

# More...

1998 Annual Report





Kellogg Company is the world's leading producer of ready-to-eat cereal and a leading producer of grain-based convenience foods, including toaster pastries, frozen waffles, cereal bars, and bagels.

Headquartered in Battle Creek, Michigan, Kellogg Company has a 92-year heritage of excellence and a reputation for products that provide value and contribute to a healthy diet.

Kellogg products are manufactured in 20 countries on 6 continents and distributed in more than 160 countries.

Products  
more Nutrition  
more Places  
more Focus means



## Financial Highlights

| (millions, except per share data)                                                                                                                             | 1998                              | Change | 1997                              | Change | 1996                                | Change |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------|--------|-----------------------------------|--------|-------------------------------------|--------|
| Net sales                                                                                                                                                     | \$6,762.1                         | -1%    | \$6,830.1                         | +2%    | \$6,676.6                           | -5%    |
| Operating profit, excluding non-recurring charges (a)                                                                                                         | 965.6                             | -19%   | 1,193.2                           | +9%    | 1,095.0                             | -13%   |
| Earnings, excluding non-recurring charges and other unusual items (a) and before cumulative effect of accounting change (b)                                   | 548.9                             | -22%   | 704.5                             | +8%    | 651.1                               | -14%   |
| Earnings per share (basic and diluted), excluding non-recurring charges and other unusual items (a) and before cumulative effect of accounting change (b) (c) | 1.35                              | -21%   | 1.70                              | +11%   | 1.53                                | -12%   |
| Operating profit                                                                                                                                              | 895.1                             | -11%   | 1,009.1                           | +5%    | 958.9                               | +14%   |
| Net earnings                                                                                                                                                  | 502.6                             | -8%    | 546.0                             | +3%    | 531.0                               | +8%    |
| Net earnings per share (basic and diluted) (c)                                                                                                                | 1.23                              | -7%    | 1.32                              | +6%    | 1.25                                | +12%   |
| Net cash provided by operating activities                                                                                                                     | 719.7                             | -18%   | 879.8                             | +24%   | 711.5                               | -32%   |
| Capital expenditures                                                                                                                                          | 373.9                             | +20%   | 312.4                             | +2%    | 307.3                               | -3%    |
| Average shares outstanding (c)                                                                                                                                | 407.8                             |        | 414.1                             |        | 424.9                               |        |
| Dividends per share (c)                                                                                                                                       | \$ .92                            | +6%    | \$ .87                            | +7%    | \$ .81                              | +8%    |
| Year-end stock price (c)                                                                                                                                      | \$ 34 <sup>1</sup> / <sub>8</sub> | -31%   | \$ 49 <sup>5</sup> / <sub>8</sub> | +51%   | \$ 32 <sup>13</sup> / <sub>16</sub> | -15%   |

(a) Refer to Management's Discussion and Analysis on pages 16-21 and Notes 3 and 4 within Notes to Consolidated Financial Statements for further explanation of non-recurring charges and other unusual items for years 1996-1998.

(b) Refer to Management's Discussion and Analysis on pages 16-21 and Note 1 within Notes to Consolidated Financial Statements for further explanation of cumulative effect of accounting change in 1997.

(c) Restated for two-for-one stock split effective August 22, 1997.

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# More Growth

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# More C

TO OUR SHAREOWNERS

*We are fully committed  
to return to both top-line  
and bottom-line growth.*



*Carlos M. Gutierrez*

*Arnold G. Langbo*

# Growth

While we look to the future with great optimism at Kellogg Company, our performance in 1998 was disappointing, particularly following a year of growth in 1997.

Our level of cereal marketing investment early in 1998 was not sufficient in the face of extremely competitive market conditions. This situation hurt our volume performance for much of the year and, combined with other issues in markets around the world, led to a decline in both sales and earnings. Nonetheless, we continue to have the utmost confidence in the future of our grain-based businesses, and we are fully committed to return to both top-line and bottom-line growth.

## Our Strategy for Growth

Although our 1998 business results were below our performance expectations, it was a year in which we put in place key elements of a stronger foundation for future growth. This included investments in new product development and a complete overhaul of our corporate headquarters and North American organizational structure.

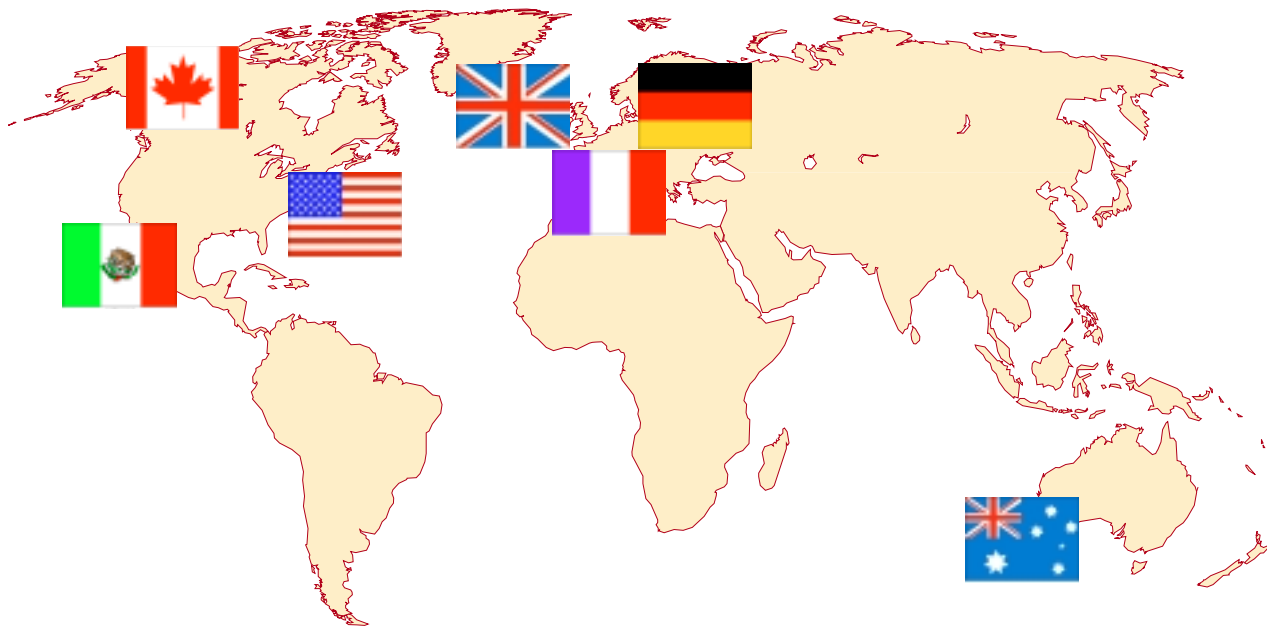
Also in 1998, we adopted this five-point strategy for growth in 1999 and beyond:

Leading the food industry in innovation. Kellogg Company is rolling out a broader grain-based product portfolio, including great-tasting new cereals,

innovative convenience foods, and new grain-based products outside our traditional lines. We also are adding to the nutritional value delivered by our products, including reformulations that we believe will help many long-established *Kellogg's*® cereal brands return to growth. Pages 6-9 of this report further describe some of our most important innovation initiatives.

Investing in our largest cereal markets. During 1999, we will invest in growth in our seven largest cereal markets: the United States, the United Kingdom, Mexico, Canada, Australia, Germany, and France. In addition to major product improvement programs, we are

## INVESTING IN OUR LARGEST CEREAL MARKETS



*A high strategic priority for 1999 is promoting growth  
in Kellogg Company's seven largest cereal markets:*

1. the United States, 2. the United Kingdom, 3. Mexico,
4. Canada, 5. Australia, 6. Germany, and 7. France.

significantly increasing our overall marketing investment in these markets, which comprise nearly 70 percent of our business.

Accelerating the global growth of our convenience foods business. Around the world, consumption of food “on-the-go” continues to increase dramatically. We believe we are uniquely positioned to capitalize on this trend with products such as *Nutri-Grain*® bars, *Rice Krispies Treats*™ squares, and *Pop-Tarts*® toaster pastries. We are focusing both on expanded

geographic distribution and new distribution channels, particularly single-serve channels (see pages 10-11).

Continuing to reduce costs. From ongoing cost-reduction programs, we anticipate more than \$50 million in incremental savings in 1999. These savings need to be viewed as a requirement to remaining competitive. They will enable us to deliver still greater value to consumers and help fund business growth in 1999 and beyond.

Creating a more focused and accountable organization. Our objective is to develop a talented, diverse global workforce with every person focused on the largest, most important activities (see pages 12-13).

### Dividend and Stock News

We are pleased to report that the Kellogg Company dividend rose in 1998 for the 42nd consecutive year, with an increase of 5 cents per share to \$.92. We also continued our program of purchasing Kellogg shares, with 1998 purchases totaling \$239.7 million.

## Appointments and Recognition

We offer sincere thanks and best wishes to Russell G. Mawby, who retired from the Kellogg Company Board of Directors in April 1998 after 24 years of distinguished service, and to Donald H. Rumsfeld, who will retire from the Board in April 1999 after 14 years of distinguished service. We have benefited greatly from the wise counsel provided by Russ and Don during their long periods of service on the Board.

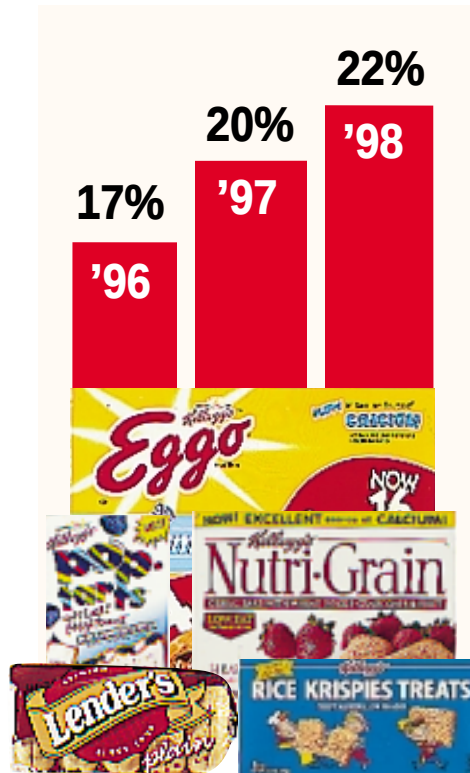
In April 1998, Dorothy A. Johnson, president and chief executive officer of the Council of Michigan Foundations, was elected to the Board.

Charles E. French, a vice president of Kellogg Company, retired during 1998 after 32 years of dedicated service. Also during 1998, John L. Forbis joined the Company as vice president – global convenience foods innovation.

In January 1999, Jacobus Groot joined Kellogg as executive vice president and president – Kellogg Asia-Pacific. In February 1999, John D. Cook joined

## CONVENIENCE FOODS SALES

(As a percentage of total sales)



*Kellogg Company's global convenience foods sales, now \$1.5 billion a year, are continuing to increase as a percentage of our total sales.*

as executive vice president and president – Kellogg North America. We are excited about the energy and insight these two executives bring to our Company.

In addition, 1999 is an important year in top-leadership transition. In January 1999, Carlos M. Gutierrez, president

and chief operating officer of Kellogg Company, was elected to the Board of Directors. Mr. Gutierrez will become chief executive officer of the Company at the Annual Meeting of Shareowners on April 23, 1999. I will continue as chairman of the board until the Annual Meeting scheduled for April 28, 2000.

We appreciate sincerely the resolve of Kellogg people amid difficulty and significant changes in 1998. We are most fortunate to have such a dedicated team that remains deeply committed to delivering superior growth and value to you, our shareowners.

Arnold G. Langbo  
Chairman of the Board  
Chief Executive Officer

Carlos M. Gutierrez  
President  
Chief Operating Officer

# Growth from a wider range of inno

*New cereals and convenience foods are expanding Kellogg Company's growth opportunities.*

Kellogg Company is building on its leadership in both cereal and convenience foods. Making healthy, great-tasting foods from grain is what we do best, and consumer demand for these foods is broad. That spells opportunity and Kellogg Company is responding.

As one major step, we are widening the boundaries of the cereal category. A particularly substantial opportunity is to create unique cereals that appeal to consumers who prefer premium products in other categories, such as coffee and ice cream. We probed successfully into this new segment in 1998 with the introduction of *Kellogg's® Smart Start®* cereal in the United States.

Now, we are more fully defining this new upscale segment with the U.S. introduction of three flavors of *Country Inn Specialties™* cereal. These grain-fruit-and-nut indulgences were

developed by Kellogg in association with leading bed-and-breakfast inns in Vermont, Georgia, and California. We believe their market potential fully matches their superior taste and texture.

Among other ways we are extending the cereal category are new *Breakfast Mates™* cereal-and-milk packets in the U.S., which represent the first presence of our cereal products in the dairy section; *Snack-Pak®* single-serve bags in the U.S.; and new *Chocos™* breakfast biscuits in India.

In convenience foods, we are broadening our *Pop-Tarts®* toaster pastries, *Nutri-Grain®* bars, and *Rice Krispies Treats™* squares franchises into multi-product powerhouses. *Pop-Tarts®* had a solid year in 1998 with the introduction of *Pop-Tarts Pastry Swirls™* and a



# vative Products

*Wild Tropical Blast™* flavor of frosted *Pop-Tarts®*. In early 1999, we are launching new *Wild Magicburst™* *Pop-Tarts®*, with icing features that appear when the product is toasted.

New technology enabled us to create *Nutri-Grain Twists™* bars, which were introduced in 1998 in the U.S. and Canada.

The *Rice Krispies Treats™* line was broadened with a new chocolate flavor in Mexico in 1998. A new chocolate-peanut butter flavor will be rolled out in the U.S. in the spring of 1999.

Also in 1999, innovation is planned for our *Lender's®* Bagels family in the U.S., and our Asia-Pacific division will launch frozen waffles and bagels in Japan under the *Kellogg's® Breadia™* brand name.

Delivering growth by developing and marketing an increasing number of distinctive grain-based products will continue to be a core strategy for Kellogg Company.



# Growth through Nutri



# tion that makes a difference

Historically committed to nutrition, Kellogg Company is embarking on new programs to deliver more health-focused value to consumers – and more value to our shareowners – through grain-based products.

In the United States, our *K-sentials™* for Growth initiative has added calcium to four major cereal brands to provide a nutrition package that promotes the growth and development of children.

Three other products, including top-selling Kellogg's Frosted Flakes® cereal, have been strengthened with our new *K-sentials™* for Energy.

This nutrition package provides B vitamins, which are essential in converting carbohydrates to energy.

Because consumers also strongly desire calcium in non-cereal grain-based products, we have led the food industry by increasing the calcium fortification in both Nutri-Grain® bars and Eggo® waffles. Nutri-Grain® is the only cereal bar which is an excellent source of calcium, and each serving of Eggo® waffles now provides as much calcium as an eight-ounce glass of milk.

Superior nutrition fortification is a worldwide initiative for Kellogg Company. The growth and energy formulations labeled *K-sentials™* in the



*Calcium fortification adds value to Eggo® waffles, Nutri-Grain® bars, and other Kellogg's® products.*

United States are being introduced under different, locally tailored names in other markets around the world. As examples, our growth formulation in Latin America, labeled *Forticalcio™*, will be in 20 countries by the end of 1999. Our growth formulation has rolled out in Japan under the *Be Big™* label. Our energy formulation will be on-shelf in more than 15 countries by the end of 1999. It already is marketed through Supercharged Kellogg's Frosted Flakes® in major markets such as the United States, the United Kingdom, and the Republic of Ireland.

We also continue to respond to specific nutritional needs in various regions of the world. For example, in Latin America, where up to 50 percent of children under age four suffer from iron deficiency, we are adding a patented, superior form of iron called iron EDTA to 75 percent of our cereal portfolio in 12 Latin American markets.

We continue to seek great-tasting ways of providing the goodness of dietary fiber to consumers. Two such initiatives in 1998 were the launches of Kellogg's® Special K® Fibre cereal in Canada and Kellogg's® Raisin Bran Crunch™ cereal in the U.S. In Australia, we have capitalized on the popularity of protein-rich soy by introducing new Kellogg's® All-Bran® Soy 'n Fibre cereal.

Finally, Kellogg Company is committed to developing products that go beyond basic nutrition and help consumers prevent and manage specific health conditions. Our new Ensemble™ foods include frozen entrees, bread, dry pasta, baked potato crisps, frozen breakfast and dessert mini-loaves, and cookies, as well as three new cereal flavors. Ensemble™, now in regional distribution in the Midwest, is the first line of foods that actively works to lower cholesterol and the first food family made with natural soluble fiber from psyllium husk and oats. The U.S. Food and Drug Administration has approved specific health claims for these two ingredients.

Ensemble™ is just the latest example of your Company's ongoing commitment to growth through providing quality grain-based products for a healthier world.



One of Kellogg Company's greatest opportunities for growth is the expansion of our convenience foods business. We want our products to be at the fingertips of today's mobile, on-the-go consumers in markets around the world. To meet this challenge, we are expanding geographically as well as into new, high-potential channels of distribution.

Our geographic expansion strategy is to focus on the biggest and best ideas and move them quickly into multiple countries. By reducing the time from research and development to actual marketing on outstanding products such as *Nutri-Grain*® bars and *Rice Krispies Treats*™ squares, we will achieve sales and profits more quickly from our best ideas.

*Twists*™ bars and for other products in our new-product pipeline for 1999 and 2000.

To support this growth, we are developing a global convenience foods infrastructure, enhanced in 1998 by the opening of a new plant in Linares, Mexico; the addition of convenience foods capacity at our Wrexham cereal plant in the United Kingdom; the purchase of a convenience foods plant in Bangi, Malaysia; and the acquisition of Day Dawn, a producer of both convenience foods and cereal in Brisbane, Australia.

Going hand-in-hand with our geographic expansion of convenience foods is expansion

# Growth by reaching consumers

*Single-serve Kellogg's® products are in hundreds of thousands of new outlets, including convenience stores in Mexico (above) and the United States (right).*

*Nutri-Grain*® bars, now successfully marketed in five countries, are scheduled for launch in five additional countries in 1999. *Rice Krispies Treats*™ squares, now also in five countries, are expected to expand to 10 new countries in 1999. Similarly aggressive launch schedules are being developed for our new *Nutri-Grain*

into new channels of distribution. A particularly strong global opportunity is single-serve distribution — at gas stations, convenience stores, supermarket checkout counters, break stations, waiting rooms, and other places that lend themselves to on-the-spot, often unplanned



# in new Places

purchases. In Mexico, for example, we have placed our products in nearly 100,000 single-serve outlets in just a year, with substantial further expansion under way in 1999. In the United States, our single-serve outlets will nearly double by the year 2000.

