



McDonald's Corporation 2004 Financial Report



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11-year summary

DOLLARS IN MILLIONS,
EXCEPT PER SHARE DATA

	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994
Company-operated sales	\$14,224	12,795	11,500	11,041	10,467	9,512	8,895	8,136	7,571	6,863	5,793
Franchised and affiliated revenues	\$ 4,841	4,345	3,906	3,829	3,776	3,747	3,526	3,273	3,116	2,932	2,528
Total revenues	\$19,065	17,140	15,406	14,870	14,243	13,259	12,421	11,409	10,687	9,795	8,321
Operating income	\$ 3,541⁽¹⁾	2,832 ⁽²⁾	2,113 ⁽³⁾	2,697 ⁽⁴⁾	3,330	3,320	2,762 ⁽⁵⁾	2,808	2,633	2,601	2,241
Income before taxes and cumulative effect of accounting changes	\$ 3,203⁽¹⁾	2,346 ⁽²⁾	1,662 ⁽³⁾	2,330 ⁽⁴⁾	2,882	2,884	2,307 ⁽⁵⁾	2,407	2,251	2,169	1,887
Net income	\$ 2,279⁽¹⁾	1,471 ^(2,6)	893 ^(3,7)	1,637 ⁽⁴⁾	1,977	1,948	1,550 ⁽⁵⁾	1,642	1,573	1,427	1,224
Cash provided by operations	\$ 3,904	3,269	2,890	2,688	2,751	3,009	2,766	2,442	2,461	2,296	1,926
Capital expenditures	\$ 1,419	1,307	2,004	1,906	1,945	1,868	1,879	2,111	2,375	2,064	1,539
Treasury stock purchases	\$ 605	439	687	1,090	2,002	933	1,162	765	605	321	500
Financial position at year end:											
Total assets	\$27,838	25,838	24,194	22,535	21,684	20,983	19,784	18,242	17,386	15,415	13,592
Total debt	\$ 9,220	9,731	9,979	8,918	8,474	7,252	7,043	6,463	5,523	4,836	4,351
Total shareholders' equity	\$14,201	11,982	10,281	9,488	9,204	9,639	9,465	8,852	8,718	7,861	6,885
Shares outstanding IN MILLIONS	1,270	1,262	1,268	1,281	1,305	1,351	1,356	1,371	1,389	1,400	1,387
Per common share:											
Net income—basic	\$ 1.81 ⁽¹⁾	1.16 ^(2,6)	.70 ^(3,7)	1.27 ⁽⁴⁾	1.49	1.44	1.14 ⁽⁵⁾	1.17	1.11	.99	.84
Net income—diluted	\$ 1.79 ⁽¹⁾	1.15 ^(2,6)	.70 ^(3,7)	1.25 ⁽⁴⁾	1.46	1.39	1.10 ⁽⁵⁾	1.15	1.08	.97	.82
Dividends declared	\$.55	.40	.24	.23	.22	.20	.18	.16	.15	.13	.12
Market price at year end	\$ 32.06	24.83	16.08	26.47	34.00	40.31	38.41	23.88	22.69	22.56	14.63
Company-operated restaurants	9,212	8,959	9,000	8,378	7,652	6,059	5,433	4,887	4,294	3,783	3,216
Franchised restaurants	18,248	18,132	17,864	17,395	16,795	15,949	15,086	14,197	13,374	12,186	10,944
Affiliated restaurants	4,101	4,038	4,244	4,320	4,260	4,301	3,994	3,844	3,216	2,330	1,739
Total Systemwide restaurants	31,561	31,129	31,108	30,093	28,707	26,309	24,513	22,928	20,884	18,299	15,899
Franchised and affiliated sales⁽⁸⁾	\$37,065	33,137	30,026	29,590	29,714	28,979	27,084	25,502	24,241	23,051	20,194

(1) Includes pretax operating charges of \$130 million related to asset/goodwill impairment and \$160 million (\$21 million related to 2004 and \$139 million related to prior years) for a correction in the Company's lease accounting practices and policies (see Other operating expense, net note to the consolidated financial statements for further details), as well as a nonoperating gain of \$49 million related to the sale of the Company's interest in a U.S. real estate partnership, for a total pretax expense of \$241 million (\$172 million after tax or \$0.13 per share).

(2) Includes pretax charges of \$408 million (\$323 million after tax or \$0.25 per share) primarily related to the disposition of certain non-McDonald's brands and asset/goodwill impairment. See Other operating expense, net note to the consolidated financial statements for further details.

(3) Includes pretax charges of \$853 million (\$700 million after tax or \$0.55 per share) primarily related to restructuring certain international markets and eliminating positions, restaurant closings/asset impairment and the write-off of technology costs. See Other operating expense, net note to the consolidated financial statements for further details.

(4) Includes pretax operating charges of \$378 million primarily related to the U.S. business reorganization and other global change initiatives, and restaurant closings/asset impairment as well as net pretax nonoperating income of \$125 million primarily related to a gain on the initial public offering of McDonald's Japan, for a total pretax expense of \$253 million (\$143 million after tax or \$0.11 per share).

(5) Includes pretax charges of \$322 million (\$219 million after tax or \$0.16 per share) consisting of \$162 million of Made For You costs and \$160 million related to a home office productivity initiative.

