principally related to net experience losses associated with employer pension and other postretirement benefit plans that are recorded in other comprehensive income, net of tax.

(millions)	Deferred tax assets		Deferred tax liabilities	
	2008	2007	2008	2007
U.S. state income taxes	\$ 7	\$ 7	\$ 59	\$ 44
Advertising and promotion-related	23	23	10	12
Wages and payroll taxes	27	23	—	—
Inventory valuation	18	20	2	3
Employee benefits	479	153	26	66
Operating loss and credit carryforwards	27	17	—	—
Hedging transactions	22	7	5	—
Depreciation and asset disposals	17	15	299	299
Capitalized interest	7	6	12	12
Trademarks and other intangibles	—	—	461	454
Deferred compensation	51	52	—	—
Deferred intercompany revenue	—	11	—	—
Stock options	46	37	—	—
Unremitted foreign earnings	—	—	18	—
Other	44	26	9	17
	768	397	901	907
Less valuation allowance	(22)	(22)	—	—
Total deferred taxes	\$ 746	\$ 375	\$ 901	\$ 907
Net deferred tax asset (liability)	\$(155)	\$(532)		
Classified in balance sheet as:				
Prepaid assets	\$ 112	\$ 103		
Accrued income taxes	(15)	(9)		
Other assets	48	21		
Other liabilities	(300)	(647)		
Net deferred tax asset (liability)	\$(155)	\$(532)		

The change in valuation allowance against deferred tax assets was:

(millions)	2008	2007	2006
Balance at beginning of year	\$22	\$ 28	\$19
Additions charged to income tax expense	6	4	12
Reductions credited to income tax expense	(3)	(12)	(4)
Currency translation adjustments	(3)	2	1
Balance at end of year	\$22	\$ 22	\$28

Cash paid for income taxes was (in millions): 2008—\$397; 2007—\$560; 2006—\$428. Income tax benefits realized from stock option exercises and deductibility of other equity-based awards are presented in Note 8.

Uncertain tax positions

The Company adopted Interpretation No. 48 "Accounting for Uncertainty in Income Taxes"

(FIN No. 48) as of the beginning of its 2007 fiscal year. This interpretation clarifies what criteria must be met prior to recognition of the financial statement benefit, in accordance with SFAS No. 109, "Accounting for Income Taxes," of a position taken in a tax return.

FIN No. 48 is based on a benefit recognition model. Provided that the tax position is deemed more likely than not of being sustained, FIN No. 48 permits a company to recognize the largest amount of tax benefit that is greater than 50 percent likely of being ultimately realized upon settlement. The tax position must be derecognized when it is no longer more likely than not of being sustained. 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 files income taxes in the U.S. federal jurisdiction, and in various state, local, and foreign jurisdictions. For the past several years, the Company's annual provision for U.S. federal income taxes has represented approximately 70% of the Company's consolidated income tax provision. With limited exceptions, the Company is no longer subject to U.S. federal examinations by the Internal Revenue Service (IRS) for years prior to 2006. During the second quarter of 2008, the IRS commenced a focused review of the Company's 2006 and 2007 U.S. federal income tax returns which is anticipated to be completed during the second quarter of 2009. The Company also entered into the IRS' Compliance Assurance Program ("CAP") for the 2008 tax year. The Company is also under examination for income and non-income tax filings in various state and foreign jurisdictions, most notably: 1) a U.S.-Canadian transfer pricing issue pending international arbitration ("Competent Authority") with a related advanced pricing agreement for years 1997-2008; and 2) an on-going examination of 2002-2005 U.K. income tax filings.

As of January 3, 2009, the Company has classified \$35 million of unrecognized tax benefits as a current liability, representing several individually insignificant income tax positions under examination in various jurisdictions. Management's estimate of reasonably possible changes in unrecognized tax benefits during the next twelve months is comprised of the aforementioned current liability balance expected to be settled within one year, offset by approximately \$5 million of projected additions related primarily to ongoing intercompany transfer pricing activity. Management is currently unaware of any issues under review that could result in significant additional payments, accruals, or other material deviation in this estimate.