Single-serve expansion complements our strong foodservice business, which is positioned for growth in 1999, both inside and outside its traditional core markets of the United States, Canada, and the United Kingdom.

As eating on-the-run becomes more and more a way of life around the world, Kellogg's® nutritious, grain-based products will be available – whenever and wherever consumers desire a healthy, nourishing meal or snack. This at-your-fingertips availability will be a key driver of growth for Kellogg Company in 1999 and the new century.



*Proud members of the Country Inn Specialties™ development team (below) represent the talent and commitment of Kellogg people around the world.*

Growth from simplicity, accou



A thorough work activity analysis in Kellogg's headquarters and North American operations during 1998 will generate significant cost savings. Equally significant, however, is how this analysis will result in changes that will increase the focus and accountability of our organization and simplify many aspects of our operations.

An accountable organization is an empowered organization. To increase accountability, we have more closely linked performance measures to actual business results. We also are drawing clearer distinctions between performance levels to reward our highest-performing employees. These revisions are designed to foster both individual and team achievement.

the workplace. Now, in the challenging environment of the global economy, diversity isn't just the right thing to do, it's a business imperative.

The composition of our Board of Directors reflects our recognition of this imperative. With six female and minority group members among its 14-member roster, we believe

# n tability, and Focus

We have tightened our focus to fewer, higher-value projects and on more specifically defined business strategies. We want every Kellogg person focused on the largest, most important activities.

Seeking greater simplicity, we have delayed our entire headquarters and North American salaried organization so that there typically are no more than two levels between senior management and our front-line employees in any department.

In summary, Kellogg Company is committed to being a focused, results-oriented organization ready for the challenges of 1999 and the 21st century.

One other fundamental quality of the Kellogg organization is our commitment to a diverse workforce. We often have been recognized for leadership in providing equal opportunity in

that our Board is one of the most gender and ethnically diverse in the business world.

Our commitment to diversity is strong and long-term. Simply put, companies that value and foster diversity will be advantaged in the marketplace of the 21st century, while companies that don't will be disadvantaged.

The seeking out, training, and retention of a diverse, highly talented workforce is central to Kellogg Company's commitment to be a results-oriented organization ready for the challenges of the future and focused on creating value for you, our shareowners.



# Selected Financial Data

(millions, except per share data and number of employees)

|                              | Net sales        | % Growth    | (a)<br>Operating profit | % Growth     | (a)(b)<br>Earnings before accounting change | % Growth     | Average shares outstanding (c) |
|------------------------------|------------------|-------------|-------------------------|--------------|---------------------------------------------|--------------|--------------------------------|
| 10-year compound growth rate | 5%               |             | 1%                      |              | —                                           |              |                                |
| <b>1998</b>                  | <b>\$6,762.1</b> | <b>(1)%</b> | <b>\$ 895.1</b>         | <b>(11)%</b> | <b>\$ 502.6</b>                             | <b>(11)%</b> | <b>407.8</b>                   |
| 1997                         | 6,830.1          | 2           | 1,009.1                 | 5            | 564.0                                       | 6            | 414.1                          |
| 1996                         | 6,676.6          | (5)         | 958.9                   | 14           | 531.0                                       | 8            | 424.9                          |
| 1995                         | 7,003.7          | 7           | 837.5                   | (28)         | 490.3                                       | (30)         | 438.3                          |
| 1994                         | 6,562.0          | 4           | 1,162.6                 | 16           | 705.4                                       | 4            | 448.6                          |
| 1993                         | 6,295.4          | 2           | 1,004.6                 | (5)          | 680.7                                       | —            | 463.0                          |
| 1992                         | 6,190.6          | 7           | 1,062.8                 | 3            | 682.8                                       | 13           | 477.7                          |
| 1991                         | 5,786.6          | 12          | 1,027.9                 | 16           | 606.0                                       | 21           | 482.4                          |
| 1990                         | 5,181.4          | 11          | 886.0                   | 21           | 502.8                                       | 19           | 483.2                          |
| 1989                         | 4,651.7          | 7           | 732.5                   | (8)          | 422.1                                       | (12)         | 488.4                          |
| 1988                         | 4,348.8          | 15          | 794.1                   | 15           | 480.4                                       | 21           | 492.8                          |

|             | Total assets     | Return on average assets | Shareholders' equity | Return on average equity | Property, net    | Capital expenditures | Depreciation and amortization |
|-------------|------------------|--------------------------|----------------------|--------------------------|------------------|----------------------|-------------------------------|
| <b>1998</b> | <b>\$5,051.5</b> | <b>10%</b>               | <b>\$ 889.8</b>      | <b>53%</b>               | <b>\$2,888.8</b> | <b>\$373.9</b>       | <b>\$278.1</b>                |
| 1997        | 4,877.6          | 11                       | 997.5                | 49                       | 2,773.3          | 312.4                | 287.3                         |
| 1996        | 5,050.0          | 11                       | 1,282.4              | 37                       | 2,932.9          | 307.3                | 251.5                         |
| 1995        | 4,414.6          | 11                       | 1,590.9              | 29                       | 2,784.8          | 315.7                | 258.8                         |
| 1994        | 4,467.3          | 16                       | 1,807.5              | 40                       | 2,892.8          | 354.3                | 256.1                         |
| 1993        | 4,237.1          | 16                       | 1,713.4              | 37                       | 2,768.4          | 449.7                | 265.2                         |
| 1992        | 4,015.0          | 11                       | 1,945.2              | 21                       | 2,662.7          | 473.6                | 231.5                         |
| 1991        | 3,925.8          | 16                       | 2,159.8              | 30                       | 2,646.5          | 333.5                | 222.8                         |
| 1990        | 3,749.4          | 14                       | 1,901.8              | 28                       | 2,595.4          | 320.5                | 200.2                         |
| 1989        | 3,390.4          | 14                       | 1,634.4              | 30                       | 2,406.3          | 508.7                | 167.6                         |
| 1988        | 3,297.9          | 16                       | 1,483.2              | 36                       | 2,131.9          | 538.1                | 139.7                         |

(a) Operating profit for 1998 includes non-recurring charges of \$70.5 (\$46.3 after tax or \$12 per share). Operating profit for 1997 includes non-recurring charges of \$184.1 (\$140.5 after tax or \$34 per share). Operating profit for 1996 includes non-recurring charges of \$136.1 (\$97.8 after tax or \$23 per share). Earnings before accounting change for 1996 include a charge of \$35.0 (\$22.3 after tax or \$0.05 per share) for a contribution to the Kellogg's Corporate Citizenship Fund. Operating profit for 1995 includes non-recurring charges of \$421.8 (\$271.3 after tax or \$62 per share). Operating profit for 1993 includes non-recurring charges of \$64.3 (\$41.1 after tax or \$0.09 per share). Refer to Management's Discussion and Analysis on pages 16-21 and Notes 3 and 4 within the Notes to Consolidated Financial Statements for further explanation of non-recurring charges and other unusual items for years 1996-1998.

(b) Earnings before accounting change for 1997 exclude the effect of a charge of \$18.0 after tax (\$0.04 per share) to write off business process reengineering costs in accordance with guidance issued by the Emerging Issues Task Force of the FASB. Earnings before accounting change for 1992 and 1989 exclude the effect of adopting the following Statements of Financial Accounting Standards (SFAS): in 1992, a charge of \$251.6 (\$53 per share) net of \$144.6 of income tax benefit for the transition effect of SFAS #106, "Employers' Accounting for Postretirement Benefits Other Than Pensions;" and, in 1989, a gain of \$48.1 (\$0.10 per share) for SFAS #96 "Accounting for Income Taxes."

(c) All share data retroactively restated to reflect 2-for-1 stock splits in 1997 and 1991. All earnings per share data represent both basic and diluted earnings per share.

| Per Common Share Data (c)                            |                                            |                                           |                         |                                                    |                                                                  |                                |
|------------------------------------------------------|--------------------------------------------|-------------------------------------------|-------------------------|----------------------------------------------------|------------------------------------------------------------------|--------------------------------|
| (a)(b)<br>Earnings<br>before<br>accounting<br>change | Cash<br>dividends                          | (d)<br>Price/<br>earnings<br>ratio        | Stock<br>price<br>range | Net cash<br>provided by<br>operating<br>activities | Net cash<br>provided by/<br>(used in)<br>financing<br>activities | Common<br>stock<br>repurchases |
| 2%                                                   | 9%                                         |                                           |                         |                                                    |                                                                  |                                |
| <b>\$1.23</b>                                        | <b>\$.92</b>                               | <b>28</b>                                 | <b>\$30-50</b>          | <b>\$ 719.7</b>                                    | <b>(\$358.3)</b>                                                 | <b>\$239.7</b>                 |
| 1.36                                                 | .87                                        | 36                                        | 32-50                   | 879.8                                              | (607.3)                                                          | 426.0                          |
| 1.25                                                 | .81                                        | 26                                        | 31-40                   | 711.5                                              | 94.0                                                             | 535.7                          |
| 1.12                                                 | .75                                        | 34                                        | 26-40                   | 1,041.0                                            | (759.2)                                                          | 374.7                          |
| 1.57                                                 | .70                                        | 18                                        | 24-30                   | 966.8                                              | (559.5)                                                          | 327.3                          |
| 1.47                                                 | .66                                        | 19                                        | 23-34                   | 800.2                                              | (464.2)                                                          | 548.1                          |
| 1.43                                                 | .60                                        | 23                                        | 27-37                   | 741.9                                              | (422.6)                                                          | 224.1                          |
| 1.26                                                 | .54                                        | 26                                        | 17-33                   | 934.4                                              | (537.7)                                                          | 83.6                           |
| 1.04                                                 | .48                                        | 18                                        | 14-19                   | 819.2                                              | (490.9)                                                          | 86.9                           |
| .87                                                  | .43                                        | 20                                        | 14-20                   | 533.5                                              | (143.2)                                                          | 78.6                           |
| .98                                                  | .38                                        | 16                                        | 12-17                   | 492.3                                              | 52.1                                                             | 33.6                           |
| Long-term<br>debt                                    | (e)<br>Debt to<br>market<br>capitalization | Pretax<br>interest<br>coverage<br>(times) | Current<br>ratio        | Advertising<br>expense                             | R&D<br>expense                                                   | Number of<br>employees         |
| <b>\$1,614.5</b>                                     | <b>16%</b>                                 | <b>7</b>                                  | <b>.9</b>               | <b>\$695.3</b>                                     | <b>\$121.9</b>                                                   | <b>14,498</b>                  |
| 1,415.4                                              | 10                                         | 9                                         | .9                      | 780.4                                              | 106.1                                                            | 14,339                         |
| 726.7                                                | 14                                         | 13                                        | .7                      | 778.9                                              | 84.3                                                             | 14,511                         |
| 717.8                                                | 5                                          | 12                                        | 1.1                     | 891.5                                              | 72.2                                                             | 14,487                         |
| 719.2                                                | 8                                          | 23                                        | 1.2                     | 856.9                                              | 71.7                                                             | 15,657                         |
| 521.6                                                | 7                                          | 27                                        | 1.0                     | 772.4                                              | 59.2                                                             | 16,151                         |
| 314.9                                                | 3                                          | 33                                        | 1.2                     | 782.3                                              | 56.7                                                             | 16,551                         |
| 15.2                                                 | 3                                          | 17                                        | .9                      | 708.3                                              | 34.7                                                             | 17,017                         |
| 295.6                                                | 7                                          | 10                                        | .9                      | 648.5                                              | 38.3                                                             | 17,239                         |
| 371.4                                                | 10                                         | 10                                        | .9                      | 611.4                                              | 42.9                                                             | 17,268                         |
| 272.1                                                | 9                                          | 14                                        | .9                      | 560.9                                              | 42.0                                                             | 17,461                         |

(d) The price/earnings ratio was calculated based on year-end stock price divided by earnings before the accounting changes referred to in note (b). These earnings include the non-recurring charges and other unusual items referred to in note (a). Excluding the impact of these unusual items, the price/earnings ratio in 1998, 1997, 1996, 1995, and 1993 would have been 25, 29, 21, 22, and 19, respectively.

(e) Debt to market capitalization was calculated based on year-end total debt balance divided by market capitalization. Market capitalization was calculated based on year-end stock price multiplied by the number of shares outstanding at year-end.

# Value-Focused Global Growth

The Company's renewed commitment to growth in the marketplace is the primary driver for our governing objective of maximizing long-term share-owner value. Our global infrastructure uniquely positions our business for growth. Strong brand equities, innovative ideas, and the accelerated roll-out of convenience foods, supported by increased marketing investment, are critical components of our strategy.

Current global investment opportunities are considerable and require a balancing of future profitable growth with competitive returns in the near term. The application of value-based management principles determines how we allocate scarce resources against competing options. The execution of these strategies will ensure we deliver our commitment of both returning to and sustaining top-line and bottom-line growth in pursuit of value creation.

## Management's Discussion and Analysis

Kellogg Company and Subsidiaries

### Results of operations

#### Overview

Kellogg Company manufactures and markets ready-to-eat cereal and other grain-based convenience food products, including toaster pastries, frozen waffles, cereal bars, and bagels, throughout the world. Principal markets for these products include the United States and Great Britain. Operations are managed via four major geographic areas – North America, Europe, Asia-Pacific, and Latin America – which are the basis of the Company's reportable operating segment information. The Company leads the global ready-to-eat cereal category with an estimated 38% annualized share of worldwide volume. Additionally, the Company is the North American market leader in the toaster pastry, cereal/granola bar, frozen waffle, and pre-packaged bagel categories.

During 1998, the Company realized declines in earnings per share both with and without unusual items (discussed below). The Company experienced significant competitive pressure combined with category softness in its major ready-to-eat cereal markets, to which it responded by accelerating investment in long-term growth strategies, including product development, technology, and efficiency initiatives.

For the full year of 1998, Kellogg Company reported net earnings and earnings per share of \$502.6 million and \$1.23, respectively, compared to 1997 net earnings of \$546.0 million and net earnings per share of \$1.32. Net earnings and earnings per share for 1996 were \$531.0 million and \$1.25, respectively. (All per share amounts reflect the 2-for-1 stock split effective August 22, 1997. All earnings per share presented represent both basic and diluted earnings per share.)

During the current and prior years, the Company reported non-recurring charges and other unusual items that have been excluded from all applicable amounts presented below for purposes of comparison between years. Additionally, results for 1997 are presented before the cumulative effect of a change in the method of accounting for business process reengineering costs. Refer to the separate section below on non-recurring charges and other unusual items for further information.

#### 1998 compared to 1997

Excluding non-recurring charges and other unusual items, the Company reported 1998 earnings per share of \$1.35, a 21% decrease from the prior-year result of \$1.70. The year-to-year decrease in earnings per share of \$.35 resulted from \$.33 of business decline, \$.01 of unfavorable tax rate movements, and \$.03 of unfavorable foreign currency movements, partially offset by a \$.02 benefit from share repurchase. The business decline was principally attributable to cereal category softness and competitive pressures in North America and Europe, and continued global investments in brand-building marketing activities and streamlining initiatives. Foreign currency movements had a minimal net impact in Europe and negatively impacted earnings by 2% on a consolidated basis due to currency devaluation in Latin America and Asia-Pacific.

The Company realized the following volume results during 1998:

|               | Change |
|---------------|--------|
| North America | -4.3%  |
| Europe        | -1.2%  |
| Asia-Pacific  | +6.9%  |
| Latin America | +16.2% |
| Global total  | -1.3%  |

|                          | Change |
|--------------------------|--------|
| Global cereal            | -2.0%  |
| Global convenience foods | +1.1%  |
| Global total             | -1.3%  |

Within North America and Europe, volume declines were principally due to softness in the ready-to-eat cereal business. Asia-Pacific experienced record volume due to a combination of cereal growth and new convenience food product introductions. Latin America continued to post double-digit increases in both ready-to-eat cereal and convenience foods, with record volume results throughout 1998.

The global convenience foods volume increase was driven by double-digit growth in the Company's international markets offset by softness within North America, primarily due to declines in the Lender's Bagels business.

On an annualized basis, regional volume market share of the ready-to-eat cereal category was approximately 33% in North America, 43% in Europe, 43% in Asia-Pacific, and 61% in Latin America.

Consolidated net sales decreased 1% for 1998. Adjusted for unfavorable foreign currency translation, sales were even with the prior year, with the unfavorable impact of volume declines offset by favorable pricing and product mix movements. On an operating segment basis, net sales versus the prior year were:

|                         | North America | Europe   | Asia-Pacific | Latin America | Consolidated |
|-------------------------|---------------|----------|--------------|---------------|--------------|
| Business                | -1%           | —        | +7%          | +16%          | —            |
| Foreign currency impact | -1%           | —        | -15%         | -4%           | -1%          |
| <b>Total change</b>     | <b>-2%</b>    | <b>—</b> | <b>-8%</b>   | <b>+12%</b>   | <b>-1%</b>   |

Margin performance for 1998 and 1997 was:

|                  | 1998   | 1997   | Change |
|------------------|--------|--------|--------|
| Gross margin     | +51.5% | +52.1% | -.6%   |
| SGA%(a)          | -37.2% | -34.6% | -2.6%  |
| Operating margin | +14.3% | +17.5% | -3.2%  |

(a) Selling, general and administration expense as a percentage of net sales.

The gross margin decline was due to a combination of the fixed cost absorption impact of lower volumes combined with incremental costs related to launching new products in Europe and North America. The increase in SGA% reflects increased global research and development costs to support our ongoing innovation strategy combined with significant marketing investment and increased spending on streamlining initiatives.