(6) Includes a \$37 million after-tax charge (\$0.03 per share) to reflect the cumulative effect of the adoption of SFAS No. 143 "Accounting for Asset Retirement Obligations," which requires legal obligations associated with the retirement of long-lived assets to be recognized at their fair value at the time the obligations are incurred. See Summary of significant accounting policies note to the consolidated financial statements for further details.

(7) Includes a \$99 million after-tax charge (\$0.08 per share—basic and \$0.07 per share—diluted) to reflect the cumulative effect of the adoption of SFAS No. 142 "Goodwill and Other Intangible Assets," which eliminates the amortization of goodwill and instead subjects it to annual impairment tests. See Summary of significant accounting policies note to the consolidated financial statements for further details. Adjusted for the nonamortization provisions of SFAS No. 142, net income per common share would have been \$0.02 higher in 2001 and 2000 and \$0.01 higher in 1999-1996.

(8) While franchised and affiliated sales are not recorded as revenues by the Company, management believes they are important in understanding the Company's financial performance because these sales are the basis on which the Company calculates and records franchised and affiliated revenues and are indicative of the financial health of the franchisee base.

Overview

Description of the business

The Company primarily operates and franchises McDonald's restaurants. In addition, the Company operates certain non-McDonald's brands that are not material to the Company's overall results. Of the more than 30,000 McDonald's restaurants in over 100 countries, more than 8,000 are operated by the Company, approximately 18,000 are operated by franchisees/licensees and about 4,000 are operated by affiliates. In general, the Company owns the land and building or secures long-term leases for restaurant sites regardless of who operates the restaurant. This ensures long-term occupancy rights and helps control related costs.

Revenues consist of sales by Company-operated restaurants and fees from restaurants operated by franchisees and affiliates. These fees primarily include rent, service fees and/or royalties that are based on a percent of sales, with specified minimum rent payments. Fees vary by type of site, amount of Company investment and local business conditions. These fees, along with occupancy and operating rights, are stipulated in franchise/license agreements that generally have 20-year terms.

The business is managed as distinct geographic segments: United States; Europe; Asia/Pacific, Middle East and Africa (APMEA); Latin America and Canada. In addition, throughout this report we present a segment entitled "Other" that includes non-McDonald's brands (e.g., Boston Market and Chipotle Mexican Grill). The U.S. and Europe segments each accounts for approximately 35% of total revenues. France, Germany and the United Kingdom account for about 65% of Europe's revenues; Australia, China and Japan (a 50%-owned affiliate accounted for under the equity method) account for over 45% of APMEA's revenues; and Brazil accounts for about 40% of Latin America's revenues. These seven markets along with the U.S. and Canada are referred to as "major markets" throughout this report and comprise approximately 70% of total revenues.

In analyzing business trends, management considers a variety of performance and financial measures including Systemwide sales growth, comparable sales growth, operating margins and returns.

- Constant currency results exclude the effects of foreign currency translation and are calculated by translating current year results at prior year average exchange rates. Management reviews and analyzes business results in constant currencies and bases certain compensation plans on these results because the Company believes they better represent the underlying business trends.
- Systemwide sales in this report include sales by all McDonald's and Other restaurants, whether operated by the Company, by franchisees or by affiliates. While sales by franchisees and affiliates are not recorded as revenues by the Company, management believes the information is

important in understanding the Company's financial performance because it is the basis on which the Company calculates and records franchised and affiliated revenues and is indicative of the financial health of our franchisee base.

- Comparable sales are a key performance indicator used within the retail industry and are indicative of acceptance of the Company's initiatives as well as local economic and consumer trends. Increases or decreases in comparable sales represent the percent change in constant currency sales from the same period in the prior year for all McDonald's restaurants in operation at least thirteen months. McDonald's reports on a calendar basis and therefore the comparability of the same month, quarter and year with the corresponding period of the prior year will be impacted by the mix of days. The number of weekdays, weekend days and timing of holidays in a given timeframe can have a positive or negative impact on comparable sales. The Company refers to this impact as the calendar shift/trading day adjustment. This impact varies geographically due to consumer spending patterns and has the greatest impact on monthly comparable sales and typically has minimal impact annually, with the exception of leap years, such as 2004, due to an incremental full day of sales.

- Return on incremental invested capital (ROIIC) is a measure reviewed by management to determine the effectiveness of capital deployed. The one-year return is calculated by taking the increase in operating income plus depreciation and amortization between 2004 and 2003 (numerator) and dividing this by the weighted average of 2004 and 2003 adjusted cash used for investing activities (denominator). The calculation assumes an average exchange rate over the periods included in the calculation. In addition to the one-year ROIIC, management reviews this measure over longer time periods in assessing the effectiveness of capital deployed and in allocating capital to business units.

Strategic direction and financial performance

In 2002, the Company's results reflected a focus on growth through adding new restaurants, with associated high levels of capital expenditures and debt financing. This strategy, combined with challenging economic conditions and increased competition in certain key markets, adversely affected results and returns on investment.

In 2003, the Company introduced a comprehensive revitalization plan to increase McDonald's relevance to today's consumers as well as improve our financial discipline. We redefined our strategy to emphasize growth through adding more customers to existing restaurants and aligned the System around our customer-focused Plan to Win. Designed to deliver operational excellence and leadership marketing, this Plan focuses on the five drivers of exceptional customer experiences—people, products, place, price and promotion.