Following is a reconciliation of the Company's total gross unrecognized tax benefits as of the years ended January 3, 2009 and December 29, 2007. For the

2008 year, approximately \$110 million represents the amount that, if recognized, would affect the Company's effective income tax rate in future periods. This amount differs from the gross unrecognized tax benefits presented in the table due to the decrease in U.S. federal income taxes which would occur upon recognition of the state tax benefits included therein.

(millions)	2008	2007
Balance at beginning of year	\$169	\$143
Tax positions related to current year:		
Additions	24	31
Reductions	—	—
Tax positions related to prior years:		
Additions	2	22
Reductions	(56)	(26)
Settlements	(3)	(1)
Lapses in statutes of limitation	(4)	—
Balance at end of year	\$132	\$169

The current portion of the Company's unrecognized tax benefits is presented in the balance sheet within accrued income taxes within other current liabilities, and the amount expected to be settled after one year is recorded in other liabilities.

The Company classifies income tax-related interest and penalties as interest expense and selling, general, and administrative expense, respectively. For the year ended January 3, 2009, the Company recognized a reduction of \$2 million of tax-related interest and penalties and had approximately \$29 million accrued at January 3, 2009. For the year ended December 29, 2007, the company recognized \$9 million of tax-related interest and penalties and had \$31 million accrued at year end.

NOTE 12 FINANCIAL INSTRUMENTS AND CREDIT RISK CONCENTRATION

The carrying values of the Company's short-term items, including cash, cash equivalents, accounts receivable, accounts payable and notes payable approximate fair value. The fair value of long-term debt is calculated based on incremental borrowing rates currently available on loans with similar terms and maturities. The fair value of the Company's long-term debt at January 3, 2009 exceeded its carrying value by approximately \$246 million.

The Company is exposed to certain market risks which exist as a part of its ongoing business operations. Management uses derivative financial and commodity instruments, where appropriate, to manage these risks. In general, instruments used as hedges must be effective at reducing the risk associated with the exposure being hedged and must be designated as a hedge at the inception of the contract. In accordance with SFAS No. 133, the Company designates derivatives as cash flow hedges, fair value hedges, net investment hedges, or other contracts used to reduce volatility in the translation of foreign currency earnings

to U.S. dollars. The fair values of all hedges are recorded in accounts receivable, other assets, other current liabilities and other liabilities. Gains and losses representing either hedge ineffectiveness, hedge components excluded from the assessment of effectiveness, or hedges of translational exposure are recorded in other income (expense), net. Within the Consolidated Statement of Cash Flows, settlements of cash flow and fair value hedges are classified as an operating activity; settlements of all other derivatives are classified as a financing activity.

Cash flow hedges

Qualifying derivatives are accounted for as cash flow hedges when the hedged item is a forecasted transaction. Gains and losses on these instruments are recorded in other comprehensive income until the underlying transaction is recorded in earnings. When the hedged item is realized, gains or losses are reclassified from accumulated other comprehensive income to the Consolidated Statement of Earnings on the same line item as the underlying transaction. For all cash flow hedges, gains and losses representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness were insignificant during the periods presented.

The cumulative net loss attributable to cash flow hedges recorded in accumulated other comprehensive income at January 3, 2009, was \$24 million, related to forward interest rate contracts settled during 2001 and 2003 in conjunction with fixed rate long-term debt issuances, 10-year natural gas price swaps entered into in 2006, and commodity price cash flow hedges, partially offset by gains on foreign currency cash flow hedges. The interest rate contract losses will be reclassified into interest expense over the next 23 years. The natural gas swap losses will be reclassified to cost of goods sold over the next 8 years. Gains and losses related to foreign currency and commodity price cash flow hedges will be reclassified into earnings during the next 18 months.

Fair value hedges

Qualifying derivatives are accounted for as fair value hedges when the hedged item is a recognized asset, liability, or firm commitment. Gains and losses on these instruments are recorded in earnings, offsetting gains and losses on the hedged item. For all fair value hedges, gains and losses representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness were insignificant during the periods presented.