Operating profit (loss) on an operating segment basis was:

| (millions)                                                          | North America  | Europe         | Asia-Pacific  | Latin America  | Corporate and other | Consolidated     |
|---------------------------------------------------------------------|----------------|----------------|---------------|----------------|---------------------|------------------|
| 1998 operating profit (loss) as reported                            | \$790.8        | \$208.1        | \$44.9        | \$107.2        | (\$255.9)           | \$ 895.1         |
| Non-recurring charges                                               | 40.8           | 3.3            | 3.4           | —              | 23.0                | 70.5             |
| <b>1998 operating profit (loss) excluding non-recurring charges</b> | <b>\$831.6</b> | <b>\$211.4</b> | <b>\$48.3</b> | <b>\$107.2</b> | <b>(\$232.9)</b>    | <b>\$965.6</b>   |
| 1997 operating profit (loss) as reported                            | \$847.0        | \$189.9        | \$22.5        | \$111.6        | (\$161.9)           | \$1,009.1        |
| Non-recurring charges                                               | 37.8           | 115.9          | 28.6          | .2             | 1.6                 | 184.1            |
| <b>1997 operating profit (loss) excluding non-recurring charges</b> | <b>\$884.8</b> | <b>\$305.8</b> | <b>\$51.1</b> | <b>\$111.8</b> | <b>(\$160.3)</b>    | <b>\$1,193.2</b> |
| % change – 1998 vs. 1997 excluding non-recurring charges            |                |                |               |                |                     |                  |
| Business                                                            | -6%            | -31%           | +11%          | -1%            | -45%                | -18%             |
| Foreign currency impact                                             | —              | —              | -16%          | -3%            | —                   | -1%              |
| <b>Total change</b>                                                 | <b>-6%</b>     | <b>-31%</b>    | <b>-5%</b>    | <b>-4%</b>     | <b>-45%</b>         | <b>-19%</b>      |

Gross interest expense, prior to amounts capitalized, increased 8% versus the prior year to \$127.3 million. The higher interest expense resulted from overall increased debt levels, partially offset by a lower effective interest rate.

Excluding the impact of non-recurring charges and other unusual items, the effective income tax rate was 35.7%, an increase of .4 percentage points versus the prior-year rate. The higher effective tax rate is primarily due to lower earnings and country mix. For both 1998 and 1997, the effective tax rate benefited from statutory rate reductions in the United Kingdom, as well as favorable adjustments in other jurisdictions. The effective income tax rate based on reported earnings (before cumulative effect of accounting change) was 35.8% in 1998 and 37.6% in 1997.

### 1997 compared to 1996

Excluding non-recurring charges and other unusual items, the Company reported 1997 earnings per share of \$1.70, an 11% increase over the prior-year results of \$1.53. The year-over-year increase in earnings per share of \$.17 resulted from \$.12 of business growth, \$.03 of common stock repurchases, and \$.04 of favorable tax rate movements, partially offset by \$.02 of unfavorable foreign currency movements. The business growth was principally attributable to cereal volume growth in North America and Latin America, continued double-digit growth in other convenience foods volume, and reductions in manufacturing and marketing costs. Foreign currency movements negatively impacted earnings 1% on a consolidated basis. The negative impact of the Lender's Bagels business, acquired in December 1996, was approximately \$.05.

The Company achieved the following volume growth during 1997:

|                 | Change |
|-----------------|--------|
| North America   | +16.1% |
| Europe          | +2.6%  |
| Asia-Pacific    | +1.5%  |
| Latin America   | +16.3% |
| Global total(a) | +11.3% |

|                             | Change |
|-----------------------------|--------|
| Global cereal               | +3.4%  |
| Global convenience foods(b) | +47.2% |
| Global total                | +11.3% |

(a) Excluding Lender's, acquired in December 1996, global volume growth was 5.0%.

(b) Excluding Lender's, global convenience foods growth was 12.5%.

Within North America, the Company recovered cereal volume declines of the prior year, and slightly exceeded 1995 results. Growth in Europe was partially offset by a decline in the United Kingdom, while Asia-Pacific was slowed by softness in Australia. Latin America achieved record annual volume results.

Consolidated net sales increased 2% for 1997. The favorable impact of strong volumes was partially offset by unfavorable pricing and product mix movements, and a negative foreign currency impact of 2%. Excluding the Lender's business, consolidated net sales were even with the prior year. On an operating segment basis, net sales versus the prior year were:

|                         | North America | Europe     | Asia-Pacific | Latin America | Consolidated |
|-------------------------|---------------|------------|--------------|---------------|--------------|
| Business                | +4%           | +2%        | +2%          | +13%          | +4%          |
| Foreign currency impact | —             | -5%        | -7%          | -1%           | -2%          |
| <b>Total change</b>     | <b>+4%</b>    | <b>-3%</b> | <b>-5%</b>   | <b>+12%</b>   | <b>+2%</b>   |

Margin performance for 1997 and 1996 was:

|                  | 1997   | 1996   | Change |
|------------------|--------|--------|--------|
| Gross margin     | +52.1% | +53.2% | -1.1%  |
| SGA%(a)          | -34.6% | -36.8% | +2.2%  |
| Operating margin | +17.5% | +16.4% | +1.1%  |

(a) Selling, general and administrative expense as a percentage of net sales.

Gross margin performance for 1997 benefited from volume increases and year-over-year operational cost savings. However, these favorable factors were outweighed by the negative impact of prior-year pricing actions. The reduction in SGA% primarily reflects reduced promotional spending in North America.

Operating profit (loss) on an operating segment basis was:

| (millions)                                                          | North America  | Europe         | Asia-Pacific  | Latin America  | Corporate and other | Consolidated     |
|---------------------------------------------------------------------|----------------|----------------|---------------|----------------|---------------------|------------------|
| <b>1997 operating profit (loss) excluding non-recurring charges</b> | <b>\$884.8</b> | <b>\$305.8</b> | <b>\$51.1</b> | <b>\$111.8</b> | <b>(\$160.3)</b>    | <b>\$1,193.2</b> |
| 1996 operating profit (loss) as reported                            | \$751.2        | \$249.8        | \$31.2        | \$ 93.5        | (\$166.8)           | \$958.9          |
| Non-recurring charges                                               | 11.1           | 55.3           | 30.1          | .7             | 38.9                | 136.1            |
| <b>1996 operating profit (loss) excluding non-recurring charges</b> | <b>\$762.3</b> | <b>\$305.1</b> | <b>\$61.3</b> | <b>\$94.2</b>  | <b>(\$127.9)</b>    | <b>\$1,095.0</b> |
| % change – 1997 vs. 1996 excluding non-recurring charges            |                |                |               |                |                     |                  |
| Business                                                            | +16%           | +4%            | -9%           | +20%           | -25%                | +11%             |
| Foreign currency impact                                             | —              | -4%            | -8%           | -1%            | —                   | -2%              |
| <b>Total change</b>                                                 | <b>+16%</b>    | <b>—</b>       | <b>-17%</b>   | <b>+19%</b>    | <b>-25%</b>         | <b>+9%</b>       |

Gross interest expense, prior to amounts capitalized, increased 70% versus the prior year to \$117.9 million. The higher interest expense resulted from increased debt levels to fund the Lender's Bagels business acquisition and the Company's common stock repurchase program.

Excluding the impact of non-recurring charges and other unusual items, the effective income tax rate was 35.3%, 1.5 percentage points lower than the prior-year rate. The lower effective tax rate is primarily due to enactment of a 2% statutory rate reduction in the United Kingdom, effective April 1, 1997, as well as favorable adjustments in other jurisdictions. The effective income tax rate based on reported earnings (before cumulative effect of accounting change) was 37.6% in 1997 and 38.2% in 1996. For both 1997 and 1996, the higher reported rate (as compared to the rate excluding the impact of unusual items) primarily relates to certain non-recurring charges for which no tax benefit was provided, based on management's assessment of the likelihood of recovering such benefit in future years.

Other expense for 1996 included a charge of \$35.0 million for a contribution to the Kellogg's Corporate Citizenship Fund, a private trust established for charitable donations.

## Liquidity and capital resources

The Company's financial condition remained strong throughout 1998. A strong cash flow, combined with a program of issuing commercial paper and maintaining worldwide credit facilities, provides adequate liquidity to meet the Company's operational needs. In August 1998, Moody's lowered its rating on the Company's senior unsecured notes from Aa1 to Aa2 reflecting the Company's increased use of cash for investments in marketing, product development, and other initiatives in the highly competitive markets around the world. Management believes that this change will have an insignificant impact on future borrowing costs. The rating agency confirmed the Company's Prime-1 commercial paper rating.

Net cash provided by operating activities was \$719.7 million during 1998, compared to \$879.8 million in 1997, with the decrease due principally to lower earnings and unfavorable working capital movements. The ratio of current assets to current liabilities was .9 at December 31, 1998 and 1997.

Net cash used in investing activities was \$398.0 million, compared to \$329.3 million in 1997. The increase was primarily due to property additions, which increased from \$312.4 million in 1997 to \$373.9 million for 1998.

Net cash used in financing activities was \$358.3 million, primarily related to common stock repurchases of \$239.7 million and dividend payments of \$375.3 million, partially offset by a net increase in total debt of \$241.5 million. The Company's total 1998 per share dividend payment was \$.92, a 5.7% increase over the prior-year payment of \$.87.

On August 1, 1997, the Company's Board of Directors approved a 2-for-1 stock split to shareholders of record at the close of business August 8, 1997, effective August 22, 1997, and also authorized retirement of 105.3 million common shares (pre-split) held in treasury. All per share and shares outstanding data have been restated retroactively to reflect the stock split.

Under existing plans authorized by the Company's Board of Directors, management spent \$239.7 million during 1998 to repurchase 6.3 million shares of the Company's common stock at an average price of \$38 per share. The open repurchase authorization, which has been extended through December 31, 1999, was \$149.4 million at year-end 1998.

Notes payable primarily consist of commercial paper borrowings in the United States and borrowings under a \$200 million revolving credit agreement in Europe with several international banks initiated during December 1998. At December 31, 1998, outstanding borrowings under the revolving credit agreement were \$148.5 million with an effective interest rate of 5.5%. U.S. borrowings at December 31, 1998, were \$423.3 million with an effective interest rate of 5.2%. Associated with the U.S. borrowings, during September 1997, the Company purchased a \$225 million notional, four-year fixed interest rate cap. Under the terms of the cap, if the Federal Reserve AA composite rate on 30-day commercial paper increases to 6.33%, the Company will pay this fixed rate on \$225 million of its commercial paper borrowings. If the rate increases to 7.68% or above, the cap will expire. As of year-end 1998, the rate was 4.90%.

In October 1998, the Company issued \$200 million of seven-year 4.875% fixed rate U.S. Dollar Notes. Management used the proceeds from this issuance to replace maturing long-term debt. Management entered into a series of interest rate hedges throughout 1998 to effectively fix the interest rate prior to issuance. The effect of the hedges, when combined with original issue discounts, resulted in an overall effective rate for this debt of 6.07%.

To reduce short-term borrowings, on February 4, 1998, the Company issued \$400 million of three-year 5.75% fixed rate U.S. Dollar Notes. Accordingly, an equivalent amount of commercial paper borrowings was classified as long-term debt in the December 31, 1997, balance sheet. These Notes were issued under an existing "shelf registration" with the Securities and Exchange Commission, and provide an option to holders to extend the obligation for an additional four years at a predetermined interest rate of 5.63% plus the Company's then-current credit spread. As a result of this option, the effective interest rate on the three-year Notes is 5.23%. Concurrent with this issuance, the Company entered into a \$400 million notional, three-year fixed-to-floating interest rate swap, indexed to the Federal Reserve AA composite rate on 30-day commercial paper.

On January 29, 1997, the Company issued \$500 million of seven-year 6.625% fixed rate Euro Dollar Notes. This debt was issued primarily to fund the purchase of the Lender's Bagels business, acquired in December 1996. In conjunction with this issuance, the Company settled \$500 million notional amount of interest rate forward swap agreements, which effectively fixed the interest rate on the debt at 6.354%. Associated with this debt, during September 1997, the Company entered into a \$225 million notional, 4½-year fixed-to-floating interest rate swap, indexed to the three-month London Interbank Offered Rate (LIBOR). Under the terms of this swap,

if three-month LIBOR decreases to 4.71% or below, the swap will expire. At year-end 1998, three-month LIBOR was 5.07%.

To replace other long-term debt maturing during 1997, the Company issued \$500 million of four-year 6.125% Euro Dollar Notes on August 5, 1997. In conjunction with this issuance, the Company settled \$400 million notional amount of interest rate forward swap agreements that effectively fixed the interest rate on the debt at 6.4%. Associated with this debt, during September 1997, the Company entered into a \$200 million notional, four-year fixed-to-floating interest rate swap, indexed to three-month LIBOR.

The ratio of total debt to market capitalization at December 31, 1998, was 16%, up from 10% at December 31, 1997, due to a combination of a lower stock price and higher debt levels in 1998.

## Non-recurring charges and other unusual items

From 1995 to the present, management has commenced major productivity and operational streamlining initiatives in an effort to optimize the Company's cost structure. The incremental costs of these programs have been reported throughout 1995-1998 as non-recurring charges.

In addition to the non-recurring charges reported for streamlining initiatives, the Company incurred charges for other unusual items. Furthermore, net earnings for 1997 included a cumulative effect of accounting change related to business process reengineering costs. In summary, the following charges were excluded from reported results for purposes of comparison within the "Results of operations" section above:

| Non-recurring charges & other unusual items       |                     |                                                                                |                 |                              |
|---------------------------------------------------|---------------------|--------------------------------------------------------------------------------|-----------------|------------------------------|
| Impact on<br>(millions, except<br>per share data) | Operating<br>profit | Earnings before<br>income taxes &<br>cumulative effect of<br>accounting change | Net<br>earnings | Net<br>earnings<br>per share |
| <b>1998:</b>                                      |                     |                                                                                |                 |                              |
| Streamlining initiatives                          | \$70.5              | \$70.5                                                                         | \$46.3          | \$ .12                       |
| <b>1997:</b>                                      |                     |                                                                                |                 |                              |
| Streamlining initiatives                          | \$161.1             | \$161.1                                                                        |                 |                              |
| Impairment losses                                 | 23.0                | 23.0                                                                           |                 |                              |
| <b>Total non-recurring<br/>charges</b>            | <b>\$184.1</b>      | <b>\$184.1</b>                                                                 | <b>\$140.5</b>  | <b>\$ .34</b>                |
| <b>Cumulative effect<br/>of accounting change</b> | <b>—</b>            | <b>—</b>                                                                       | <b>\$ 18.0</b>  | <b>\$ .04</b>                |
| <b>1996:</b>                                      |                     |                                                                                |                 |                              |
| Streamlining initiatives                          | \$121.1             | \$121.1                                                                        |                 |                              |
| Litigation provision                              | 15.0                | 15.0                                                                           |                 |                              |
| Private trust<br>contribution(a)                  | —                   | 35.0                                                                           |                 |                              |
| <b>Total</b>                                      | <b>\$136.1</b>      | <b>\$171.1</b>                                                                 | <b>\$120.1</b>  | <b>\$ .28</b>                |

(a) Recorded in other income (expense), net.

The 1998 streamlining charges relate primarily to an overhead activity analysis that resulted in the elimination of approximately 550 employees and 240 contractors from the Company's headquarters and North American operations through a combination of involuntary early retirement and severance programs. The charges consist mainly of employee retirement and separation benefits, outplacement services, associated consulting and

other related costs. This initiative is expected to result in annual pre-tax savings of \$105 million, beginning in 1999. Cash outlays for the 1998 charges during 1998 were \$8 million, with the remainder to be spent during 1999. Total cash outlays during 1998 for all streamlining initiatives were approximately \$47 million. Refer to Note 3 within Notes to Consolidated Financial Statements for further information.

All streamlining programs commenced since 1995, including the aforementioned 1998 initiatives, are expected to result in the elimination of approximately 3,500 employee positions by the end of 1999, with approximately 95% of this reduction already achieved. These programs are expected to deliver average annual pre-tax savings in excess of \$300 million by the year 2000, with approximately \$250 million of that amount to be realized in 1999. These savings are not necessarily indicative of current and future incremental earnings due to management's commitment to invest in competitive business strategies, new markets, and growth opportunities.

In addition to the non-recurring charges reported during 1997 and 1996 for streamlining initiatives, the Company incurred charges for the following unusual items:

- During 1997, the Company included in non-recurring charges \$23.0 million of asset impairment losses which resulted from an evaluation of the Company's ability to recover components of its investments in the emerging markets of Asia-Pacific.
- During 1996, the Company included in non-recurring charges a provision of \$15.0 million for the potential settlement of certain litigation.
- During 1996, the Company included in other expense a charge of \$35.0 million for a contribution to the Kellogg's Corporate Citizenship Fund, which is expected to satisfy the charitable-giving plans of this private trust through the year 2000.

The Company's streamlining initiatives will continue throughout 1999. The aforementioned overhead activity analysis will be extended to Europe and Latin America during the first half of 1999. Management believes these initiatives will result in the elimination of several hundred employee positions, requiring separation benefit costs to be incurred. Since the number of employees affected, their job functions, and their locations have not yet been identified, the costs that may result are not yet known. The combination of this Europe and Latin America overhead activity analysis and other ongoing cost-reduction programs is expected to result in more than \$50 million in incremental savings in 1999.

The foregoing discussion of streamlining initiatives contains forward-looking statements regarding headcount reductions, cash requirements, and realizable savings. Actual amounts may vary depending on the final determination of important factors, such as identification of specific employees to be separated from pre-determined pools, actual amounts of asset removal and relocation costs, dates of asset disposal and costs to maintain assets up to the date of disposal, proceeds from asset disposals, final negotiation of third party contract buy-outs, and other items.

## New accounting pronouncements

In March 1998, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AcSEC) issued Statement of Position (SOP) 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." SOP 98-1 provides guidance on the classification of software project costs between expense and capital. During April 1998, AcSEC also issued SOP 98-5 "Reporting on Costs of Start-up Activities." SOP 98-5 prescribes that the costs of opening a new facility, commencing business in a new market, or similar start-up activities must be expensed as incurred. Both of these pronouncements are effective for fiscal years beginning after December 15, 1998. SOP 98-1 is to be applied on a prospective basis to costs incurred on or after the date of adoption. The initial application of SOP 98-5 is to be reported as a cumulative effect of a change in accounting principle, if material. Management intends to adopt SOP 98-1 and SOP 98-5 effective January 1, 1999, and does not expect the impact of adoption to have a significant impact on the Company's financial results.

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) #133 "Accounting for Derivative Instruments and Hedging Activities." This Statement establishes accounting and reporting standards for derivative instruments, requiring recognition of the fair value of all derivatives as assets or liabilities on the balance sheet. SFAS #133 is effective for fiscal years beginning after June 15, 1999. Management intends to adopt the provisions of SFAS #133 effective January 1, 2000, and does not expect the impact of adoption to have a significant impact on the Company's financial results.