The near-term goal of our revitalization plan was to fortify the foundation of our business. By year-end 2004, we substantially achieved this goal.

We improved the taste of many of our core menu offerings and introduced products that have been well received by consumers such as new salad lines, breakfast and chicken offerings. We offered a variety of price options that appeal to a broad spectrum of consumers. We streamlined processes such as new product development and restaurant operations, improved our training programs, and implemented performance measures, including a restaurant review and measurement process, to enable and motivate restaurant employees to serve customers better. We have begun to remodel many of our restaurants to create more contemporary, welcoming environments. We also launched the “I’m lovin’ it” marketing theme, which achieved high levels of consumer awareness worldwide and gained McDonald’s recognition as 2004 Marketer of the Year by *Advertising Age* magazine.

Over the past two years, we have also exercised increased financial discipline; we paid down debt, reduced capital expenditures and reduced selling, general & administrative expenses as a percent of revenues. In addition, we returned a significant amount of excess cash to shareholders in the form of dividends and share repurchases.

For each quarter of 2004, McDonald’s increased customer visits, improved margins and delivered double-digit growth in operating income and earnings per share. In addition, comparable sales were positive across all geographic segments during each and every quarter.

Our 2004 performance reflected the underlying strength of our U.S. business, which generated impressive sales and margin improvements for the second consecutive year. In Europe, our 2004 comparable sales for the year were 2.4%. This indicates that we are making progress toward revitalizing this important business segment, despite challenges in certain markets.

Highlights from the year included:

- Comparable sales increased 6.9% on top of a 2.4% increase in 2003.
- Consolidated revenues increased 11% to a record high of \$19 billion. Excluding the positive impact of currency translation, revenues increased 7%.
- Systemwide sales increased 12%. Excluding the positive impact of currency translation, Systemwide sales increased 8%.
- Net income per common share totaled \$1.79, compared with \$1.15 in 2003.
- Company-operated margins as a percent of sales improved 80 basis points progressing towards our goal of increasing Company-operated margins to the levels reached in the year 2000.
- Cash from operations increased more than \$600 million to \$3.9 billion, primarily due to increased margins driven by higher sales at existing restaurants as well as stronger foreign currencies.

- Capital expenditures increased to \$1.4 billion, with a higher percentage related to reinvestment in existing restaurants as compared with 2003.
- Debt pay-down totaled more than \$800 million.
- The annual dividend was increased 38%, to about \$700 million.
- Share repurchases totaled about \$600 million.
- ROIC was 41% for 2004. The decrease in impairment and other charges included in the increase in operating income between 2004 and 2003 benefited the return 10 percentage points. (See attached exhibit to this report.)

Outlook for 2005

The long-term goal of our revitalization plan was to create a differentiated customer experience—one that builds brand loyalty and delivers sustainable, profitable growth for shareholders. Looking forward, consistent with that goal, we are targeting average annual Systemwide sales and revenue growth of 3% to 5%, average annual operating income growth of 6% to 7%, and annual returns on incremental invested capital in the high teens. These targets exclude the impact of foreign currency translation.

As we move into 2005, we continue to execute our restaurant review and measurement process through a combination of graded restaurant visits, anonymous mystery shops and customer surveys, and we are rewarding high service levels with special incentives.

We also continue to evolve our menu to remain relevant. In the U.S., Fruit N’ Walnut Salads, as well as new, premium chicken sandwiches will be added to the menu, along with a new coffee blend. In Europe, we will introduce a range of new products. In Canada, Toasted Deli Sandwiches were introduced during the fourth quarter of 2004 and a similar product line is being launched in Australia in 2005. New products and branded everyday value remain a focus, as we continue to refresh our offerings and feature our EuroSaver Menu in several European markets, the Amazing Value Menu in Asia and the Dollar Menu in the U.S.

We continue our remodeling and rebuilding efforts and are enhancing our convenience with initiatives such as extended hours.

Another priority in 2005 is our continued focus on the well-being of our customers. We plan to build on the progress made last year through menu choice, providing education and information about our food, and encouraging physical activity through various programs and partnerships. This year we will leverage our size, reach, and resources to positively impact millions of families worldwide.

We are confident in our plans for 2005. At the same time, we recognize the challenges we face. For example, we must continue to deliver solid results in the U.S., a very competitive marketplace, despite difficult sales comparisons. We believe that the combination of initiatives that benefited our U.S. business in 2004 along with new products will continue to create positive momentum in 2005.

Outside the U.S., we must build on successes in some markets and overcome challenges in others. Notably, some key markets must increase consumer relevance, while others must build the business despite economic challenges. We believe that we are in a better position to overcome these issues today than we have been for some time. For example, in 2005 we sent 20 million households in the U.K. a brand book that combines value offers with important information designed to educate our customers about our product quality, balanced choices and social responsibility efforts. Additionally, we introduced a value menu in Germany, an economically challenged market, with heavy advertising support. Our plan is to leverage successes in markets, such as the U.S., Australia and France, to improve results in other countries.

In light of Chipotle Mexican Grill's strong performance and growing popularity, we are exploring strategic alternatives to fuel growth of this emerging fast-casual brand, which currently operates more than 400 restaurants. We believe Chipotle's value and potential might be maximized through alternative strategies that could include raising additional equity capital in public or private markets. This would have an additional benefit of enabling us to allocate more resources to growing sales and profits at existing McDonald's restaurants.