Net investment hedges

Qualifying derivative and nonderivative financial instruments are accounted for as net investment hedges when the hedged item is a nonfunctional currency investment in a subsidiary. Gains and losses on these instruments are included in foreign currency translation adjustments in other comprehensive income.

Other contracts

The Company also periodically enters into foreign currency forward contracts and options to reduce volatility in the translation of foreign currency earnings to U.S. dollars. Gains and losses on these instruments are recorded in other income (expense), net, generally reducing the exposure to translation volatility during a full-year period.

Foreign exchange risk

The Company is exposed to fluctuations in foreign currency cash flows related primarily to third-party purchases, intercompany transactions and nonfunctional currency denominated third-party debt. The Company is also exposed to fluctuations in the value of foreign currency investments in subsidiaries and cash flows related to repatriation of these investments. Additionally, the Company is exposed to volatility in the translation of foreign currency earnings to U.S. dollars. Management assesses foreign currency risk based on transactional cash flows and translational volatility and enters into forward contracts, options, and currency swaps to reduce fluctuations in net long or short currency positions. Forward contracts and options are generally less than 18 months duration. Currency swap agreements are established in conjunction with the term of underlying debt issues.

For foreign currency cash flow and fair value hedges, the assessment of effectiveness is generally based on changes in spot rates. Changes in time value are reported in other income (expense), net.

Interest rate risk

The Company is exposed to interest rate volatility with regard to future issuances of fixed rate debt and existing issuances of variable rate debt. The Company periodically uses interest rate swaps, including forward-starting swaps, to reduce interest rate volatility and funding costs associated with certain debt issues, and to achieve a desired proportion of variable versus fixed rate debt, based on current and projected market conditions.

Variable-to-fixed interest rate swaps are accounted for as cash flow hedges and the assessment of effectiveness is based on changes in the present value of interest payments on the underlying debt. Fixed-to-variable interest rate swaps are accounted for as fair value hedges and the assessment of effectiveness is based on changes in the fair value of the underlying debt, using incremental borrowing rates currently available on loans with similar terms and maturities.

Price risk

The Company is exposed to price fluctuations primarily as a result of anticipated purchases of raw and packaging materials, fuel, and energy. The Company has historically used the combination of long-term contracts with suppliers, and exchange-traded futures and option contracts to reduce price fluctuations in a

desired percentage of forecasted raw material purchases over a duration of generally less than 18 months. During 2006, the Company entered into two separate 10-year over-the-counter commodity swap transactions to reduce fluctuations in the price of natural gas used principally in its manufacturing processes.

Commodity contracts are accounted for as cash flow hedges. The assessment of effectiveness for exchange-traded instruments is based on changes in futures prices. The assessment of effectiveness for over-the-counter transactions is based on changes in designated indexes.

Credit risk concentration

The Company is exposed to credit loss in the event of nonperformance by counterparties on derivative financial and commodity contracts. This credit loss is limited to the cost of replacing these contracts at current market rates. In some instances the Company has reciprocal collateralization agreements with counterparties regarding fair value positions in excess of certain thresholds. These agreements call for the posting of collateral in the form of cash, treasury securities or letters of credit if a fair value loss position to the Company or its counterparties exceeds a certain amount. There were no collateral balance requirements at January 3, 2009 or December 29, 2007.

Financial instruments, which potentially subject the Company to concentrations of credit risk are primarily cash, cash equivalents, and accounts receivable. The Company places its investments in highly rated financial institutions and investment-grade short-term debt instruments, and limits the amount of credit exposure to any one entity. Management believes concentrations of credit risk with respect to accounts receivable is limited due to the generally high credit quality of the Company's major customers, as well as the large number and geographic dispersion of smaller customers. However, the Company conducts a disproportionate amount of business with a small number of large multinational grocery retailers, with the five largest accounts comprising approximately 30% of consolidated accounts receivable at January 3, 2009.