On November 20, 1997, the Emerging Issues Task Force (EITF) of the FASB reached a consensus in EITF Issue 97-13 that the costs of business process reengineering activities are to be expensed as incurred. This consensus also applies to business process reengineering activities that are part of an information technology project. Beginning in 1996, the Company has undertaken an Enterprise Business Applications (EBA) initiative that combines design and installation of business processes and software packages to achieve global best practices. Under the EBA initiative, the Company had capitalized certain external costs associated with business process reengineering activities as part of the software asset. EITF Issue 97-13 prescribes that previously capitalized business process reengineering costs should be expensed and reported as a cumulative effect of a change in accounting principle. Accordingly, for the fourth quarter of 1997, the Company reported a charge of \$18.0 million (net of tax benefit of \$7.7 million) or \$.04 per share for write-off of business process reengineering costs. Such costs were expensed as incurred during 1998 and the fourth quarter of 1997 and were insignificant.

## Year 2000

The Company established a global program in 1997 to address the millennium date change issue (the inability of certain computer software, hardware, and other equipment with embedded computer chips to properly process two-digit year-date codes after 1999). The program is structured to address all date-related risks to the Company's business in four major categories: information technology systems, embedded technology systems, suppliers, and customers.

In the information technology and embedded systems categories, the inventories and detailed assessments are complete, remediation is 70% complete, and testing is 50% complete. Remediation and testing are on schedule with planned completion by June 30, 1999, for business critical and important systems.

The Company is spending approximately \$70 million during 1998 and 1999 to become Year 2000 compliant. This amount includes the costs of activities described above, as well as costs to replace non-compliant systems for which replacement was accelerated to meet Year 2000 requirements. On a global basis, spending through December 31, 1998, is consistent with the overall percentage of program completion of approximately 70%. These amounts do not include the effect of other planned system initiatives that will contribute to the Year 2000 compliance effort. Management believes that to the extent these other planned system initiatives impact the Year 2000 project, they will be completed as scheduled by mid-1999.

The Company is continuing a contingency planning process started in 1998 designed to mitigate business risks due to unexpected date-related issues within any of the Year 2000 program categories across all key business units worldwide. The testing results for information technology and embedded systems are being coupled with risk assessments of the Company's suppliers, customers, and other internal initiatives, and incorporated into this contingency planning process. These plans are expected to be defined in each of the Company's four operating segments of North America, Europe, Asia-Pacific, and Latin America by April of 1999, for execution in preparation for the millennium transition.

While management believes that the estimated cost of becoming Year 2000 compliant is not significant to the Company's financial results, failure to complete all the work in a timely manner could result in material financial risk. While management expects all planned work to be completed, there can be no guarantee that all systems will be in compliance by the Year 2000, that the systems of other companies and government agencies on which the Company relies will be converted in a timely manner, or that contingency planning will be able to fully address all potential interruptions. Therefore, date-related issues could cause delays in the Company's ability to produce or ship its products, process transactions, or otherwise conduct business in any of its markets.

## Euro conversion

On January 1, 1999, eleven European countries (Germany, France, Spain, Italy, Ireland, Portugal, Finland, Luxembourg, Belgium, Austria, and the Netherlands) implemented a single currency zone, the Economic and Monetary Union (EMU). The new currency, the Euro, has become the official currency of the participating countries. Those countries financial markets and banking systems are quoting financial and treasury data in Euros from January 1, 1999.

The Euro will exist alongside the old national currencies during a transition period from January 1, 1999, to January 1, 2002. During this period, entities within participating countries must complete changes which enable them to transact in the Euro. National currencies will be withdrawn no later than July 1, 2002. This transition to the Euro currency will involve changing budgetary, accounting, pricing, costing, and fiscal systems in companies and public administrations, as well as the simultaneous handling of parallel currencies and conversion of legacy data. During the first quarter of 1999, the Euro currency has demonstrated stability. However, this early stability needs to be observed over a longer period before conclusions can be drawn on the currency's long-term viability.

In early 1998, management formed a task force to monitor EMU developments, evaluate the impact of the Euro conversion on the Company's operations, and develop and execute action plans, as necessary. The task force has completed a full EMU impact assessment identifying company-wide, cross-functional effects of the Euro. Required business strategy, system, and process changes within the Company's European region are underway with certain markets already Euro compliant. Many of these changes will be made in conjunction with other significant technology initiatives currently under way, and will be completed in accordance with the Company's timetable for transacting with its suppliers and customers in the Euro. Results of task force assessments indicate that most suppliers and customers desire to initiate Euro transactions during 2000 and 2001.

Management expects to complete financial, operational, and manufacturing system conversions during 2001. Although Management currently believes the Company will be able to accommodate any required changes in its operations, there can be no assurance that the Company, its customers, suppliers, financial service providers, or government agencies will meet all of the Euro currency requirements on a timely basis. Such failure to complete the necessary work could result in material financial risk.

## 1999 outlook

Management is not aware of any adverse trends that would materially affect the Company's strong financial position. Should suitable investment opportunities or working capital needs arise that would require additional financing, management believes that the Company's strong credit rating, balance sheet, and earnings history provide a base for obtaining additional financial resources at competitive rates and terms. Based on the expectation of cereal volume growth, and strong results from product innovation and the continued global roll-out of convenience foods, management believes the Company is well-positioned to deliver sales and earnings growth for the full year 1999. The Company will continue to identify and pursue streamlining and productivity initiatives to optimize its cost structure.

The Company is currently reviewing strategies related to the Lender's Bagels business, given its performance since acquisition. The Company has evaluated the recoverability of Lender's long-lived assets as of December 31, 1998, and although this evaluation has not resulted in the recognition of an impairment loss, management expects to update its assessment during 1999.

Additional expectations for 1999 include a gross profit margin of 51-52%, an SGA% of 36-37%, an effective income tax rate of 36-37%, and capital spending of approximately \$270 million.

The foregoing projections concerning impact of future borrowing costs, accounting changes, volume growth, profitability, capital spending, and common stock repurchase activity are forward-looking statements that involve risks and uncertainties. Actual results may differ materially due to the impact of competitive conditions, marketing spending and/or incremental pricing actions on actual volumes and product mix; the levels of spending on system initiatives, properties, business opportunities, continued streamlining initiatives, and other general and administrative costs; raw material price and labor cost fluctuations; foreign currency exchange rate fluctuations; changes in statutory tax law; interest rates available on short-term financing; the impact of stock market conditions on common stock repurchase activity; and other items.

# Consolidated Statement of Earnings

Year ended December 31,

| (millions, except per share data)                                              | 1998             | 1997      | 1996      |
|--------------------------------------------------------------------------------|------------------|-----------|-----------|
| <b>Net sales</b>                                                               | <b>\$6,762.1</b> | \$6,830.1 | \$6,676.6 |
| Cost of goods sold                                                             | 3,282.6          | 3,270.1   | 3,122.9   |
| Selling and administrative expense                                             | 2,513.9          | 2,366.8   | 2,458.7   |
| Non-recurring charges                                                          | 70.5             | 184.1     | 136.1     |
| <b>Operating profit</b>                                                        | <b>895.1</b>     | 1,009.1   | 958.9     |
| Interest expense                                                               | 119.5            | 108.3     | 65.6      |
| Other income (expense), net                                                    | 6.9              | 3.7       | (33.4)    |
| <b>Earnings before income taxes and cumulative effect of accounting change</b> | <b>782.5</b>     | 904.5     | 859.9     |
| Income taxes                                                                   | 279.9            | 340.5     | 328.9     |
| <b>Earnings before cumulative effect of accounting change</b>                  | <b>502.6</b>     | 564.0     | 531.0     |
| Cumulative effect of accounting change (net of tax)                            | —                | (18.0)    | —         |
| <b>Net earnings</b>                                                            | <b>\$ 502.6</b>  | \$ 546.0  | \$ 531.0  |
| <b>Per share amounts (basic and diluted):</b>                                  |                  |           |           |
| <b>Earnings before cumulative effect of accounting change</b>                  | <b>\$ 1.23</b>   | \$ 1.36   | \$ 1.25   |
| Cumulative effect of accounting change                                         | —                | (.04)     | —         |
| <b>Net earnings per share</b>                                                  | <b>\$ 1.23</b>   | \$ 1.32   | \$ 1.25   |

Refer to Notes to Consolidated Financial Statements.

# Consolidated Statement of Shareholders' Equity

| (millions)                                     | Common stock |                | Capital in excess of par value | Retained earnings | Treasury stock |                   | Accumulated other comprehensive income | Total shareholders' equity | Total comprehensive income |
|------------------------------------------------|--------------|----------------|--------------------------------|-------------------|----------------|-------------------|----------------------------------------|----------------------------|----------------------------|
|                                                | shares       | amount         |                                |                   | shares         | amount            |                                        |                            |                            |
| Balance, January 1, 1996                       | 311.1        | \$ 77.8        | \$ 105.2                       | \$ 3,963.0        | 94.4           | (\$2,361.2)       | (\$ 193.9)                             | \$ 1,590.9                 |                            |
| Common stock repurchases                       |              |                |                                |                   | 7.4            | (535.7)           |                                        | (535.7)                    |                            |
| Net earnings                                   |              |                |                                | 531.0             |                |                   |                                        | 531.0                      | \$ 531.0                   |
| Dividends                                      |              |                |                                | (343.7)           |                |                   |                                        | (343.7)                    |                            |
| Other comprehensive income                     |              |                |                                |                   |                |                   | 27.6                                   | 27.6                       | 27.6                       |
| Stock options exercised and other              | .4           | .1             | 18.7                           |                   | .1             | (6.5)             |                                        | 12.3                       |                            |
| <b>Balance, December 31, 1996</b>              | <b>311.5</b> | <b>77.9</b>    | <b>123.9</b>                   | <b>4,150.3</b>    | <b>101.9</b>   | <b>(2,903.4)</b>  | <b>(166.3)</b>                         | <b>1,282.4</b>             | <b>\$558.6</b>             |
| Common stock repurchases (pre-split)           |              |                |                                |                   | 3.9            | (290.9)           |                                        | (290.9)                    |                            |
| Stock options exercised and other (pre-split)  | .6           | .1             | 31.9                           |                   | —              | (3.9)             |                                        | 28.1                       |                            |
| Retirement of treasury stock                   | (105.3)      | (26.3)         | (55.8)                         | (3,095.8)         | (105.3)        | 3,177.9           |                                        | —                          |                            |
| Two-for-one stock split                        | 206.8        | 51.7           | (51.7)                         |                   | .5             | —                 |                                        | —                          |                            |
| Common stock repurchases (post-split)          |              |                |                                |                   | 3.1            | (135.1)           |                                        | (135.1)                    |                            |
| Net earnings                                   |              |                |                                | 546.0             |                |                   |                                        | 546.0                      | \$ 546.0                   |
| Dividends                                      |              |                |                                | (360.1)           |                |                   |                                        | (360.1)                    |                            |
| Other comprehensive income                     |              |                |                                |                   |                |                   | (115.6)                                | (115.6)                    | (115.6)                    |
| Stock options exercised and other (post-split) | 1.2          | .3             | 44.3                           |                   | —              | (1.9)             |                                        | 42.7                       |                            |
| <b>Balance, December 31, 1997</b>              | <b>414.8</b> | <b>103.7</b>   | <b>92.6</b>                    | <b>1,240.4</b>    | <b>4.1</b>     | <b>(157.3)</b>    | <b>(281.9)</b>                         | <b>997.5</b>               | <b>\$430.4</b>             |
| Common stock repurchases                       |              |                |                                |                   | 6.3            | (239.7)           |                                        | (239.7)                    |                            |
| Net earnings                                   |              |                |                                | 502.6             |                |                   |                                        | 502.6                      | \$ 502.6                   |
| Dividends                                      |              |                |                                | (375.3)           |                |                   |                                        | (375.3)                    |                            |
| Other comprehensive income                     |              |                |                                |                   |                |                   | (10.5)                                 | (10.5)                     | (10.5)                     |
| Stock options exercised and other              | .5           | .1             | 12.4                           |                   | (.1)           | 2.7               |                                        | 15.2                       |                            |
| <b>Balance, December 31, 1998</b>              | <b>415.3</b> | <b>\$103.8</b> | <b>\$105.0</b>                 | <b>\$1,367.7</b>  | <b>10.3</b>    | <b>(\$ 394.3)</b> | <b>(\$292.4)</b>                       | <b>\$ 889.8</b>            | <b>\$492.1</b>             |

Refer to Notes to Consolidated Financial Statements.

# Consolidated Balance Sheet

At December 31,

*(millions, except share data)*

|                                                                                                                            | 1998             | 1997             |
|----------------------------------------------------------------------------------------------------------------------------|------------------|------------------|
| <b>Current assets</b>                                                                                                      |                  |                  |
| Cash and cash equivalents                                                                                                  | \$ 136.4         | \$ 173.2         |
| Accounts receivable, less allowances of \$12.9 and \$7.5                                                                   | 693.0            | 587.5            |
| Inventories                                                                                                                | 451.4            | 434.3            |
| Other current assets                                                                                                       | 215.7            | 272.7            |
| <b>Total current assets</b>                                                                                                | <b>1,496.5</b>   | <b>1,467.7</b>   |
| <b>Property, net</b>                                                                                                       | <b>2,888.8</b>   | <b>2,773.3</b>   |
| <b>Other assets</b>                                                                                                        | <b>666.2</b>     | <b>636.6</b>     |
| <b>Total assets</b>                                                                                                        | <b>\$5,051.5</b> | <b>\$4,877.6</b> |
| <b>Current liabilities</b>                                                                                                 |                  |                  |
| Current maturities of long-term debt                                                                                       | \$ 1.1           | \$ 211.2         |
| Notes payable                                                                                                              | 620.4            | 368.6            |
| Accounts payable                                                                                                           | 386.9            | 328.0            |
| Other current liabilities                                                                                                  | 710.1            | 749.5            |
| <b>Total current liabilities</b>                                                                                           | <b>1,718.5</b>   | <b>1,657.3</b>   |
| <b>Long-term debt</b>                                                                                                      | <b>1,614.5</b>   | <b>1,415.4</b>   |
| <b>Other liabilities</b>                                                                                                   | <b>828.7</b>     | <b>807.4</b>     |
| <b>Shareholders' equity</b>                                                                                                |                  |                  |
| Common stock, \$.25 par value, 500,000,000 shares authorized<br>Issued: 415,343,626 shares in 1998 and 414,823,142 in 1997 | 103.8            | 103.7            |
| Capital in excess of par value                                                                                             | 105.0            | 92.6             |
| Retained earnings                                                                                                          | 1,367.7          | 1,240.4          |
| Treasury stock, at cost:<br>10,346,524 shares in 1998 and 4,143,124 shares in 1997                                         | (394.3)          | (157.3)          |
| Accumulated other comprehensive income                                                                                     | (292.4)          | (281.9)          |
| <b>Total shareholders' equity</b>                                                                                          | <b>889.8</b>     | <b>997.5</b>     |
| <b>Total liabilities and shareholders' equity</b>                                                                          | <b>\$5,051.5</b> | <b>\$4,877.6</b> |

Refer to Notes to Consolidated Financial Statements.

# Consolidated Statement of Cash Flows

Year ended December 31,

| (millions)                                                                                    | 1998            | 1997            | 1996            |
|-----------------------------------------------------------------------------------------------|-----------------|-----------------|-----------------|
| <b>Operating activities</b>                                                                   |                 |                 |                 |
| Net earnings                                                                                  | \$ 502.6        | \$ 546.0        | \$ 531.0        |
| Items in net earnings not requiring (providing) cash:                                         |                 |                 |                 |
| Depreciation and amortization                                                                 | 278.1           | 287.3           | 251.5           |
| Deferred income taxes                                                                         | 46.2            | 38.5            | 58.0            |
| Non-recurring charges, net of cash paid                                                       | 62.2            | 133.8           | 90.6            |
| Other                                                                                         | 21.7            | 9.5             | 14.5            |
| Pension and other postretirement benefit contributions                                        | (88.8)          | (114.5)         | (156.8)         |
| Changes in operating assets and liabilities                                                   | (102.3)         | (20.8)          | (77.3)          |
| <b>Net cash provided by operating activities</b>                                              | <b>719.7</b>    | <b>879.8</b>    | <b>711.5</b>    |
| <b>Investing activities</b>                                                                   |                 |                 |                 |
| Additions to properties                                                                       | (373.9)         | (312.4)         | (307.3)         |
| Acquisitions of businesses                                                                    | (27.8)          | (25.4)          | (505.2)         |
| Property disposals                                                                            | 6.8             | 5.9             | 11.6            |
| Other                                                                                         | (3.1)           | 2.6             | 14.1            |
| <b>Net cash used in investing activities</b>                                                  | <b>(398.0)</b>  | <b>(329.3)</b>  | <b>(786.8)</b>  |
| <b>Financing activities</b>                                                                   |                 |                 |                 |
| Net issuances (reductions) of notes payable,<br>with maturities less than or equal to 90 days | (152.9)         | (374.7)         | 906.6           |
| Issuances of notes payable, with maturities greater than 90 days                              | 5.5             | 4.8             | 137.0           |
| Reductions of notes payable, with maturities greater than 90 days                             | (.8)            | (14.1)          | (79.0)          |
| Issuances of long-term debt                                                                   | 600.0           | 1,000.0         | —               |
| Reductions of long-term debt                                                                  | (210.3)         | (507.9)         | (3.4)           |
| Net issuances of common stock                                                                 | 15.2            | 70.7            | 12.2            |
| Common stock repurchases                                                                      | (239.7)         | (426.0)         | (535.7)         |
| Cash dividends                                                                                | (375.3)         | (360.1)         | (343.7)         |
| <b>Net cash provided by (used in) financing activities</b>                                    | <b>(358.3)</b>  | <b>(607.3)</b>  | <b>94.0</b>     |
| Effect of exchange rate changes on cash                                                       | (.2)            | (13.8)          | 3.2             |
| Increase (decrease) in cash and cash equivalents                                              | (36.8)          | (70.6)          | 21.9            |
| Cash and cash equivalents at beginning of year                                                | 173.2           | 243.8           | 221.9           |
| <b>Cash and cash equivalents at end of year</b>                                               | <b>\$ 136.4</b> | <b>\$ 173.2</b> | <b>\$ 243.8</b> |

Refer to Notes to Consolidated Financial Statements.