While the Company does not provide specific guidance on earnings per share, the following information is provided to assist in analyzing the Company's results.

- Changes in constant currency Systemwide sales are driven by changes in comparable sales and restaurant unit expansion. The Company expects net restaurant additions to add slightly more than 1 percentage point to sales growth in 2005 (in constant currencies). Most of this anticipated growth will result from restaurants opened in 2004.
- The Company does not provide specific guidance on changes in comparable sales. However, as a perspective, assuming no change in cost structure, a 1 percentage point increase in U.S. comparable sales would increase annual earnings per share by about 2 cents. Similarly, an increase of 1 percentage point in Europe's comparable sales would increase annual earnings per share by about 1.5 cents.
- The Company expects full-year 2005 selling, general & administrative expenses to be relatively flat or to increase slightly in constant currencies and to decline as a percent of revenues and Systemwide sales, compared with 2004.
- A significant part of the Company's operating income is from outside the U.S., and about 70% of its total debt is denominated in foreign currencies. Accordingly, earnings are affected by changes in foreign currency exchange rates, particularly the Euro and the British Pound. If the Euro and the British Pound both move

10% in the same direction (compared with 2004 average rates), the Company's annual earnings per share would change about 6 cents to 7 cents. In 2004, foreign currency translation benefited earnings per share by 6 cents due primarily to the Euro and the British Pound.

- For 2005, the Company expects its net debt principal repayments to be approximately \$600 million to \$800 million. At the end of 2004, McDonald's debt-to-capital ratio was 39%. We plan to maintain a debt-to-capital ratio of 35% to 40% in the near term. The Company expects interest expense to be relatively flat in 2005 compared with 2004, based on current interest and foreign currency exchange rates and after considering net repayments.
- The Company expects capital expenditures for 2005 to be approximately \$1.7 billion, reflecting higher investment in existing restaurants and stronger foreign currencies.
- The Company expects to return at least \$1.3 billion to shareholders through dividends and share repurchases in 2005.
- The Company plans to adopt Financial Accounting Standards Board (FASB) Statement 123(R), *Share-Based Payment*, during first quarter 2005 and restate prior periods. Partly in anticipation of these new accounting rules, the Company modified its compensation plans to limit eligibility to receive share-based compensation and shifted a portion of share-based compensation to primarily cash-based incentive compensation. We expect the 2005 impact of the adoption of Statement 123(R) combined with the modifications to the Company's compensation plans to be about \$0.10 per share of expense.

A number of factors can affect our business, including the effectiveness of operating initiatives and changes in global and local business and economic conditions. These and other risks are noted under Forward-looking statements at the end of Management's discussion and analysis.

Consolidated operating results

Operating results

DOLLARS IN MILLIONS, EXCEPT PER SHARE DATA	2004		2003		2002
	Amount	Increase/ (decrease)	Amount	Increase/ (decrease)	Amount
Revenues					
Sales by Company-operated restaurants	\$14,224	11%	\$12,795	11%	\$11,500
Revenues from franchised and affiliated restaurants	4,841	11	4,345	11	3,906
Total revenues	19,065	11	17,140	11	15,406
Operating costs and expenses					
Company-operated restaurant expenses	12,100	10	11,006	11	9,907
Franchised restaurants—occupancy expenses	1,003	7	938	12	840
Selling, general & administrative expenses	1,980	8	1,833	7	1,713
Other operating expense, net	441	(17)	531	(36)	833
Total operating costs and expenses	15,524	8	14,308	8	13,293
Operating income	3,541	25	2,832	34	2,113
Interest expense	358	(8)	388	4	374
Nonoperating (income) expense, net	(20)	nm	98	27	77
Income before provision for income taxes and cumulative effect of accounting changes	3,203	36	2,346	41	1,662
Provision for income taxes	924	10	838	25	670
Income before cumulative effect of accounting changes	2,279	51	1,508	52	992
Cumulative effect of accounting changes, net of tax*	–	nm	(37)	nm	(99)
Net income	\$ 2,279	55%	\$ 1,471	65%	\$ 893
Per common share-diluted:					
Income before cumulative effect of accounting changes	\$ 1.79	52%	\$ 1.18	53%	\$.77
Cumulative effect of accounting changes*	–	nm	(.03)	nm	(.07)
Net income	\$ 1.79	56%	\$ 1.15	64%	\$.70
Weighted average common shares outstanding—diluted	1,273.7		1,276.5		1,281.5

* See Cumulative effect of accounting changes for further discussion.

nm Not meaningful.

Impairment and other charges, net

The Company recorded charges associated with certain strategic actions, as well as from annual goodwill and asset impairment testing in 2004, 2003 and 2002. These charges generally represent actions or transactions related to the implementation of strategic initiatives of the Company, items that are unusual or infrequent in nature (such as the dispositions of certain non-McDonald's brands in 2003), charges resulting from impairment testing and a lease accounting correction in 2004. McDonald's management does not include these items when reviewing business

performance trends because we do not believe these items are indicative of expected ongoing results.

On a pretax basis, the Company recorded \$241 million of impairment and other charges (net) in 2004, \$408 million of impairment and other charges in 2003 and \$853 million of impairment and other charges in 2002. All items were recorded in other operating expense with the exception of the gain related to the sale of the Company's interest in a U.S. real estate partnership during 2004, which was recorded in nonoperating income.