NOTE 13 FAIR VALUE MEASUREMENTS

SFAS No. 157, "Fair Value Measurements," was adopted by the Company as of the beginning of its 2008 fiscal year, as discussed in Note 1 herein. As required by SFAS No. 157, the Company has categorized its financial assets and liabilities into a three-level fair value hierarchy, based on the nature of the inputs used in determining fair value. The hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). Following is a description of each

category in the fair value hierarchy and the financial assets and liabilities of the Company that are included in each category at January 3, 2009.

Level 1 — Financial assets and liabilities whose values are based on unadjusted quoted prices for identical assets or liabilities in an active market. For the Company, level 1 financial assets and liabilities consist primarily of commodity derivative contracts.

Level 2 — Financial assets and liabilities whose values are based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the asset or liability. For the Company, level 2 financial assets and liabilities consist of interest rate swaps and over-the-counter commodity and currency contracts.

The Company's calculation of the fair value of interest rate swaps is derived from a discounted cash flow analysis based on the terms of the contract and the interest rate curve. Commodity derivatives are valued using an income approach based on the commodity index prices less the contract rate multiplied by the notional amount. Foreign currency contracts are valued using an income approach based on forward rates less the contract rate multiplied by the notional amount.

Level 3 — Financial assets and liabilities whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management's own assumptions about the assumptions a market participant would use in pricing the asset or liability. The Company does not have any level 3 financial assets or liabilities.

The following table presents the Company's fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis as of January 3, 2009:

(millions)	Level 1	Level 2	Level 3	Total
Assets:				
Derivatives (recorded in other receivables)	\$ 9	\$ 34	\$—	\$ 43
Derivatives (recorded in other assets)	—	43	—	43
Total assets	\$ 9	\$ 77	\$—	\$ 86
Liabilities:				
Derivatives (recorded in other current liabilities)	\$—	\$(17)	\$—	\$(17)
Derivatives (recorded in other liabilities)	—	(4)	—	(4)
Total liabilities	\$—	\$(21)	\$—	\$(21)

NOTE 14 CONTINGENCIES

The Company is subject to various legal proceedings and claims in the ordinary course of business covering matters such as general commercial, governmental regulations, antitrust and trade regulations, product

liability, intellectual property, employment and other actions. Management has determined that the ultimate resolution of these matters will not have a material adverse effect on the Company's financial position or results of operations.

NOTE 15 SUBSEQUENT EVENT

On January 14, 2009, the Company announced a precautionary hold on certain *Austin* and *Keebler* branded peanut butter sandwich crackers and certain *Famous Amos* and *Keebler* branded peanut butter cookies while the U.S. Food and Drug Administration and other authorities investigated Peanut Corporation of America ("PCA"), one of Kellogg's peanut paste suppliers for the cracker and cookie products. On January 16, 2009, Kellogg voluntarily recalled those products because the paste ingredients supplied to Kellogg had the potential to be contaminated with salmonella. The recall was expanded on January 31, February 2 and February 17, 2009 to include certain *Bear Naked*, *Kashi* and *Special K* products impacted by PCA ingredients.

The Company has incurred costs associated with the recalls and in accordance with U.S. GAAP recorded certain items associated with this subsequent event in its fiscal year 2008 financial results.

The charges associated with the recalls reduced North America full-year 2008 operating profit by \$34 million or \$0.06 EPS. Of the total charges, \$12 million related to estimated customer returns and consumer rebates and was recorded as a reduction to net sales; \$21 million related to costs associated with returned product and the disposal and write-off of inventory which was recorded as cost of goods sold; and \$1 million related to other costs which were recorded as SGA expense.