# Notes to Consolidated Financial Statements

Kellogg Company and Subsidiaries

## Note 1 Accounting policies

### Consolidation

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

Certain amounts in the prior year financial statements have been reclassified to conform to the current year presentation.

### Cash and cash equivalents

Highly liquid temporary investments with original maturities of less than three months are considered to be cash equivalents. The carrying amount approximates fair value.

### Inventories

Inventories are valued at the lower of cost (principally average) or market.

### Property

Fixed assets are recorded at cost and depreciated over estimated useful lives using straight-line methods for financial reporting and accelerated methods for tax reporting. Cost includes an amount of interest associated with significant capital projects.

### Goodwill and other intangible assets

Intangible assets are amortized principally on a straight-line basis over the estimated periods benefited, generally 40 years for goodwill and periods ranging from 5 to 40 years for other intangible assets. The realizability of goodwill and other intangibles is evaluated periodically when events or circumstances indicate a possible inability to recover the carrying amount. Evaluation is based on various analyses, including cash flow and profitability projections.

### Advertising

The costs of advertising are generally expensed as incurred.

### Recently adopted pronouncements

In 1998, the Company adopted several statements issued by the Financial Accounting Standards Board (FASB). In June 1997, the FASB issued Statement of Financial Accounting Standards (SFAS) #130 "Reporting Comprehensive Income," which requires companies to disclose all items recognized under accounting standards as components of comprehensive income. In June 1997, the FASB issued SFAS #131 "Disclosures about Segments of an Enterprise and Related Information," which requires certain information to be reported about operating segments consistent with management's internal view of the Company. In February 1998, the FASB issued SFAS #132 "Employers' Disclosures about Pensions and Other Postretirement Benefits," which revises and standardizes disclosures for pension and other postretirement benefit plans.

On November 20, 1997, the Emerging Issues Task Force (EITF) of the FASB reached a consensus in EITF Issue 97-13 that the costs of business process reengineering activities are to be expensed as incurred. This consensus also applies to business process reengineering activities that are part of an information technology project. Beginning in 1996, the Company has undertaken an Enterprise Business Applications (EBA) initiative that combines design and installation of business processes and software packages to achieve global best practices. Under the EBA initiative, the Company had capitalized certain external costs associated with business process reengineering activities as part of the software asset. EITF Issue 97-13 prescribes that previously capitalized business process reengineering costs should be expensed and reported as a cumulative effect of a change in accounting principle. Accordingly, for the fourth quarter of 1997, the Company reported a charge of \$18.0 million (net of tax benefit of \$7.7 million) or \$.04 per share for write-off of business process reengineering costs. Such costs were expensed as incurred during 1998 and the fourth quarter of 1997 and were insignificant.

### Recently issued pronouncements

In March 1998, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AcSEC) issued Statement of Position (SOP) 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." SOP 98-1 provides guidance on the classification of software project costs between expense and capital. During April 1998, AcSEC also issued

SOP 98-5 "Reporting on Costs of Start-up Activities." SOP 98-5 prescribes that the costs of opening a new facility, commencing business in a new market, or similar start-up activities must be expensed as incurred. Both of these pronouncements are effective for fiscal years beginning after December 15, 1998. SOP 98-1 is to be applied on a prospective basis to costs incurred on or after the date of adoption. The initial application of SOP 98-5 is to be reported as a cumulative effect of a change in accounting principle, if material. Management intends to adopt SOP 98-1 and SOP 98-5 effective January 1, 1999.

In June 1998, the FASB issued SFAS #133 "Accounting for Derivative Instruments and Hedging Activities." This Statement establishes accounting and reporting standards for derivative instruments, requiring recognition of the fair value of all derivatives as assets or liabilities on the balance sheet. SFAS #133 is effective for fiscal years beginning after June 15, 1999. Management intends to adopt the provisions of SFAS #133 effective January 1, 2000.

The impact of adoption of these pronouncements on the Company's financial results is not expected to be significant.

### Common stock split

On August 1, 1997, the Company's Board of Directors approved a 2-for-1 stock split to shareholders of record at the close of business August 8, 1997, effective August 22, 1997, and also authorized retirement of 105.3 million common shares (pre-split) held in treasury. All per share and shares outstanding data in the Consolidated Statement of Earnings and Notes to Consolidated Financial Statements have been retroactively restated to reflect the stock split.

### Stock compensation

The Company follows Accounting Principles Board Opinion (APB) #25, "Accounting for Stock Issued to Employees," in accounting for its employee stock options and other stock-based compensation. Under APB #25, because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized. As permitted, the Company has elected to adopt the disclosure provisions only of SFAS #123, "Accounting for Stock-Based Compensation" (Refer to Note 7 for further information.)

### Net 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. Weighted average shares outstanding, in millions, were 407.8, 414.1, and 424.9 for 1998, 1997, and 1996, respectively. 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 principally comprised of employee stock options issued by the Company and had an insignificant impact on the computation of diluted net earnings per share during the periods presented. Weighted average shares outstanding, in millions, for purposes of computing diluted net earnings per share were 408.6, 415.2, and 426.4 for 1998, 1997, and 1996, respectively.

### Comprehensive income

Comprehensive income includes all changes in equity during a period except those resulting from investments by or distributions to shareholders. For the Company, comprehensive income for all periods presented consists solely of net earnings and foreign currency translation adjustments pursuant to SFAS #52, "Foreign Currency Translation," as follows:

| (millions)                               | 1998           | 1997    | 1996    |
|------------------------------------------|----------------|---------|---------|
| Net earnings                             | <b>\$502.6</b> | \$546.0 | \$531.0 |
| Other comprehensive income (loss):       |                |         |         |
| Foreign currency translation adjustments | <b>(11.1)</b>  | (112.1) | 26.6    |
| Related tax effect                       | <b>.6</b>      | (3.5)   | 1.0     |
|                                          | <b>(10.5)</b>  | (115.6) | 27.6    |
| Total comprehensive income               | <b>\$492.1</b> | \$430.4 | \$558.6 |

### Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## Note 2 Acquisition

On December 16, 1996, the Company purchased certain assets and liabilities of the Lender's Bagels business from Kraft Foods, Inc. for \$466 million in cash, including related acquisition costs. The acquisition was accounted for as a purchase. The results of Lender's operations from the date of the acquisition to December 31, 1996, were not significant. The acquisition was initially financed through commercial paper borrowings that were replaced with long-term debt in January 1997. Intangible assets included in the allocation of purchase price consisted of goodwill and trademarks of \$329 million and non-compete covenants of \$20 million. The goodwill and trademarks are being amortized over 40 years and the non-compete covenants are being amortized over 5 years.

The unaudited pro forma combined historical results, as if the Lender's Bagels business had been acquired at the beginning of fiscal 1996, are estimated to be net sales of \$6.87 billion, net earnings of \$524.3 million, and net earnings per share of \$1.23. The pro forma results are not necessarily indicative of what actually would have occurred if the acquisition had been completed as of the beginning of the fiscal period presented, nor are they necessarily indicative of future consolidated results.

## Note 3 Non-recurring charges

Operating profit for 1998 includes non-recurring charges of \$70.5 million (\$46.3 million after tax or \$12 per share) for streamlining initiatives.

Operating profit for 1997 includes non-recurring charges of \$184.1 million (\$140.5 million after tax or \$34 per share), comprised of \$161.1 million for streamlining initiatives and \$23.0 million for asset impairment losses.

Operating profit for 1996 includes non-recurring charges of \$136.1 million (\$97.8 million after tax or \$23 per share), comprised of \$121.1 million for streamlining initiatives and \$15.0 million for potential settlement of certain litigation.

### Streamlining initiatives

From 1995 to the present, management has commenced major productivity and operational streamlining initiatives in an effort to optimize the Company's cost structure. The incremental costs of these programs have been reported throughout 1995-1998 as non-recurring charges.

The 1998 streamlining charges relate primarily to an overhead activity analysis that resulted in the elimination of approximately 550 employees and 240 contractors from the Company's headquarters and North American operations through a combination of involuntary early retirement and severance programs. The charges consist mainly of employee retirement and separation benefits, outplacement services, associated consulting and other related costs. Cash outlays for the 1998 charges during 1998 were \$8 million, with the remainder to be spent during 1999. Total cash outlays during 1998 for all streamlining initiatives were approximately \$47 million.

The 1997 charges for streamlining initiatives relate principally to management's plan to optimize the Company's pan-European operations, as well as ongoing productivity programs in the United States and Australia. A major component of the pan-European initiatives was the late-1997 closing of plants and separation of employees in Riga, Latvia; Svendborg, Denmark; and Verola, Italy. Approximately 50% of the total 1997 streamlining charges consist of manufacturing asset write-downs, with the balance comprised of current and anticipated cash outlays for employee separation benefits, equipment removal, production redeployment, associated management consulting, and similar costs. Total cash outlays during 1997 for streamlining initiatives were approximately \$85 million.

The 1996 charges for streamlining initiatives result from management's actions to consolidate and reorganize operations in the United States, Europe, and other international locations. Cash outlays for streamlining initiatives were approximately \$120 million in 1996. All streamlining programs commenced since 1995, including

the aforementioned 1998 initiatives, are expected to result in the elimination of approximately 3,500 employee positions by the end of 1999, with approximately 95% of this reduction already achieved.

The components of the streamlining charges, as well as reserve balances remaining at December 31, 1998, 1997, and 1996, were:

| (millions)                             | Employee retirement & severance benefits (a) | Asset write-offs | Asset removal | Other costs | Total   |
|----------------------------------------|----------------------------------------------|------------------|---------------|-------------|---------|
| Remaining reserve at December 31, 1995 | \$57.5                                       | \$ —             | \$36.5        | \$ —        | \$ 94.0 |
| 1996 streamlining charges (b)          | 31.4                                         | 37.5             | 13.5          | 38.7        | 121.1   |
| Amounts utilized during 1996           | (65.0)                                       | (37.5)           | (19.6)        | (38.7)      | (160.8) |
| Remaining reserve at December 31, 1996 | 23.9                                         | —                | 30.4          | —           | 54.3    |
| 1997 streamlining charges              | 22.4                                         | 78.1             | 19.3          | 41.3        | 161.1   |
| Amounts utilized during 1997           | (22.7)                                       | (78.1)           | (21.4)        | (41.3)      | (163.5) |
| Remaining reserve at December 31, 1997 | 23.6                                         | —                | 28.3          | —           | 51.9    |
| 1998 streamlining charges              | 59.8                                         | 5.5              | 3.0           | 2.2         | 70.5    |
| Amounts utilized during 1998           | (43.8)                                       | (5.5)            | (19.4)        | (2.2)       | (70.9)  |
| Remaining reserve at December 31, 1998 | \$39.6                                       | \$ —             | \$11.9        | \$ —        | \$ 51.5 |

(a) Includes approximately \$5 and \$18 of pension and postretirement health care curtailment losses and special termination benefits recognized in 1996 and 1998, respectively. (Refer to Notes 8 and 9.)

(b) Includes \$23 of reversals of prior-year reserves due to lower than expected employee severance payments and asset removal costs, and other favorable factors.

### Other

In addition to the non-recurring charges reported for streamlining initiatives, the Company incurred charges for the following unusual items:

- During 1997, asset impairment losses of \$23.0 million, which resulted from evaluation of the Company's ability to recover components of its investments in the emerging markets of Asia-Pacific.
- During 1996, a provision of \$15.0 million for the potential settlement of certain litigation.

### 1999 events

The Company's streamlining initiatives will continue throughout 1999. The aforementioned overhead activity analysis will be extended to Europe and Latin America during the first half of 1999. Management believes these initiatives will result in the elimination of several hundred employee positions, requiring separation benefit costs to be incurred. Since the number of employees affected, their job functions, and their locations have not yet been identified, the costs that may result are not yet known.

## Note 4 Other income and expense

Other income and expense includes non-operating items such as interest income, foreign exchange gains and losses, and charitable donations.

Other expense for 1996 includes a charge of \$35.0 million (\$22.3 million after tax or \$.05 per share) for a contribution to the Kellogg's Corporate Citizenship Fund, a private trust established for charitable donations. This contribution is expected to satisfy the charitable-giving plans of this trust through the year 2000.

## Note 5 Leases

Operating leases are generally for equipment and warehouse space. Rent expense on all operating leases was \$36.5 million in 1998, \$38.6 million in 1997, and \$37.9 million in 1996. At December 31, 1998, future minimum annual rental commitments under non-cancelable operating leases totaled \$62 million consisting of (in millions): 1999-\$16; 2000-\$12; 2001-\$9; 2002-\$8; 2003-\$6; 2004 and beyond-\$11.

## Note 6 Debt

Notes payable consist of commercial paper borrowings in the United States at the highest credit rating available, borrowings against a revolving credit agreement in Europe and, to a lesser extent, bank loans of foreign subsidiaries at competitive market rates. U.S. borrowings at December 31, 1998, were \$423.3 million with an effective interest rate of 5.2%. U.S. borrowings at December 31, 1997 (including \$400 million classified in long-term debt, as discussed in (d) below), were \$744.2 million with an effective interest rate of 5.7%. Associated with these borrowings, during September 1997, the Company purchased a \$225 million notional, four-year fixed interest rate cap. Under the terms of the cap, if the Federal Reserve AA composite rate on 30-day commercial paper increases to 6.33%, the Company will pay this fixed rate on \$225 million of its commercial paper borrowings. If the rate increases to 7.68% or above, the cap will expire. As of year-end 1998, the rate was 4.90%.

In December 1998, the Company entered into a \$200 million, three-year revolving credit agreement with several international banks. At December 31, 1998, outstanding borrowings under this agreement were \$148.5 million with an effective interest rate of 5.5%. Additionally, the Company has entered into financing arrangements which provide for the sale of future foreign currency revenues. As of December 31, 1998, the Company had committed to borrowings during 1999 in the cumulative principle amount of approximately \$280 million. No borrowings were outstanding under these arrangements at December 31, 1998 or 1997. At December 31, 1998, the Company had \$715.9 million of total short-term lines of credit, of which \$543.6 million were unused and available for borrowing on an unsecured basis.

Long-term debt at year-end consisted of:

| (millions)                    | 1998             | 1997      |
|-------------------------------|------------------|-----------|
| (a) Seven-Year Notes due 2005 | \$ 200.0         | \$ —      |
| (b) Seven-Year Notes due 2004 | 500.0            | 500.0     |
| (c) Four-Year Notes due 2001  | 500.0            | 500.0     |
| (d) Three-Year Notes due 2001 | 400.0            | —         |
| (e) Five-Year Notes due 1998  | —                | 200.0     |
| (d) Commercial paper          | —                | 400.0     |
| Other                         | 15.6             | 26.6      |
|                               | <b>1,615.6</b>   | 1,626.6   |
| Less current maturities       | <b>(1.1)</b>     | ( 211.2)  |
| Balance, December 31          | <b>\$1,614.5</b> | \$1,415.4 |

(a) In October 1998, the Company issued \$200 of seven-year 4.875% fixed rate U.S. Dollar Notes to replace maturing long-term debt. The Company entered into a series of interest rate hedges throughout 1998 to effectively fix the interest rate prior to issuance. The effect of the hedges, when combined with original issue discounts, resulted in an effective interest rate on this debt of 6.07%.

(b) In January 1997, the Company issued \$500 of seven-year 6.625% fixed rate Euro Dollar Notes. In conjunction with this issuance, the Company settled \$500 notional amount of interest rate forward swap agreements, which effectively fixed the interest rate on the debt at 6.354%. Associated with this debt, during September 1997, the Company entered into a \$225 notional, 4½-year fixed-to-floating interest rate swap, indexed to the three-month London Interbank Offered Rate (LIBOR). Under the terms of this swap, if three-month LIBOR decreases to 4.71% or below, the swap will expire. At year-end 1998, three-month LIBOR was 5.07%.

(c) In August 1997, the Company issued \$500 of four-year 6.125% Euro Dollar Notes. In conjunction with this issuance, the Company settled \$400 notional amount of interest rate forward swap agreements which effectively fixed the interest rate on the debt at 6.4%. Associated with this debt, during September 1997, the Company entered into a \$200 notional, four-year fixed-to-floating interest rate swap, indexed to three-month LIBOR.

(d) At December 31, 1997, \$400 of the Company's commercial paper was classified as long-term, based on the Company's intent and ability to refinance as evidenced by an issuance of \$400 of three-year 5.75% fixed rate U.S. Dollar Notes on February 4, 1998. These Notes were issued under an existing "shelf registration" with the Securities and Exchange Commission, and provide an option to holders to extend the obligation for an additional four years at a predetermined interest rate of 5.63% plus the Company's then-current credit spread. As a result of this option, the effective interest rate on the three-year Notes is 5.23%. Concurrent with this issuance, the Company entered into a \$400 notional, three-year fixed-to-floating interest rate swap, indexed to the Federal Reserve AA Composite Rate on 30-day commercial paper.

(e) In October 1993, the Company issued \$200 of five-year 6.25% Euro Canadian Dollar Notes which were swapped into 4.629% fixed rate U.S. Dollar obligations for the duration of the five-year term.

Scheduled principal repayments on long-term debt are (in millions): 1999 - \$1; 2000 - \$6; 2001 - \$900; 2002 - \$5; 2003 - \$2; 2004 and beyond - \$702.

Interest paid was (in millions): 1998 - \$113; 1997 - \$85; 1996 - \$67. Interest expense capitalized as part of the construction cost of fixed assets was (in millions): 1998 - \$7.8; 1997 - \$9.6; 1996 - \$3.8.

## Note 7 Stock options

The Key Employee Long-Term Incentive Plan provides for benefits to be awarded to executive-level employees in the form of stock options, performance shares, performance units, incentive stock options, restricted stock grants, and other stock-based awards. Options granted under this plan generally vest over two years and, prior to September 1997, vested at the date of grant. The Bonus Replacement Stock Option Plan allows certain key executives to receive stock options that generally vest immediately in lieu of part or all of their respective bonus. Options granted under this plan are issued from the Key Employee Long-Term Incentive Plan. The Kellogg Employee Stock Ownership Plan is designed to offer stock and other incentive awards based on Company performance to employees who are not eligible to participate in the Key Employee Long-Term Incentive Plan. Options awarded under the Kellogg Employee Stock Ownership Plan are subject to graded vesting over a five-year period. Under these plans (the "stock option plans"), options are granted with exercise prices equal to the fair market value of the Company's common stock at the time of grant, exercisable for a 10-year period following the date of grant, subject to vesting rules.