Impairment and other charges—(income)/expense

IN MILLIONS, EXCEPT PER SHARE DATA	Pretax			After tax ⁽³⁾			Per common share—diluted		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
Restaurant closings/impairment ⁽¹⁾	\$130	\$136	\$402	\$116	\$140	\$336	\$.09	\$.11	\$.26
Restructuring	—	272	267	—	183	244	—	.14	.19
Lease accounting correction:									
Current year's impact	21	—	—	13	—	—	.01	—	—
Prior years' impact	139	—	—	92	—	—	.07	—	—
Other:									
Operating	—	—	184	—	—	120	—	—	.10
Nonoperating	(49)	—	—	(49)	—	—	(.04)	—	—
Total ⁽²⁾	\$241	\$408	\$853	\$172	\$323	\$700	\$.13	\$.25	\$.55

(1) Although restaurant closings occur each year, the restaurant closing charges in 2003 and 2002, discussed below, were the result of separate intensive reviews by management in conjunction with other strategic actions.

(2) See Other operating expense, net note to the consolidated financial statements for a summary of the activity in the related liabilities, if any. The Company expects to use cash provided by operations to fund the remaining obligations, primarily related to leases.

(3) Certain items were not tax effected.

■ Restaurant closings/asset impairment

In 2004, the Company recorded \$130 million of pretax charges for asset and goodwill impairment, primarily in South Korea driven by its significant decline in performance over the past few years.

In 2003, the Company recorded \$136 million of net pretax charges consisting of: \$148 million primarily related to asset/goodwill impairment in Latin America; \$30 million for about 50 restaurant closings associated with strategic actions in Latin America; and a \$42 million favorable adjustment to the 2002 charge for restaurant closings, primarily due to about 85 fewer closings than originally anticipated.

In 2002, the Company recorded \$402 million of pretax charges consisting of: \$302 million related to management's decision to close about 750 underperforming restaurants primarily in the U.S. and Japan; and \$100 million primarily related to the impairment of assets for certain existing restaurants in Europe and Latin America. Most of the restaurants identified for closing had negative cash flows and/or very low annual sales volumes. Also, in many cases they would have required significant capital investment to remain financially viable.

■ Restructuring

In 2003, the Company recorded \$272 million of pretax charges consisting of: \$237 million related to the loss on the sale of Donatos Pizzeria, the closing of all Donatos and Boston Market restaurants outside the U.S. and the exit of a

domestic joint venture with Fazoli's; and \$35 million related to revitalization plan actions of McDonald's Japan, including headcount reductions, the closing of Pret A Manger stores in Japan and the early termination of a long-term management services agreement. These actions were consistent with management's strategy of concentrating the Company's capital and resources on the best near-term opportunities and avoiding those that distract from restaurant-level execution.

In 2002, the Company initiated actions designed to optimize restaurant operations and improve the business and recorded \$267 million of net pretax charges consisting of: \$201 million related to the anticipated transfer of ownership in five countries in the Middle East and Latin America to developmental licensees and ceasing operations in two countries in Latin America; \$81 million primarily related to eliminating approximately 600 positions (about half of which were in the U.S. and half of which were in international markets), reallocating resources and consolidating certain home office facilities to control costs; and a \$15 million favorable adjustment to the 2001 restructuring charge due to lower employee-related costs than originally anticipated. Under the developmental license business structure, which the Company successfully employs in about 30 markets outside the U.S. (approximately 400 restaurants), the licensee owns the business, including the real estate interest. While the Company generally does not have any capital invested in these markets, it receives a royalty based on a percent of sales.

■ *Lease accounting correction*

Like other companies in the restaurant and retail industries, McDonald's recently reviewed its accounting practices and policies with respect to leasing transactions. Following this review and in consultation with its external auditors, McDonald's has corrected an error in its prior practices to conform the lease term used in calculating straight-line rent expense with the term used to amortize improvements on leased property. The result of the correction is primarily to accelerate the recognition of rent expense under certain leases that include fixed-rent escalations by revising the computation of straight-line rent expense to include these escalations for certain option periods. As the correction relates solely to accounting treatment, it does not affect McDonald's historical or future cash flows or the timing of payments under the related leases and its effect on the Company's current or prior years' earnings per share, cash from operations and shareholders' equity is immaterial. These adjustments primarily impact the U.S., China, Boston Market and Chipotle. Other markets were less significantly impacted, as many of the leases outside of the U.S. do not contain fixed-rent escalations. In 2005, we

expect the rent expense related to this computation to be about \$25 million of which about 40% relates to non-McDonald's brands.

■ *Other*

In 2004, the Company recorded a nonoperating gain of \$49 million related to the sale of the Company's interest in a U.S. real estate partnership. As a result of this transaction, the Company was able to reverse a valuation allowance related to certain capital loss carryforwards (see Provision for income taxes in Management's discussion and analysis).

In 2002, the Company recorded \$184 million of pretax charges consisting of \$170 million primarily related to the write-off of software development costs as a result of management's decision to terminate a long-term technology project; and \$14 million primarily related to the write-off of receivables and inventory in Venezuela as a result of the temporary closure of all McDonald's restaurants due to a national strike. Although the terminated technology project was expected to deliver long-term benefits, it was no longer viewed as the best use of capital, as the anticipated Systemwide cost over several years was expected to be more than \$1 billion.