NOTE 16 QUARTERLY FINANCIAL DATA (unaudited)

(millions, except per share data)	Net sales		Gross profit	
	2008	2007	2008	2007
First	\$ 3,258	\$ 2,963	\$1,364	\$1,264
Second	3,343	3,015	1,444	1,377
Third	3,288	3,004	1,403	1,342
Fourth	2,933	2,794	1,156	1,196
	\$12,822	\$11,776	\$5,367	\$5,179

	Net earnings		Net earnings per share			
	2008	2007	2008		2007	
			Basic	Diluted	Basic	Diluted
First	\$ 315	\$ 321	\$.82	\$.81	\$.81	\$.80
Second	312	301	.82	.82	.76	.75
Third	342	305	.90	.89	.77	.76
Fourth	179	176	.47	.47	.45	.44
	\$1,148	\$1,103				

The principal market for trading Kellogg shares is the New York Stock Exchange (NYSE). At year-end 2008, the closing price on the NYSE was \$45.05 and there were 41,229 shareowners of record.

Dividends paid per share and the quarterly price ranges on the NYSE during the last two years were:

2008 — Quarter	Dividend per share	Stock price	
		High	Low
First	\$.3100	\$53.00	\$46.25
Second	.3100	54.15	47.87
Third	.3400	58.51	47.62
Fourth	.3400	57.66	40.32
	\$1.3000		
2007 — Quarter			
First	\$.2910	\$52.02	\$48.68
Second	.2910	54.42	51.05
Third	.3100	56.89	51.02
Fourth	.3100	56.31	51.49
	\$1.2020		

NOTE 17 OPERATING SEGMENTS

Kellogg Company is the world's leading producer of cereal and a leading producer of convenience foods, including cookies, crackers, toaster pastries, cereal bars, fruit snacks, frozen waffles and veggie foods. Kellogg products are manufactured and marketed globally. Principal markets for these products include the United States and United Kingdom. The Company currently manages its operations in four geographic operating segments, comprised of North America and the three International operating segments of Europe, Latin America and Asia Pacific. Beginning in 2007, the Asia Pacific segment includes South Africa, which was formerly a part of Europe. Prior years were restated for comparison purposes.

The measurement of operating segment results is generally consistent with the presentation of the Consolidated Statement of Earnings and Balance Sheet. Intercompany transactions between operating segments were insignificant in all periods presented.

(millions)	2008	2007	2006
Net sales			
North America	\$ 8,457	\$ 7,786	\$ 7,349
Europe	2,619	2,357	2,057
Latin America	1,030	984	891
Asia Pacific (a)	716	649	610
Consolidated	\$12,822	\$11,776	\$10,907
Segment operating profit			
North America	\$ 1,447	\$ 1,345	\$ 1,341
Europe	390	397	321
Latin America	209	213	220
Asia Pacific (a)	92	88	90
Corporate	(185)	(175)	(206)
Consolidated	\$ 1,953	\$ 1,868	\$ 1,766
Depreciation and amortization			
North America	\$ 249	\$ 239	\$ 242
Europe	72	71	65
Latin America	24	24	22
Asia Pacific (a)	23	23	19
Corporate	7	15	5
Consolidated	\$ 375	\$ 372	\$ 353
Interest expense			
North America	\$ 1	\$ 2	\$ 9
Europe	2	13	27
Latin America	—	1	—
Asia Pacific (a)	—	—	—
Corporate	305	303	271
Consolidated	\$ 308	\$ 319	\$ 307
Income taxes			
North America	\$ 418	\$ 388	\$ 396
Europe	25	27	7
Latin America	38	40	32
Asia Pacific (a)	16	14	18
Corporate	(12)	(25)	14
Consolidated	\$ 485	\$ 444	\$ 467
Total assets (b)			
North America	\$ 8,443	\$ 8,255	\$ 7,996
Europe	1,545	2,017	2,325
Latin America	515	527	661
Asia Pacific (a)	408	397	385
Corporate	4,305	5,276	4,934
Elimination entries	(4,270)	(5,075)	(5,587)
Consolidated	\$10,946	\$11,397	\$10,714
Additions to long-lived assets (c)			
North America	\$ 288	\$ 443	\$ 316
Europe	244	76	54
Latin America	70	37	53
Asia Pacific (a)	103	21	27
Corporate	5	5	3
Consolidated	\$ 710	\$ 582	\$ 453

(a) Includes Australia, Asia and South Africa.