The Key Employee Long-Term Incentive Plan contains an accelerated ownership feature ("AOF"). An AOF option is granted when Company stock is surrendered to pay the exercise price of a stock option. The holder of the option is granted an AOF option for the number of shares surrendered. For all AOF options, the original expiration date is not changed but the options vest immediately.

As permitted by SFAS #123 "Accounting for Stock-Based Compensation," the Company has elected to account for the stock option plans under APB #25 "Accounting for Stock Issued to Employees." Accordingly, no compensation cost has been recognized for these plans.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. Had compensation cost for the stock option plans been determined based on the fair value at the grant date consistent with SFAS #123, the Company's net earnings and earnings per share are estimated as follows:

| (millions, except per share data)          | 1998           | 1997    | 1996    |
|--------------------------------------------|----------------|---------|---------|
| Net earnings                               |                |         |         |
| As reported                                | <b>\$502.6</b> | \$546.0 | \$531.0 |
| Pro forma                                  | <b>\$484.4</b> | \$520.8 | \$514.1 |
| Net earnings per share (basic and diluted) |                |         |         |
| As reported                                | <b>\$1.23</b>  | \$1.32  | \$1.25  |
| Pro forma                                  | <b>\$1.19</b>  | \$1.26  | \$1.21  |

The fair value of each option grant was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

|                               | 1998          | 1997   | 1996   |
|-------------------------------|---------------|--------|--------|
| Risk-free interest rate       | <b>5.56%</b>  | 6.31%  | 6.16%  |
| Dividend yield                | <b>2.00%</b>  | 1.97%  | 2.30%  |
| Volatility                    | <b>21.28%</b> | 19.83% | 19.16% |
| Average expected term (years) | <b>3.47</b>   | 3.52   | 3.34   |
| Fair value of options granted | <b>\$8.45</b> | \$7.48 | \$6.32 |

Under the Key Employee Long-Term Incentive Plan, options for 9.8 million and 13.2 million shares were available for grant at December 31, 1998 and 1997, respectively. Under the Kellogg Employee Stock Ownership Plan, options for 6.0 million and 6.9 million shares were available for grant at December 31, 1998 and 1997, respectively. Transactions under these plans were:

| (millions, except per share data)                                 | 1998  | 1997  | 1996  |
|-------------------------------------------------------------------|-------|-------|-------|
| Under option, January 1                                           | 12.4  | 11.2  | 8.4   |
| Granted                                                           | 6.8   | 6.0   | 5.2   |
| Exercised                                                         | (1.7) | (4.5) | (2.1) |
| Cancelled                                                         | (1.1) | (.3)  | (.3)  |
| Under option, December 31                                         | 16.4  | 12.4  | 11.2  |
| Exercisable, December 31                                          | 8.7   | 8.1   | 7.6   |
| Shares available, December 31,<br>for options that may be granted | 15.8  | 20.1  | 23.8  |
| Average prices per share                                          |       |       |       |
| Under option, January 1                                           | \$35  | \$33  | \$30  |
| Granted                                                           | 43    | 36    | 38    |
| Exercised                                                         | 34    | 33    | 30    |
| Cancelled                                                         | 33    | 34    | 30    |
| Under option, December 31                                         | \$38  | \$35  | \$33  |
| Exercisable, December 31                                          | \$36  | \$36  | \$35  |

Employee stock options outstanding and exercisable under these plans as of December 31, 1998, were:

| (millions, except<br>per share data) | Outstanding          |                                          |                                                                | Exercisable          |                                          |
|--------------------------------------|----------------------|------------------------------------------|----------------------------------------------------------------|----------------------|------------------------------------------|
|                                      | Number of<br>Options | Weighted<br>average<br>exercise<br>price | Weighted<br>average<br>remaining<br>contractual<br>life (yrs.) | Number of<br>Options | Weighted<br>average<br>exercise<br>price |
| Range of<br>exercise<br>prices       |                      |                                          |                                                                |                      |                                          |
| \$15 – 34                            | 5.1                  | \$31                                     | 5.0                                                            | 3.5                  | \$30                                     |
| 35 – 39                              | 3.9                  | 38                                       | 4.9                                                            | 2.6                  | 38                                       |
| 40 – 44                              | 6.6                  | 44                                       | 1.8                                                            | 1.8                  | 43                                       |
| 45 – 50                              | .8                   | 48                                       | 5.7                                                            | .8                   | 48                                       |
|                                      | 16.4                 |                                          |                                                                | 8.7                  |                                          |

## Note 8 Pension benefits

The Company has a number of U.S. and foreign pension plans to provide retirement benefits for its employees. 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. Plan funding strategies are influenced by tax regulations. Plan assets consist primarily of equity securities with smaller holdings of bonds, real estate, and other investments. Investment in Company common stock represented 2.4% and 4.2% of consolidated plan assets at December 31, 1998 and 1997, respectively.

The components of pension expense were:

| (millions)                                            | 1998    | 1997    | 1996    |
|-------------------------------------------------------|---------|---------|---------|
| Service cost                                          | \$ 41.3 | \$ 29.9 | \$ 27.6 |
| Interest cost                                         | 81.3    | 79.6    | 72.8    |
| Expected return on plan assets                        | (113.9) | (104.7) | (95.0)  |
| Amortization of unrecognized<br>transition obligation | .7      | (.3)    | (.5)    |
| Amortization of unrecognized prior<br>service cost    | 7.5     | 7.9     | 7.2     |
| Recognized losses                                     | 10.0    | 4.7     | 5.2     |
| Curtailment loss and special<br>termination benefits  | 17.4    | —       | 4.0     |
| Pension expense – Company plans                       | 44.3    | 17.1    | 21.3    |
| Pension expense – multiemployer plans                 | 1.2     | 1.9     | 2.0     |
| Total pension expense                                 | \$ 45.5 | \$ 19.0 | \$ 23.3 |

The worldwide weighted average actuarial assumptions were:

|                                         | 1998  | 1997  | 1996  |
|-----------------------------------------|-------|-------|-------|
| Discount rate                           | 6.7%  | 7.6%  | 7.9%  |
| Long-term rate of compensation increase | 4.9%  | 4.9%  | 5.2%  |
| Long-term rate of return on plan assets | 10.5% | 10.5% | 10.5% |

The aggregate change in projected benefit obligation, change in plan assets, and funded status were:

| (millions)                                           | 1998      | 1997      |
|------------------------------------------------------|-----------|-----------|
| <b>Change in projected benefit obligation</b>        |           |           |
| Projected benefit obligation at<br>beginning of year | \$1,133.4 | \$1,036.3 |
| Service cost                                         | 41.3      | 29.9      |
| Interest cost                                        | 81.3      | 79.6      |
| Plan participants' contributions                     | 1.4       | —         |
| Amendments                                           | 9.6       | 1.3       |
| Actuarial loss                                       | 133.6     | 41.1      |
| Benefits paid                                        | (70.5)    | (62.7)    |
| Other                                                | 1.1       | 7.9       |
| Projected benefit obligation at end of year          | \$1,331.2 | \$1,133.4 |

### Change in plan assets

|                                                   |           |           |
|---------------------------------------------------|-----------|-----------|
| Fair value of plan assets at<br>beginning of year | \$1,209.0 | \$1,048.7 |
| Actual return on plan assets                      | 132.6     | 210.4     |
| Employer contribution                             | 54.7      | 38.8      |
| Plan participants' contributions                  | 1.4       | —         |
| Benefits paid                                     | (70.5)    | (62.7)    |
| Other                                             | (8.9)     | (26.2)    |
| Fair value of plan assets at end of year          | \$1,318.3 | \$1,209.0 |

### Funded status

|                                 |           |          |
|---------------------------------|-----------|----------|
|                                 | (\$ 12.9) | \$ 75.6  |
| Unrecognized net loss           | 111.5     | 7.4      |
| Unrecognized transition amount  | 4.2       | 4.4      |
| Unrecognized prior service cost | 36.2      | 47.2     |
| Prepaid pension                 | \$ 139.0  | \$ 134.6 |

### Amounts recognized in the statement of financial position consist of

|                           |          |          |
|---------------------------|----------|----------|
| Prepaid benefit cost      | \$ 213.6 | \$ 185.4 |
| Accrued benefit liability | (88.4)   | (61.5)   |
| Intangible asset          | 13.8     | 10.7     |
| Net amount recognized     | \$ 139.0 | \$ 134.6 |

The projected benefit obligation, accumulated benefit obligation, and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets were, in millions, \$104.6, \$84.5, and \$8.3, respectively, as of December 31, 1998, and \$87.1, \$69.1, and \$15.4, respectively, as of December 31, 1997.

All gains and losses, other than curtailment losses and special termination benefits, are recognized over the average remaining service period of active plan participants. Curtailment losses and special termination benefits recognized in 1998 and 1996 relate to operational workforce reduction initiatives undertaken during these years and are recorded as a component of non-recurring charges. (Refer to Note 3 for further information.)

Certain of the Company's subsidiaries sponsor 401(k) or similar savings plans for active employees. Expense related to these plans was (in millions): 1998-\$16; 1997-\$16; 1996-\$17.

## Note 9 Nonpension postretirement benefits

Certain of the Company's North American subsidiaries provide health care and other benefits to substantially all retired employees, their covered dependents, and beneficiaries. Generally, employees are eligible for these benefits when one of the following service/age requirements is met: 30 years and any age; 20 years and age 55; 5 years and age 62. Plan assets consist primarily of equity securities with smaller holdings of bonds.

Components of postretirement benefit expense were:

| (millions)                                        | 1998   | 1997   | 1996   |
|---------------------------------------------------|--------|--------|--------|
| Service cost                                      | \$ 9.1 | \$ 9.6 | \$11.2 |
| Interest cost                                     | 36.8   | 37.2   | 40.2   |
| Expected return on plan assets                    | (15.0) | (13.3) | —      |
| Amortization of unrecognized prior service cost   | (.5)   | (.5)   | .3     |
| Recognized gains                                  | (5.3)  | (6.3)  | —      |
| Curtailment loss and special termination benefits | 1.0    | —      | 1.0    |
| Postretirement benefit expense                    | \$26.1 | \$26.7 | \$52.7 |

The worldwide weighted average actuarial assumptions were:

|                                         | 1998  | 1997  | 1996  |
|-----------------------------------------|-------|-------|-------|
| Discount rate                           | 7.0%  | 7.25% | 7.75% |
| Long-term rate of return on plan assets | 10.5% | 10.5% | n/a   |

The aggregate change in accumulated postretirement benefit obligation, change in plan assets, and funded status were:

| (millions)                                                                  | 1998      | 1997      |
|-----------------------------------------------------------------------------|-----------|-----------|
| <b>Change in accumulated benefit obligation</b>                             |           |           |
| Accumulated benefit obligation at beginning of year                         | \$523.3   | \$494.1   |
| Service cost                                                                | 9.1       | 9.6       |
| Interest cost                                                               | 36.8      | 37.2      |
| Actuarial loss                                                              | 7.6       | 11.9      |
| Amendments                                                                  | 2.2       | —         |
| Benefits paid                                                               | (29.5)    | (29.0)    |
| Other                                                                       | (.7)      | (.5)      |
| Accumulated benefit obligation at end of year                               | \$548.8   | \$523.3   |
| <b>Change in plan assets</b>                                                |           |           |
| Fair value of plan assets at beginning of year                              | \$150.7   | \$ 81.0   |
| Actual return on plan assets                                                | 22.1      | 23.0      |
| Employer contribution                                                       | 34.1      | 75.7      |
| Benefits paid                                                               | (29.5)    | (29.0)    |
| Fair value of plan assets at end of year                                    | \$177.4   | \$150.7   |
| <b>Funded status</b>                                                        |           |           |
| Unrecognized net gain                                                       | (80.9)    | (86.5)    |
| Unrecognized prior service cost                                             | (6.2)     | (8.1)     |
| Accrued postretirement benefit cost                                         | (\$458.5) | (\$467.2) |
| <b>Amounts recognized in the statement of financial position consist of</b> |           |           |
| Accrued benefit liability                                                   | (\$458.5) | (\$467.2) |

The assumed health care cost trend rate was 7.0% for 1998, decreasing gradually to 4.2% by the year 2003 and remaining at that level thereafter. These trend rates reflect the Company's prior experience and management's expectation that future rates will decline. 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 | \$6.5                         | (\$4.2)                       |
| Effect on postretirement benefit obligation             | \$65.4                        | (\$54.5)                      |

All gains and losses, other than curtailment losses and special termination benefits, are recognized over the average remaining service period of active plan participants. Curtailment losses and special termination benefits recognized in 1998 and 1996 relate to operational workforce reduction initiatives undertaken during these years and are recorded as a component of non-recurring charges. (Refer to Note 3 for further information.) Since December 1996, the Company has contributed to a voluntary employee benefit association (VEBA) trust for funding of its nonpension postretirement benefit obligations.

## Note 10 Income taxes

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

| (millions)                                                                     | 1998    | 1997    | 1996    |
|--------------------------------------------------------------------------------|---------|---------|---------|
| <b>Earnings before income taxes and cumulative effect of accounting change</b> |         |         |         |
| United States                                                                  | \$564.0 | \$576.4 | \$516.7 |
| Foreign                                                                        | 218.5   | 328.1   | 343.2   |
|                                                                                | \$782.5 | \$904.5 | \$859.9 |

|                     |         |         |         |
|---------------------|---------|---------|---------|
| <b>Income taxes</b> |         |         |         |
| Currently payable   |         |         |         |
| Federal             | \$128.7 | \$129.4 | \$130.6 |
| State               | 17.8    | 29.6    | 21.9    |
| Foreign             | 87.2    | 143.0   | 118.4   |
|                     | 233.7   | 302.0   | 270.9   |
| Deferred            |         |         |         |
| Federal             | 30.6    | 50.2    | 45.7    |
| State               | 1.7     | 4.0     | 11.4    |
| Foreign             | 13.9    | (15.7)  | .9      |
|                     | 46.2    | 38.5    | 58.0    |
| Total income taxes  | \$279.9 | \$340.5 | \$328.9 |

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

|                                             | 1998  | 1997  | 1996  |
|---------------------------------------------|-------|-------|-------|
| U.S. statutory rate                         | 35.0% | 35.0% | 35.0% |
| Foreign rates varying from 35%              | (2.0) | (1.6) | .7    |
| State income taxes, net of federal benefit  | 2.4   | 2.4   | 2.5   |
| Net change in valuation allowances          | 2.9   | 1.6   | (.1)  |
| Statutory rate changes, deferred tax impact | (.3)  | (.5)  | —     |
| Other                                       | (2.2) | .7    | .1    |
| Effective income tax rate                   | 35.8% | 37.6% | 38.2% |

The 1998 and 1997 increases in valuation allowances on deferred tax assets and corresponding impacts on the effective income tax rate, as presented above, primarily result from management's assessment of the Company's ability to utilize certain operating loss and tax credit carryforwards. Total tax benefits of carryforwards at year-end 1998 and 1997 were \$55.1 million and \$30.4 million, respectively, and principally expire after five years.

The deferred tax assets and liabilities included in the balance sheet at year-end were:

| (millions)                              | Deferred tax assets |         | Deferred tax liabilities |         |
|-----------------------------------------|---------------------|---------|--------------------------|---------|
|                                         | 1998                | 1997    | 1998                     | 1997    |
| Current:                                |                     |         |                          |         |
| Promotion and advertising               | \$ 26.0             | \$ 65.0 | \$ 9.9                   | \$ 10.5 |
| Wages and payroll taxes                 | 27.3                | 13.8    | —                        | —       |
| Health and postretirement benefits      | 18.1                | 15.7    | 3.8                      | 2.4     |
| State taxes                             | 5.7                 | 8.1     | —                        | —       |
| Operating loss and credit carryforwards | 1.5                 | 2.1     | —                        | —       |
| Other                                   | 27.9                | 24.2    | 15.4                     | 12.3    |
|                                         | 106.5               | 128.9   | 29.1                     | 25.2    |
| Less valuation allowance                | (1.5)               | (4.1)   | —                        | —       |
|                                         | 105.0               | 124.8   | 29.1                     | 25.2    |
| Noncurrent:                             |                     |         |                          |         |
| Depreciation and asset disposals        | 15.7                | 18.8    | 347.4                    | 326.0   |
| Health and postretirement benefits      | 164.3               | 163.5   | 58.8                     | 56.2    |
| Capitalized interest                    | —                   | —       | 28.3                     | 28.8    |
| State taxes                             | —                   | —       | 1.9                      | 2.6     |
| Operating loss and credit carryforwards | 53.6                | 28.3    | —                        | —       |
| Other                                   | 36.4                | 26.6    | 9.9                      | 5.8     |
|                                         | 270.0               | 237.2   | 446.3                    | 419.4   |
| Less valuation allowance                | (67.1)              | (41.8)  | —                        | —       |
|                                         | 202.9               | 195.4   | 446.3                    | 419.4   |
| Total deferred taxes                    | \$307.9             | \$320.2 | \$475.4                  | \$444.6 |

At December 31, 1998, foreign subsidiary earnings of \$1.2 billion were considered permanently invested in those businesses. Accordingly, U.S. income taxes have not been provided on these earnings. Foreign withholding taxes of approximately \$75 million would be payable upon remittance of these earnings. Subject to certain limitations, the withholding taxes would then be available for use as credits against the U.S. tax liability.

Cash paid for income taxes was (in millions): 1998-\$211; 1997-\$332; 1996-\$281.

## Note 11 Financial instruments and credit risk concentration

The fair values of the Company's financial instruments are based on carrying value in the case of short-term items, quoted market prices for derivatives and investments, and, in the case of long-term debt, incremental borrowing rates currently available on loans with similar terms and maturities. The carrying amounts of the Company's cash, cash equivalents, receivables, notes payable, and long-term debt approximate fair value.

The Company is exposed to certain market risks which exist as a part of its ongoing business operations and 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. Deferred gains or losses related to any instrument 1) designated but ineffective as a hedge of existing assets, liabilities, or firm commitments, or 2) designated as a hedge of an anticipated transaction which is no longer likely to occur, are recognized immediately in the statement of earnings.