Impact of foreign currencies on reported results

While changing foreign currencies affect reported results, McDonald's lessens exposures, where practical, by financing in local currencies, hedging certain foreign-denominated cash flows, and purchasing goods and services in local currencies.

In 2004 and 2003, foreign currency translation had a positive impact on consolidated revenues, operating income and earnings per share due to the strengthening of several major currencies, primarily the Euro and British Pound. In 2002, foreign currency translation had a minimal impact on revenues as the stronger Euro and British Pound were offset by weaker Latin American currencies (primarily the Argentine Peso, Brazilian Real and Venezuelan Bolivar); however, operating income in 2002 was positively impacted by foreign currency translation primarily due to the stronger Euro and British Pound.

Impact of foreign currency translation on reported results

IN MILLIONS, EXCEPT PER SHARE DATA	Reported amount			Currency translation benefit/(loss)		
	2004	2003	2002	2004	2003	2002
Revenues	\$19,065	\$17,140	\$15,406	\$779	\$886	\$15
Company-operated margins ⁽¹⁾	2,003	1,695	1,513	91	101	29
Franchised margins ⁽¹⁾	3,832	3,405	3,064	139	195	39
Selling, general & administrative expenses	1,980	1,833	1,713	(57)	(68)	8
Operating income	3,541	2,832	2,113	160	189	90
Income before cumulative effect of accounting changes	2,279	1,508	992	80	89	42
Net income	2,279	1,471	893	80	89	42
Per common share—diluted:						
Income before cumulative effect of accounting changes	1.79	1.18	.77	.06	.07	.03
Net income	1.79	1.15	.70	.06	.07	.04

(1) Includes McDonald's restaurants only.

Revenues

In 2004, consolidated revenue growth was driven by positive performance in all segments as well as stronger foreign currencies. Consolidated revenue growth in 2003 was driven by stronger foreign currencies and strong performance in the U.S.

Revenues

DOLLARS IN MILLIONS	Amount			Increase/(decrease)		Increase/(decrease) excluding currency translation	
	2004	2003	2002	2004	2003	2004	2003
<i>Company-operated sales:</i>							
U.S.	\$ 3,828	\$ 3,594	\$ 3,172	7%	13%	7%	13%
Europe	5,174	4,498	3,982	15	13	5	-
APMEA	2,390	2,158	2,115	11	2	7	(3)
Latin America	933	774	696	21	11	21	20
Canada	730	632	505	16	25	8	11
Other	1,169	1,139	1,030	3	11	3	10
Total	\$14,224	\$12,795	\$11,500	11%	11%	6%	6%
<i>Franchised and affiliated revenues:</i>							
U.S.	\$ 2,697	\$ 2,445	\$ 2,251	10%	9%	10%	9%
Europe	1,563	1,377	1,154	14	19	3	1
APMEA	331	289	253	14	14	4	-
Latin America	75	85	118	(12)	(28)	(10)	(20)
Canada	168	146	128	15	14	7	1
Other	7	3	2	nm	33	nm	33
Total	\$ 4,841	\$ 4,345	\$ 3,906	11%	11%	7%	5%
<i>Total revenues:</i>							
U.S.	\$ 6,525	\$ 6,039	\$ 5,423	8%	11%	8%	11%
Europe	6,737	5,875	5,136	15	14	4	-
APMEA	2,721	2,447	2,368	11	3	7	(3)
Latin America	1,008	859	814	17	6	18	14
Canada	898	778	633	15	23	8	9
Other	1,176	1,142	1,032	3	11	3	11
Total	\$19,065	\$17,140	\$15,406	11%	11%	7%	6%

In the U.S., the increases in revenues in 2004 and 2003 were due to the combined strength of the strategic menu, marketing and service initiatives. Also, franchised and affiliated revenues increased at a higher rate than Company-operated sales due to a higher percentage of franchised restaurants throughout 2004 compared with 2003, while throughout 2003 there was a higher percentage of Company-owned restaurants than in 2002.

In 2004, the increase in Europe's revenues was due to strong comparable sales in Russia, which is entirely Company-operated, and positive comparable sales in France, the U.K. and many other markets, partly offset by Germany's poor performance. In 2003, Europe's revenues reflected strong performance in Russia driven by expansion and positive comparable sales, along with expansion in France, partly offset by weak results in the U.K. and Germany.

In 2004, the increase in APMEA's revenues was due primarily to strong performance in China and Australia as well as positive comparable sales in many other markets, partly offset by poor performance in South Korea. In 2003, APMEA's revenues benefited from positive comparable sales in Australia and expansion in China, but were negatively affected by weak results in Hong Kong, South Korea and Taiwan, compounded by consumer concerns about Severe Acute Respiratory Syndrome (SARS) in several markets in the first half of the year.

In Latin America, revenues in 2004 and 2003 increased in constant currencies primarily due to a higher percentage of Company-operated restaurants and positive comparable sales, especially in 2004.

The following tables present Systemwide sales growth rates and the increase or decrease in comparable sales.