(b) The Company adopted SFAS No. 158 "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans" as of the end of its 2006 fiscal year. The standard generally requires company plan sponsors to reflect the net over- or under-funded position of a defined postretirement benefit plan as an asset or liability on the balance sheet. Accordingly, the Company's consolidated and corporate total assets for 2006 were reduced by \$512 and \$152, respectively. Operating segment total assets were reduced as follows: North America-\$72; Europe-\$284; Latin America-\$3; Asia Pacific-\$1. Refer to Note 1 for further information.

(c) Includes plant, property, equipment, and purchased intangibles.

The Company's largest customer, Wal-Mart Stores, Inc. and its affiliates, accounted for approximately 20% of consolidated net sales during 2008, 19% in 2007, and 18% in 2006, comprised principally of sales within the United States.

Supplemental geographic information is provided below for net sales to external customers and long-lived assets:

(millions)	2008	2007	2006
Net sales			
United States	\$ 7,866	\$ 7,224	\$ 6,843
United Kingdom	1,026	1,018	894
Other foreign countries	3,930	3,534	3,170
Consolidated	\$12,822	\$11,776	\$10,907
Long-lived assets (a)			
United States	\$ 6,924	\$ 6,832	\$ 6,630
United Kingdom	260	378	369
Other foreign countries	847	745	685
Consolidated	\$ 8,031	\$ 7,955	\$ 7,684

(a) Includes plant, property, equipment and purchased intangibles.

Supplemental product information is provided below for net sales to external customers:

(millions)	2008	2007	2006
North America			
Retail channel cereal	\$ 3,038	\$ 2,784	\$ 2,667
Retail channel snacks	3,960	3,553	3,318
Frozen and specialty channels	1,459	1,449	1,364
International			
Cereal	3,547	3,346	3,010
Convenience foods	818	644	548
Consolidated	\$12,822	\$11,776	\$10,907

NOTE 18 SUPPLEMENTAL FINANCIAL STATEMENT DATA

Consolidated Statement of Earnings (millions)	2008	2007	2006
Research and development expense	\$ 181	\$ 179	\$191
Advertising expense	\$1,076	\$1,063	\$916

Consolidated Balance Sheet (millions)	2008	2007
Trade receivables	\$ 876	\$ 908
Allowance for doubtful accounts	(10)	(5)
Other receivables	277	108
Accounts receivable, net	\$ 1,143	\$ 1,011
Raw materials and supplies	\$ 203	\$ 234
Finished goods and materials in process	694	690
Inventories	\$ 897	\$ 924
Deferred income taxes	\$ 112	\$ 103
Other prepaid assets	114	140
Other current assets	\$ 226	\$ 243
Land	\$ 94	\$ 86
Buildings	1,579	1,614
Machinery and equipment (a)	5,112	5,249
Construction in progress	319	354
Accumulated depreciation	(4,171)	(4,313)
Property, net	\$ 2,933	\$ 2,990
Other intangibles	\$ 1,503	\$ 1,491
Accumulated amortization	(42)	(41)
Other intangibles, net	\$ 1,461	\$ 1,450
Pension	\$ 96	\$ 481
Other	298	259
Other assets	\$ 394	\$ 740
Accrued income taxes	\$ 51	\$ —
Accrued salaries and wages	280	316
Accrued advertising and promotion	357	378
Other	341	314
Other current liabilities	\$ 1,029	\$ 1,008
Nonpension postretirement benefits	\$ 553	\$ 319
Other	394	420
Other liabilities	\$ 947	\$ 739

(a) Includes an insignificant amount of capitalized internal-use software.

Allowance for doubtful accounts (millions)	2008	2007	2006
Balance at beginning of year	\$ 5	\$ 6	\$ 7
Additions charged to expense	6	1	2
Doubtful accounts charged to reserve	(1)	(2)	(3)
Balance at end of year	\$10	\$ 5	\$ 6