For all derivative financial and commodity instruments held by the Company, changes in fair values of these instruments and the resultant impact on the Company's cash flows and/or earnings would generally be offset by changes in value of underlying exposures. The impact on the Company's results and financial position of holding derivative financial and commodity instruments was insignificant during the periods presented.

### Foreign exchange risk

The Company is exposed to fluctuations in foreign currency cash flows primarily related to third party purchases, intercompany product shipments, and intercompany

loans. 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.

The Company assesses foreign currency risk based on transactional cash flows and enters into forward contracts and other commitments to sell foreign currency revenues, all of generally less than twelve months duration, to reduce fluctuations in net long or short currency positions. Foreign currency contracts are marked-to-market with net amounts due to or from counterparties recorded in accounts receivable or payable. For contracts hedging firm commitments, mark-to-market gains and losses are deferred and recognized as adjustments to the basis of the transaction. For contracts hedging subsidiary investments, mark-to-market gains and losses are recorded in the accumulated other comprehensive income component of shareholders' equity. For all other contracts, mark-to-market gains and losses are recognized currently in other income or expense. Commitments to sell future foreign currency revenues are accounted for as contingent borrowings.

The notional amounts of open forward contracts were \$22.2 million and \$143.2 million at December 31, 1998 and 1997, respectively. No borrowings were outstanding under commitments to sell foreign currency revenues at December 31, 1998 or 1997. Refer to Supplemental Financial Information on pages 33 and 34 for further information regarding these contracts.

### 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 uses interest rate caps, and currency and interest rate swaps, including forward 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.

Interest rate forward swaps are marked-to-market with net amounts due to or from counterparties recorded in interest receivable or payable. Mark-to-market gains and losses are deferred and recognized over the life of the debt issue as a component of interest expense. For other caps and swaps entered into concurrently with the debt issue, the interest or currency differential to be paid or received on the instrument is recognized in the statement of earnings as incurred, as a component of interest expense. If a position were to be terminated prior to maturity, the gain or loss realized upon termination would be deferred and amortized to interest expense over the remaining term of the underlying debt issue or would be recognized immediately if the underlying debt issue was settled prior to maturity.

The notional amounts of currency and interest rate swaps were \$1.05 billion and \$875.0 million at December 31, 1998 and 1997, respectively. Refer to Note 6 and Supplemental Financial Information on pages 33 and 34 for further information regarding these swaps.

### Price risk

The Company is exposed to price fluctuations primarily as a result of anticipated purchases of raw and packaging materials. The Company uses the combination of long cash positions with vendors, and exchange-traded futures and option contracts to reduce price fluctuations in a desired percentage of forecasted purchases over a duration of generally less than one year. Commodity contracts are marked-to-market with net amounts due to or from brokers recorded in accounts receivable or payable. Mark-to-market gains and losses are deferred and recognized as adjustments to the basis of the underlying material purchase.

### 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. Management believes that the probability of such loss is remote.

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. Concentrations of credit risk with respect to accounts receivable are limited due to the large number of customers, generally short payment terms, and their dispersion across geographic areas.

## Note 12 Quarterly financial data (unaudited)

| (millions, except<br>per share data) | Net sales                                                        |           | Gross profit                                                                  |           |
|--------------------------------------|------------------------------------------------------------------|-----------|-------------------------------------------------------------------------------|-----------|
|                                      | 1998                                                             | 1997      | 1998                                                                          | 1997      |
| First                                | <b>\$1,642.9</b>                                                 | \$1,688.9 | <b>\$ 861.1</b>                                                               | \$ 860.9  |
| Second                               | <b>1,713.5</b>                                                   | 1,719.7   | <b>893.9</b>                                                                  | 908.9     |
| Third                                | <b>1,805.8</b>                                                   | 1,803.8   | <b>936.9</b>                                                                  | 944.4     |
| Fourth                               | <b>1,599.9</b>                                                   | 1,617.7   | <b>787.6</b>                                                                  | 845.8     |
|                                      | <b>\$6,762.1</b>                                                 | \$6,830.1 | <b>\$3,479.5</b>                                                              | \$3,560.0 |
|                                      | Earnings before<br>cumulative effect of<br>accounting change (a) |           | Earnings per share<br>before cumulative effect<br>of accounting change (a)(b) |           |
|                                      | 1998                                                             | 1997      | 1998                                                                          | 1997      |
| First                                | <b>\$170.7</b>                                                   | \$160.6   | <b>\$.42</b>                                                                  | \$.38     |
| Second                               | <b>143.2</b>                                                     | 163.6     | <b>.35</b>                                                                    | .39       |
| Third                                | <b>141.9</b>                                                     | 207.2     | <b>.35</b>                                                                    | .50       |
| Fourth                               | <b>46.8</b>                                                      | 32.6      | <b>.11</b>                                                                    | .08       |
|                                      | <b>\$502.6</b>                                                   | \$564.0   |                                                                               |           |
|                                      | Net earnings (a)                                                 |           | Earnings per share (a)(b)                                                     |           |
|                                      | 1998                                                             | 1997      | 1998                                                                          | 1997      |
| First                                | <b>\$170.7</b>                                                   | \$160.6   | <b>\$.42</b>                                                                  | \$.38     |
| Second                               | <b>143.2</b>                                                     | 163.6     | <b>.35</b>                                                                    | .39       |
| Third                                | <b>141.9</b>                                                     | 207.2     | <b>.35</b>                                                                    | .50       |
| Fourth                               | <b>46.8</b>                                                      | 14.6      | <b>.11</b>                                                                    | .04       |
|                                      | <b>\$502.6</b>                                                   | \$546.0   |                                                                               |           |

(a) The quarterly results of 1998 and 1997 include the following non-recurring charges and cumulative effect of accounting change. (Refer to Notes 1 and 3 for further information.)

|                                                           | Net earnings |           | Earnings per share |         |
|-----------------------------------------------------------|--------------|-----------|--------------------|---------|
|                                                           | 1998         | 1997      | 1998               | 1997    |
| Non-recurring charges:                                    |              |           |                    |         |
| Second                                                    | \$ —         | (\$8.0)   | \$ —               | (\$.02) |
| Third                                                     | —            | (6.6)     | —                  | (.02)   |
| Fourth                                                    | (46.3)       | (125.9)   | (.12)              | (.31)   |
| Earnings before cumulative<br>effect of accounting change | (46.3)       | (140.5)   |                    |         |
| Cumulative effect of accounting<br>change — Fourth        | —            | (18.0)    | —                  | (.04)   |
| Net earnings                                              | (\$46.3)     | (\$158.5) |                    |         |

(b) Earnings per share presented represent both basic and diluted earnings per share.

The principal market for trading Kellogg shares is the New York Stock Exchange (NYSE). The shares are also traded on the Boston, Chicago, Cincinnati, Pacific, and Philadelphia Stock Exchanges. At year-end 1998, the closing price (on the NYSE) was \$34 1/8 and there were 24,634 shareholders of record.

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

| 1998 — Quarter | Dividend      | Stock Price |         |
|----------------|---------------|-------------|---------|
|                |               | High        | Low     |
| Fourth         | <b>\$.235</b> | \$37.49     | \$32.37 |
| Third          | <b>.235</b>   | 38.81       | 29.49   |
| Second         | <b>.225</b>   | 43.20       | 37.35   |
| First          | <b>.225</b>   | 49.69       | 41.81   |
|                | <b>\$.920</b> |             |         |
| 1997 — Quarter |               |             |         |
| Fourth         | \$.225        | \$50.38     | \$40.00 |
| Third          | .225          | 50.38       | 42.00   |
| Second         | .210          | 43.44       | 32.00   |
| First          | .210          | 36.38       | 32.06   |
|                | <b>\$.870</b> |             |         |

## Note 13 Operating segments

The Company manufactures and markets ready-to-eat cereal and other grain-based convenience food products, including toaster pastries, frozen waffles, cereal bars, and bagels, throughout the world. Principal markets for these products include the United States and Great Britain. Operations are managed via four major geographic areas — North America, Europe, Asia-Pacific, and Latin America — which are the basis of the Company's reportable operating segment information disclosed below. The measurement of operating segment results is generally consistent with the presentation of the Consolidated Statement of Earnings and Balance Sheet. Intercompany transactions between reportable operating segments were insignificant in all periods presented.

| (millions)       | 1998             | 1997      | 1996      |
|------------------|------------------|-----------|-----------|
| <b>Net sales</b> |                  |           |           |
| North America    | <b>\$4,175.9</b> | \$4,260.8 | \$4,086.3 |
| Europe           | <b>1,698.5</b>   | 1,702.0   | 1,749.6   |
| Asia-Pacific     | <b>377.0</b>     | 411.9     | 433.2     |
| Latin America    | <b>510.7</b>     | 455.4     | 407.5     |
| Consolidated     | <b>\$6,762.1</b> | \$6,830.1 | \$6,676.6 |

### Operating profit excluding non-recurring charges

|                     |                 |           |           |
|---------------------|-----------------|-----------|-----------|
| North America       | <b>\$ 831.6</b> | \$ 884.8  | \$ 762.3  |
| Europe              | <b>211.4</b>    | 305.8     | 305.1     |
| Asia-Pacific        | <b>48.3</b>     | 51.1      | 61.3      |
| Latin America       | <b>107.2</b>    | 111.8     | 94.2      |
| Corporate and other | <b>(232.9)</b>  | (160.3)   | (127.9)   |
| Consolidated (a)    | <b>\$ 965.6</b> | \$1,193.2 | \$1,095.0 |

### Depreciation and amortization

|                     |                 |          |          |
|---------------------|-----------------|----------|----------|
| North America       | <b>\$ 152.1</b> | \$ 153.7 | \$ 135.1 |
| Europe              | <b>54.6</b>     | 59.6     | 59.9     |
| Asia-Pacific        | <b>21.3</b>     | 21.9     | 20.7     |
| Latin America       | <b>14.2</b>     | 12.5     | 10.2     |
| Corporate and other | <b>35.9</b>     | 39.6     | 25.6     |
| Consolidated        | <b>\$ 278.1</b> | \$ 287.3 | \$ 251.5 |

### Total assets

|                     |                  |           |           |
|---------------------|------------------|-----------|-----------|
| North America       | <b>\$2,430.8</b> | \$2,519.2 | \$2,574.0 |
| Europe              | <b>1,336.0</b>   | 1,154.5   | 1,254.1   |
| Asia-Pacific        | <b>328.4</b>     | 309.5     | 449.2     |
| Latin America       | <b>380.9</b>     | 361.4     | 285.6     |
| Corporate and other | <b>1,516.7</b>   | 1,405.1   | 1,316.5   |
| Elimination entries | <b>(941.3)</b>   | (872.1)   | (829.4)   |
| Consolidated        | <b>\$5,051.5</b> | \$4,877.6 | \$5,050.0 |

### Additions to long-lived assets

|                     |                 |          |          |
|---------------------|-----------------|----------|----------|
| North America       | <b>\$ 82.5</b>  | \$ 166.5 | \$ 544.6 |
| Europe              | <b>169.1</b>    | 60.7     | 71.9     |
| Asia-Pacific        | <b>40.3</b>     | 24.3     | 34.7     |
| Latin America       | <b>41.7</b>     | 43.3     | 17.7     |
| Corporate and other | <b>98.5</b>     | 94.9     | 138.3    |
| Consolidated        | <b>\$ 432.1</b> | \$ 389.7 | \$ 807.2 |

(a) Reconciliation to operating profit as reported:

|                                                  | 1998           | 1997      | 1996      |
|--------------------------------------------------|----------------|-----------|-----------|
| Operating profit excluding non-recurring charges | <b>\$965.6</b> | \$1,193.2 | \$1,095.0 |
| Non-recurring charges                            | <b>(70.5)</b>  | (184.1)   | (136.1)   |
| Operating profit as reported                     | <b>\$895.1</b> | \$1,009.1 | \$ 958.9  |

Supplemental geographic information is provided below for revenues from external customers and long-lived assets:

| (millions)               | 1998             | 1997      | 1996      |
|--------------------------|------------------|-----------|-----------|
| <b>Net sales</b>         |                  |           |           |
| United States            | <b>\$3,858.0</b> | \$3,922.2 | \$3,733.7 |
| Great Britain            | <b>743.6</b>     | 719.0     | 673.8     |
| Other foreign countries  | <b>2,160.5</b>   | 2,188.9   | 2,269.1   |
| Consolidated             | <b>\$6,762.1</b> | \$6,830.1 | \$6,676.6 |
| <b>Long-lived assets</b> |                  |           |           |
| United States            | <b>\$1,644.2</b> | \$1,707.1 | \$1,720.0 |
| Great Britain            | <b>553.0</b>     | 452.4     | 463.2     |
| Other foreign countries  | <b>1,330.3</b>   | 1,225.2   | 1,304.3   |
| Consolidated             | <b>\$3,527.5</b> | \$3,384.7 | \$3,487.5 |

Supplemental product information is provided below for revenues from external customers:

| (millions)                    | 1998             | 1997      | 1996      |
|-------------------------------|------------------|-----------|-----------|
| Ready-to-eat cereal net sales | <b>\$5,265.4</b> | \$5,435.8 | \$5,543.8 |
| Convenience foods net sales   | <b>1,496.7</b>   | 1,394.3   | 1,132.8   |
| Consolidated                  | <b>\$6,762.1</b> | \$6,830.1 | \$6,676.6 |

## Note 14 Supplemental financial statement data

| (millions)                                | 1998           | 1997    | 1996    |
|-------------------------------------------|----------------|---------|---------|
| <b>Consolidated Statement of Earnings</b> |                |         |         |
| Research and development expense          | <b>\$121.9</b> | \$106.1 | \$84.3  |
| Advertising expense                       | <b>\$695.3</b> | \$780.4 | \$778.9 |

| Consolidated Statement of Cash Flows               | 1998             | 1997     | 1996     |
|----------------------------------------------------|------------------|----------|----------|
| Accounts receivable                                | <b>(\$102.6)</b> | \$ 5.1   | \$10.9   |
| Inventories                                        | <b>(15.0)</b>    | (8.1)    | (35.4)   |
| Other current assets                               | <b>33.2</b>      | (11.0)   | (0.5)    |
| Accounts payable                                   | <b>58.9</b>      | (8.7)    | (41.0)   |
| Other current liabilities                          | <b>(76.8)</b>    | 1.9      | (11.3)   |
| <b>Changes in operating assets and liabilities</b> | <b>(\$102.3)</b> | (\$20.8) | (\$77.3) |

| Consolidated Balance Sheet              | 1998             | 1997      |
|-----------------------------------------|------------------|-----------|
| Raw materials and supplies              | <b>\$ 133.3</b>  | \$ 135.0  |
| Finished goods and materials in process | <b>318.1</b>     | 299.3     |
| <b>Inventories</b>                      | <b>\$ 451.4</b>  | \$ 434.3  |
| Deferred income taxes                   | <b>\$ 89.9</b>   | \$ 113.4  |
| Prepaid advertising and promotion       | <b>69.9</b>      | 95.2      |
| Other                                   | <b>55.9</b>      | 64.1      |
| <b>Other current assets</b>             | <b>\$ 215.7</b>  | \$ 272.7  |
| Land                                    | <b>\$ 49.3</b>   | \$ 49.0   |
| Buildings                               | <b>1,247.9</b>   | 1,213.8   |
| Machinery and equipment                 | <b>3,608.2</b>   | 3,434.7   |
| Construction in progress                | <b>341.4</b>     | 283.1     |
| Accumulated depreciation                | <b>(2,358.0)</b> | (2,207.3) |
| <b>Property, net</b>                    | <b>\$2,888.8</b> | \$2,773.3 |
| Goodwill                                | <b>\$ 185.5</b>  | \$ 194.3  |
| Other intangibles                       | <b>194.0</b>     | 191.2     |
| Other                                   | <b>286.7</b>     | 251.1     |
| <b>Other assets</b>                     | <b>\$ 666.2</b>  | \$ 636.6  |
| Accrued income taxes                    | <b>\$ 69.4</b>   | \$ 30.5   |
| Accrued salaries and wages              | <b>100.7</b>     | 99.7      |
| Accrued advertising and promotion       | <b>243.4</b>     | 308.8     |
| Other                                   | <b>296.6</b>     | 310.5     |
| <b>Other current liabilities</b>        | <b>\$ 710.1</b>  | \$ 749.5  |
| Nonpension postretirement benefits      | <b>\$ 435.2</b>  | \$ 444.1  |
| Deferred income taxes                   | <b>259.2</b>     | 237.7     |
| Other                                   | <b>134.3</b>     | 125.6     |
| <b>Other liabilities</b>                | <b>\$ 828.7</b>  | \$ 807.4  |

# Report of Independent Accountants

## PricewaterhouseCoopers LLP

To the Shareholders and Board of Directors of Kellogg Company

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of earnings, of shareholders' equity and of cash flows present fairly, in all material respects, the financial position of Kellogg Company and its subsidiaries at December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

As discussed in Note 1 to the financial statements, the Company changed its method of accounting for business process reengineering costs effective October 1, 1997.



Battle Creek, Michigan

January 29, 1999

## Supplemental Financial Information (unaudited)

### Quantitative & qualitative disclosures related to market-risk-sensitive instruments

The Company is exposed to certain market risks which exist as a part of its ongoing business operations and uses derivative financial and commodity instruments, where appropriate, to manage these risks. The Company, as a matter of policy, does not engage in trading or speculative transactions. Refer to Note 11 within Notes to Consolidated Financial Statements for further information on accounting policies related to derivative financial and commodity instruments.

### Foreign exchange risk

The Company is exposed to fluctuations in foreign currency cash flows related to third party purchases, intercompany product shipments, and intercompany loans. 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. Primary exposures include the U.S. Dollar versus the British Pound, member currencies of the European Monetary Union, Australian Dollar, Canadian Dollar, and Mexican Peso, and in the case of inter-subsidiary transactions, the British Pound versus other European currencies. The Company assesses foreign currency risk based on transactional cash flows and enters into forward contracts and other commitments to sell foreign currency revenues, all of generally less than twelve months duration, to reduce fluctuations in net long or short currency positions. No borrowings were outstanding under commitments to sell foreign currency revenues at December 31, 1998 or 1997. As of December 31, 1998, the Company had committed to borrowings during 1999 in the cumulative principle amount of approximately \$280 million.