Systemwide sales

	Increase/(decrease)			Increase/(decrease) excluding currency translation		
	2004	2003	2002	2004	2003	2002
U.S.	10%	9%	1%	10%	9%	1%
Europe	14	18	11	4	2	5
APMEA	12	6	(3)	6	(2)	(3)
Latin America	13	(4)	(17)	13	4	4
Canada	15	17	1	7	4	2
Other	-	10	9	-	10	9
Total	12%	11%	2%	8%	5%	2%

Comparable sales—McDonald's restaurants

	Increase/(decrease)		
	2004	2003	2002
U.S.	9.6%	6.4%	(1.5)%
Europe	2.4	(0.9)	1.0
APMEA	5.6	(4.2)	(8.5)
Latin America	13.0	2.3	1.0
Canada	5.4	-	(2.5)
Total	6.9%	2.4%	(2.1)%

Operating margins

Operating margin information and discussions relate to McDonald's restaurants only and exclude non-McDonald's brands.

■ Company-operated margins

Company-operated margin dollars represent sales by Company-operated restaurants less the operating costs of these restaurants. Company-operated margin dollars increased \$308 million or 18% (13% in constant currencies) in 2004 and increased \$182 million or 12% (5% in constant currencies) in 2003. The constant currency increase in both periods was primarily due to strong comparable sales.

Company-operated margins—McDonald's restaurants

IN MILLIONS	2004	2003	2002
U.S.	\$ 731	\$ 635	\$ 507
Europe	807	708	631
APMEA	264	213	239
Latin America	89	47	66
Canada	112	92	70
Total	\$2,003	\$1,695	\$1,513

PERCENT OF SALES

U.S.	19.1%	17.7%	16.0%
Europe	15.6	15.7	15.9
APMEA	11.0	9.9	11.3
Latin America	9.5	6.1	9.4
Canada	15.3	14.6	13.7
Total	15.3%	14.5%	14.4%

Operating cost trends as a percent of sales were as follows: food & paper costs increased in 2004 and decreased in 2003, payroll costs decreased in 2004 and were flat in 2003, and occupancy & other operating decreased in 2004 and increased in 2003.

In the U.S., the Company-operated margin percent increased in 2004 primarily due to positive comparable sales, partly offset by higher commodity costs and higher staffing levels. The U.S. Company-operated margin percent increased in 2003 primarily due to positive comparable sales and lower payroll as a percent of sales due to improved productivity and lower wage inflation, partly offset by higher commodity costs.

In Europe, Russia's strong performance benefited the Company-operated margin percent for 2004 but was more than offset by weak performance in Germany and the U.K. as well as higher commodity costs for the segment. In 2003, Europe's Company-operated margin percent reflected weak performance in the U.K., partly offset by improved margin performance in Germany and France.

In APMEA, the Company-operated margin percent in 2004 reflected improved performance in Hong Kong, Australia and China and poor performance in South Korea. In 2003, the margin declined significantly due to concerns of SARS impacting sales in many markets, partly offset by the SARS-related sales tax relief received from the Chinese government.

In Latin America, the Company-operated margin percent for 2004 reflected improved performance, primarily in Brazil, Argentina and Venezuela. In 2003, results reflected difficult economic conditions in these markets.

■ Franchised margins

Franchised margin dollars represent revenues from franchised and affiliated restaurants less the Company's occupancy costs (rent and depreciation) associated with those sites. Franchised margin dollars represented more than 65% of the combined operating margins in 2004, 2003 and 2002. Franchised margin dollars increased \$427 million or 13% (8% in constant currencies) in 2004 and \$341 million or 11% (5% in constant currencies) in 2003.

Franchised margins—McDonald's restaurants

IN MILLIONS	2004	2003	2002
U.S.	\$2,177	\$1,945	\$1,781
Europe	1,195	1,044	885
APMEA	284	248	217
Latin America	45	54	79
Canada	131	114	102
Total	\$3,832	\$3,405	\$3,064

PERCENT OF REVENUES

U.S.	80.7%	79.5%	79.1%
Europe	76.5	75.8	76.7
APMEA	85.7	85.6	85.8
Latin America	60.1	64.3	66.9
Canada	78.0	78.2	79.2
Total	79.3%	78.4%	78.5%

The consolidated franchised margin percent increased for 2004 but slightly declined in 2003. Both periods benefited from strong comparable sales but reflected higher occupancy costs, due in part to an increased proportion of leased sites.

Selling, general & administrative expenses

Consolidated selling, general & administrative expenses increased 8% in 2004 and 7% in 2003 (5% and 3% in constant currencies). The constant currency increases in 2004 and 2003 reflected higher performance-based incentive compensation. In addition, 2003 included severance

and other costs associated with the strategic decision to reduce restaurant openings.

Selling, general & administrative expenses as a percent of revenues declined to 10.4% in 2004 compared with 10.7% in 2003 and 11.1% in 2002, and selling, general & administrative expenses as a percent of Systemwide sales declined to 3.9% in 2004 compared with 4.0% in 2003 and 4.1% in 2002. Management believes that analyzing selling, general & administrative expenses as a percent of Systemwide sales as well as revenues is meaningful because these costs are incurred to support Systemwide restaurants.