The tables below summarize forward contracts held at year-end 1998 and 1997. All contracts are valued in U.S. Dollars using year-end exchange rates, are hedges of anticipated transactions (unless indicated otherwise), and mature within one year.

### Contracts to sell foreign currency

| Currency sold      | Currency received  | Notional value (millions) |                | Exchange rate (fc/1US\$) |        | Fair value (millions) |              |
|--------------------|--------------------|---------------------------|----------------|--------------------------|--------|-----------------------|--------------|
|                    |                    | 1998                      | 1997           | 1998                     | 1997   | 1998                  | 1997         |
| Belgian Franc      | British Pound      | \$ 1.9                    | \$ 11.7        | 35.11                    | 35.19  | \$ —                  | \$ .5        |
| Swiss Franc        | German Deutschmark | .3                        | 3.9            | 2.08                     | 1.46   | —                     | —            |
| French Franc       | German Deutschmark | —                         | 4.3            | —                        | 6.08   | —                     | —            |
| French Franc       | Danish Kroner      | —                         | .6             | —                        | 6.06   | —                     | —            |
| Danish Kroner      | British Pound      | 3.2                       | 5.4            | 6.60                     | 6.67   | (.1)                  | .1           |
| Belgian Franc      | French Franc       | —                         | 1.0            | —                        | 36.87  | —                     | —            |
| French Franc       | British Pound      | 6.9                       | 48.0           | 5.69                     | 5.70   | (.1)                  | 2.3          |
| Irish Punt         | British Pound      | 3.4                       | 27.4           | .68                      | .66    | —                     | 1.7          |
| Spanish Peseta     | British Pound      | —                         | 1.3            | —                        | 134.72 | —                     | .2           |
| Swedish Kroner     | Danish Kroner      | 1.6                       | 16.0           | 7.41                     | 7.89   | .1                    | .1           |
| Venezuelan Bolivar | U.S. Dollar        | 2.1                       | —              | 726.67                   | —      | (.6)                  | —            |
| <b>Total</b>       |                    | <b>\$19.4</b>             | <b>\$119.6</b> |                          |        | <b>(\$ .7)</b>        | <b>\$4.9</b> |

### Contracts to purchase foreign currency

| Currency purchased     | Currency exchanged | Notional value (millions) |               | Exchange rate (fc/1US\$) |      | Fair value (millions) |                |
|------------------------|--------------------|---------------------------|---------------|--------------------------|------|-----------------------|----------------|
|                        |                    | 1998                      | 1997          | 1998                     | 1997 | 1998                  | 1997           |
| Swiss Franc (a)        | British Pound      | \$ —                      | \$ 4.7        | —                        | 1.42 | \$ —                  | (\$ .1)        |
| German Deutschmark (a) | British Pound      | —                         | .3            | —                        | 1.72 | —                     | —              |
| German Deutschmark     | British Pound      | 2.8                       | 18.6          | 1.69                     | 1.71 | —                     | (.8)           |
| <b>Total</b>           |                    | <b>\$ 2.8</b>             | <b>\$23.6</b> |                          |      | <b>\$ —</b>           | <b>(\$ .9)</b> |

(a) Designated as hedge of firm commitment.

## 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. Primary exposures include movements in U.S. Treasury rates, London Interbank Offered rates (LIBOR), and commercial paper rates. The Company uses interest rate caps, and currency and interest rate swaps, including forward 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.

The tables below provide information on the Company's significant debt issues and related hedging instruments at year-end 1998 and 1997. For foreign currency-denominated debt, the information is presented in U.S. Dollar equivalents. Variable interest rates are based on effective rates or implied forward rates as of year-end 1998. Refer to Note 6 within the Notes to Consolidated Financial Statements for further information.

| <b>Significant debt issues</b>           |                                                 |             |             |                              |                              |
|------------------------------------------|-------------------------------------------------|-------------|-------------|------------------------------|------------------------------|
| <b>Debt characteristics</b>              | <b>Principal by year of maturity (millions)</b> |             |             | <b>12/31/98</b>              | <b>12/31/97</b>              |
|                                          | <b>1999</b>                                     | <b>2001</b> | <b>2004</b> | <b>Fair value (millions)</b> | <b>Fair value (millions)</b> |
| Euro Dollar                              | \$500.0                                         |             |             | \$505.8                      | \$502.6                      |
| fixed rate                               | 6.125%                                          |             |             |                              |                              |
| effective rate (a)                       | 6.400%                                          |             |             |                              |                              |
| U.S. Dollar                              | \$400.0                                         |             |             | \$435.9                      | \$ —                         |
| fixed rate                               | 5.75%                                           |             |             |                              |                              |
| effective rate (b)                       | 5.23%                                           |             |             |                              |                              |
| Euro Dollar                              | \$500.0                                         |             |             | \$510.2                      | \$515.3                      |
| fixed rate                               | 6.625%                                          |             |             |                              |                              |
| effective rate (a)                       | 6.354%                                          |             |             |                              |                              |
| U.S. Dollar                              | \$200.0                                         |             |             | \$198.4                      | \$ —                         |
| fixed rate                               | 4.875%                                          |             |             |                              |                              |
| effective rate (a)                       | 6.070%                                          |             |             |                              |                              |
| U.S. commercial paper                    | \$423.3                                         |             |             | \$423.3                      | \$ —                         |
| weighted avg. variable                   | 5.2%                                            |             |             |                              |                              |
| Multi-currency revolving credit facility | \$148.5                                         |             |             | \$148.5                      | \$ —                         |
| effective rate (a)                       | 5.5%                                            |             |             |                              |                              |
| Other debt issues maturing in 1998:      |                                                 |             |             |                              |                              |
| Euro Canadian Dollar                     |                                                 |             |             | \$ —                         | \$186.6                      |
| U.S. commercial paper (c)                |                                                 |             |             | \$ —                         | \$744.2                      |

(a) Effective fixed interest rate paid, as a result of settlement of forward interest rate swap at date of debt issuance.

(b) Effective fixed interest rate paid, as a result of extendable feature. Refer to Note 6 within Notes to Consolidated Financial Statements for further information.

(c) \$400 million of commercial paper classified in long-term debt as of year-end 1997. Refer to Note 6 within Notes to Consolidated Financial Statements for further information.

## Interest & currency swaps & caps

| <b>Instrument characteristics</b>                                                                           |               | <b>Year of maturity (millions)</b> |             | <b>12/31/98</b>              | <b>12/31/97</b>              |
|-------------------------------------------------------------------------------------------------------------|---------------|------------------------------------|-------------|------------------------------|------------------------------|
|                                                                                                             |               | <b>2001</b>                        | <b>2002</b> | <b>Fair value (millions)</b> | <b>Fair value (millions)</b> |
| Interest rate swap — pay variable/receive fixed — hedge of existing debt issue                              | Notional amt. | \$200.0                            |             | \$5.6                        | \$ 1.3                       |
|                                                                                                             | Pay           | 5.22%                              |             |                              |                              |
|                                                                                                             | Receive       | 6.40%                              |             |                              |                              |
| Interest rate swap — pay variable/receive fixed — hedge of existing debt issue (a)                          | Notional amt. | \$225.0                            |             | \$1.1                        | \$ 1.2                       |
|                                                                                                             | Pay           | 4.86%                              |             |                              |                              |
|                                                                                                             | Receive       | 6.354%                             |             |                              |                              |
| Interest rate swap — pay variable/receive fixed — hedge of existing debt issue                              | Notional amt. | \$400.0                            |             | \$5.2                        | \$ —                         |
|                                                                                                             | Pay           | 4.49%                              |             |                              |                              |
|                                                                                                             | Receive       | 5.23%                              |             |                              |                              |
| Interest rate cap — pay fixed if 30-day C.P. rate rises to strike rate — hedge of U.S. commercial paper (b) | Notional amt. | \$225.0                            |             | (\$ .2)                      | (\$ .4)                      |
|                                                                                                             | Strike        | 6.33%                              |             |                              |                              |
|                                                                                                             | Reference     | 4.90%                              |             |                              |                              |
| Other swaps settling in 1998                                                                                |               |                                    |             | \$ —                         | (\$10.9)                     |

(a) Under the terms of this swap, if three-month LIBOR falls to 4.71% or below, the swap will expire. At year-end 1998, three-month LIBOR was 5.07%.

(b) Under the terms of this cap, if the Federal Reserve AA composite rate on 30-day commercial paper increases to 7.68% or above, the cap will expire. At year-end 1998 the rate was 4.90%.

## Price risk

The Company is exposed to price fluctuations primarily as a result of anticipated purchases of raw and packaging materials. Primary exposures include corn, wheat, soybean oil, sugar, and other ingredients for the Company's grain-based convenience foods products. The Company uses the combination of long cash positions with vendors, and exchange-traded futures and option contracts to reduce price fluctuations in a desired percentage of forecasted purchases over a duration of generally less than one year. The fair values of commodity contracts held at year-end 1998 and 1997 were insignificant, and potential near-term changes in commodity prices are not expected to have a significant impact on the Company's future earnings or cash flows.

For all derivative financial instruments presented in the tables above, changes in fair values of these instruments and the resultant impact on the Company's cash flows and/or earnings would generally be offset by changes in values of underlying transactions and positions. Therefore, it should be noted that the exclusion of certain of the underlying exposures from the tables above may be a limitation in assessing the net market risk of the Company.

# Corporate Directory

## BOARD OF DIRECTORS

### **Arnold G. Langbo**

Chairman of the Board  
Chief Executive Officer  
Kellogg Company (E\*)

### **Benjamin S. Carson, M.D.**

Director, Pediatric Neurosurgery  
The Johns Hopkins Medical Institutions  
Baltimore, Maryland (A,S)

### **Carleton S. Fiorina**

Group President  
Global Service Provider Business  
Lucent Technologies Inc.  
Warren, New Jersey (C,F)

### **Claudio X. Gonzalez**

Chairman of the Board  
Chief Executive Officer  
Kimberly-Clark de Mexico, S.A. de C.V.  
Mexico City, Mexico (C,\*F)

### **Gordon Gund**

Chairman and  
Chief Executive Officer  
Gund Investment Corporation  
Princeton, New Jersey (E,C,N\*)

### **Carlos M. Gutierrez\*\***

President  
Chief Operating Officer  
Kellogg Company

### **Dorothy A. Johnson**

President  
Chief Executive Officer  
Council of Michigan Foundations  
Grand Haven, Michigan (A,S)

### **William E. LaMothe**

Chairman Emeritus  
Kellogg Company (A,N)

### **Ann McLaughlin**

Chairman  
The Aspen Institute  
Aspen, Colorado (A,\*N)

### **J. Richard Munro**

Chairman  
Genentech Inc.  
South San Francisco, California (C,S\*)

### **Harold A. Poling**

Chairman and  
Chief Executive Officer, Retired  
Ford Motor Company  
Dearborn, Michigan (A,E,N)

### **William C. Richardson**

President and  
Chief Executive Officer  
W. K. Kellogg Foundation  
Battle Creek, Michigan (E,F,S)

### **Donald H. Rumsfeld**

Chairman  
Gilead Sciences, Inc.  
Foster City, California (E,F,\*N)

### **John L. Zabriskie**

Chairman, President, and  
Chief Executive Officer  
NEN Life Science Products, Inc.  
Boston, Massachusetts (C,F)

A = Audit Committee

C = Compensation Committee

E = Executive Committee

F = Finance Committee

N = Nominating and Corporate Governance Committee

S = Social Responsibility Committee

\*Chairman

\*\*Effective January 1999

## OFFICERS

### **Arnold G. Langbo**

Chairman of the Board  
Chief Executive Officer

### **Carlos M. Gutierrez**

President  
Chief Operating Officer

### **John D. Cook\***

Executive Vice President  
President, Kellogg North America

### **Jean-Louis Gourbin**

Executive Vice President  
President, Kellogg Europe

### **Jacobus Groot\*\***

Executive Vice President  
President, Kellogg Asia-Pacific

### **Alan F. Harris**

Executive Vice President  
President, Kellogg Latin America

### **John R. Hinton**

Executive Vice President – Administration  
Chief Financial Officer

### **Donald W. Thomason**

Executive Vice President  
Services and Technology

### **Donna J. Banks**

Senior Vice President  
Research and Development

### **Richard M. Clark**

Senior Vice President  
General Counsel and Secretary

### **Robert L. Creviston**

Senior Vice President – Human Resources

### **Jay W. Shreiner**

Senior Vice President

### **Joseph M. Stewart**

Senior Vice President – Corporate Affairs

### **Michael J. Teale**

Senior Vice President  
Worldwide Operations and Technology

### **E. Joseph Alberding, M.D.**

Vice President – Medical Affairs

### **Celeste A. Clark**

Vice President

### **John L. Forbis**

Vice President  
Global Convenience Foods Innovation

### **George A. Franklin**

Vice President  
Worldwide Government Affairs

### **Victor L. Fulgoni, III**

Vice President – Nutrition

### **Edward J. Gildea**

Vice President – Legal

### **Harvey F. Hoeltzel**

Vice President  
Worldwide Engineering and Technology

### **Richard J. Lilly**

Vice President – Travel Services

### **Jeanene M. Mallmann**

Vice President  
President – McCamly Square Division

### **William J. Mayer, M.D.**

Vice President  
President – Ensemble Functional Foods  
Company

### **W. Stephen Perry**

Vice President  
Tax, Internal Auditing, and Treasurer

### **W. Lawrence Romans**

Vice President

### **Alan Taylor**

Vice President  
Corporate Controller

### **Joseph J. Tubilewicz**

Vice President – Worldwide Purchasing

\*Effective February 1999

\*\*Effective January 1999

# Products and Manufacturing Locations

## Kellogg North America

### Products

*Kellogg's*® cereals, croutons, breading and stuffing products

*Eggo*® waffles

*Lender's*® bagels

*Nutri-Grain*®, *Rice Krispies Squares*®, *Rice Krispies Treats*™,  
*Nutri-Grain Twists*™ cereal bars

*Pop-Tarts*® toaster pastries

### Manufacturing Locations

San Jose, California

New Haven, Connecticut

West Haven, Connecticut

Atlanta, Georgia

Mattoon, Illinois

Pikeville, Kentucky

Battle Creek, Michigan

Omaha, Nebraska

Blue Anchor, New Jersey

West Seneca, New York

London, Ontario

Lancaster, Pennsylvania

Muncy, Pennsylvania

Memphis, Tennessee

Rossville, Tennessee

## Kellogg Europe

### Products

*Kellogg's*® cereals, breading products

*Nutri-Grain*®, *Rice Krispies Squares*™ cereal bars

*Pop-Tarts*® toaster pastries

### Manufacturing Locations

Bremen, Germany

Manchester, Great Britain

Wrexham, Great Britain

Springs, South Africa

Valls, Spain

## Kellogg Asia-Pacific

### Products

*Kellogg's*®, *Cerola*®, *Day Dawn*® cereals

*Nutri-Grain*®, *Rice Bubbles Treats*™, *Coco Pops*®, *Sustain*™,  
*Just Right*™, *Crunchy Nut Corn Flakes*™, *Day Dawn*® cereal bars

*Pop-Tarts*® toaster pastries

*Kellogg's Bredia*™ bagels, waffles

### Manufacturing Locations

Brisbane, Australia

Sydney, Australia

Guangzhou, China

Taloja, India

Takasaki, Japan

Bangi, Malaysia

Anseong, South Korea

Rayong, Thailand

## Kellogg Latin America

### Products

*Kellogg's*® cereals, breading products

*Eggo*® waffles

*Nutri-Grain*® cereal bars

*Pop-Tarts*® toaster pastries

### Manufacturing Locations

Pilar, Argentina

Sao Paulo, Brazil

Bogota, Colombia

Guayaquil, Ecuador

Guatemala City, Guatemala

Linares, Mexico

Queretaro, Mexico

Maracay, Venezuela

# Shareowner Information

## Directory

### Kellogg Company

One Kellogg Square  
Battle Creek, MI 49016-3599  
(616) 961-2000

### Common Stock:

Listed on the New York Stock Exchange  
Ticker Symbol: K

### Independent Accountants:

PricewaterhouseCoopers LLP

### Transfer Agent, Registrar, and Dividend

#### Disbursing Agent:

Communications concerning stock transfer, dividend payments, lost certificates, and change of address should be directed to:

Harris Trust and Savings Bank  
Shareholder Services Division  
P.O. Box A3504  
Chicago, IL 60690-3504  
(800) 323-6138

### Fiscal Agent:

5.75% Extendable Notes Due 2001  
4.875% Notes Due October 15, 2005

Harris Trust and Savings Bank  
Indenture Trust Division  
311 West Monroe, 11th floor  
P.O. Box 1878  
Chicago, IL 60690

6.625% Euro Dollar Notes Due  
January 29, 2004  
Citibank N.A., London  
336 Strand  
London WC2R 1HB England

### Trustee and Collateral Agent:

6.125% Euro Dollar Notes Due August 6, 2001  
Citibank N.A., London  
336 Strand  
London WC2R 1HB England

### Dividend Reinvestment and Stock Purchase Plan:

This plan, available to shareowners, allows for full or partial dividend reinvestment and voluntary cash purchases, with brokerage commissions and service charges paid by the Company. For details, contact:

Harris Trust and Savings Bank  
P.O. Box A3309  
Chicago, IL 60690-9939  
(800) 323-6138

### Company Information:

Kellogg news releases, including earnings announcements, are available by fax 24 hours a day through Company News On-Call at (800) 758-5804. The Kellogg extension is 483375.

Kellogg Company's website – <http://www.kelloggs.com> – contains a wide range of information about the Company, including news releases, the Annual Report, nutritional information, and recipes.

Copies of the Annual Report on audio cassette for visually impaired shareowners, the Annual Report on Form 10-K, quarterly reports on Form 10-Q, and other Company information are available upon request from:

Kellogg Company  
P.O. Box CAMB  
Battle Creek, MI 49016-1986  
(800) 962-1413

### Investor Relations:

(616) 961-2767

### Shareowner Services:

(616) 961-2380

### Kellogg Better Government Committee:

This committee is organized to permit Company shareowners, executives, administrative personnel, and their families to pool their contributions in support of candidates for elected offices at the federal level who believe in sound economic policy and real growth, and who will fight inflation and unemployment, try to decrease taxes, and reduce the growth of government. Interested shareowners are invited to write for further information:

Kellogg Better Government Committee  
ATTN: Joseph M. Stewart  
One Kellogg Square  
Battle Creek, MI 49016-3599

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