Selling, general & administrative expenses

DOLLARS IN MILLIONS	Amount			Increase/(decrease)		Increase/(decrease) excluding currency translation	
	2004	2003	2002	2004	2003	2004	2003
U.S.	\$ 602	\$ 567	\$ 558	6%	2%	6%	2%
Europe	485	424	359	14	18	4	2
APMEA	189	173	158	9	10	4	2
Latin America	107	102	102	5	–	5	8
Canada	64	54	49	20	9	11	(3)
Other	96	115	114	(16)	1	(16)	–
Corporate ⁽¹⁾	437	398	373	10	7	10	7
Total	\$1,980	\$1,833	\$1,713	8%	7%	5%	3%

(1) Corporate expenses consist of home office support costs in areas such as facilities, finance, human resources, information technology, legal, marketing, supply chain management and training.

Other operating expense, net

Other operating (income) expense, net

IN MILLIONS	2004	2003	2002
Gains on sales of restaurant businesses	\$ (45)	\$ (55)	\$(114)
Equity in earnings of unconsolidated affiliates	(60)	(37)	(24)
Other expense:			
Impairment and other charges ⁽¹⁾	130	408	853
Prior years' lease accounting correction	139	–	–
Other ⁽²⁾	277	215	118
Total	\$441	\$531	\$ 833

(1) See Other operating expense, net note to the consolidated financial statements for a discussion of the charges and a summary of the activity in the related liabilities.

(2) Includes \$21 million for current year's impact of lease accounting correction.

Gains on sales of restaurant businesses

Gains on sales of restaurant businesses include gains from sales of Company-operated restaurants as well as gains from exercises of purchase options by franchisees with business facilities lease arrangements (arrangements where the Company leases the businesses, including equipment, to franchisees who have options to purchase the businesses). The Company's purchases and sales of businesses with its franchisees and affiliates are aimed at achieving an optimal ownership mix in each market. Resulting gains or losses are recorded in operating income because the transactions are a recurring part of our business.

Equity in earnings of unconsolidated affiliates

Equity in earnings of unconsolidated affiliates—businesses in which the Company actively participates but does not control—is reported after interest expense and income taxes, except for U.S. restaurant partnerships, which are reported before income taxes. The increase in 2004 was primarily due to stronger performance in the U.S. and improved results from our Japanese affiliate. The increase in 2003 was primarily due to strong results in the U.S.

■ Other expense

The following table presents impairment and other charges and lease accounting correction amounts included in other operating expense by segment for 2004, 2003 and 2002.

Impairment and other charges

IN MILLIONS	U.S.	Europe	APMEA	Latin America	Canada	Other	Corporate	Consolidated
2004								
Restaurant closings/impairment	\$ 10	\$ 25	\$ 93	\$ 2				\$130
Lease accounting correction:								
Current year's impact	8		4			\$ 9		21
Prior years' impact	62	1	42		\$ 4	30		139
Total	80	26	139	2	4	39		290
Currency translation (loss)		(1)	(10)					(11)
Total excluding currency translation	\$ 80	\$ 25	\$129	\$ 2	\$ 4	\$ 39		\$279
2003								
Restaurant closings/impairment ⁽¹⁾	\$(11)	\$(20)	\$ 20	\$109	\$(1)	\$ 29	\$ 10	\$136
Restructuring			35			237		272
Total	(11)	(20)	55	109	(1)	266	10	408
Currency translation benefit/(loss)		3	(5)	(20)		(11)		(33)
Total excluding currency translation	\$(11)	\$(17)	\$ 50	\$ 89	\$(1)	\$255	\$ 10	\$375
2002								
Restaurant closings/impairment	\$ 74	\$135	\$ 81	\$ 62	\$ 4	\$ 31	\$ 15	\$402
Restructuring	25	9	141	66	2	3	21	267
Other		4		14	4		162	184
Total	99	148	222	142	10	34	198	853
Currency translation benefit/(loss)		(17)	(3)	23				3
Total excluding currency translation	\$ 99	\$131	\$219	\$165	\$10	\$ 34	\$198	\$856

(1) Bracketed amounts resulted from favorable adjustments to 2002 charges primarily due to fewer than anticipated restaurant closings.

In addition, other expense for 2004 reflected higher losses on asset dispositions, certain costs incurred to acquire restaurants operated by litigating franchisees in Brazil and provisions for certain contingencies, partly offset by lower provisions for uncollectible receivables in 2004 compared

with 2003. Other expense in 2003 reflected higher losses on asset dispositions, higher provisions for uncollectible receivables and costs in the U.S. related to sites that will no longer be developed as a result of management's decision to significantly reduce capital expenditures.

Operating income

Consolidated operating income in 2004 and 2003 included higher combined operating margin dollars and higher selling, general & administrative expenses when compared with 2003 and 2002, respectively. In addition, 2003 included lower gains on sales of restaurant businesses when compared with 2002. In all three years, the Company recorded impairment and other charges that are included in these results.

Operating income

DOLLARS IN MILLIONS	Amount			Increase/(decrease)		Increase/(decrease) excluding currency translation	
	2004	2003	2002	2004	2003	2004	2003
U.S.	\$2,182	\$1,982	\$1,673	10%	18%	10%	18%
Europe	1,471	1,339	1,022	10	31	-	13
APMEA	200	226	64	(11)	nm	(20)	nm
Latin America	(20)	(171)	(133)	89	(28)	91	(7)
Canada	178	163	125	9	30	2	15
Other	(16)	(295)	(66)	94	nm	94	nm
Corporate	(454)	(412)	(572)	(10)	28	(10)	28
Total	\$3,541	\$2,832	\$2,113	25%	34%	19%	25%

nm Not meaningful.

In 2004 and 2003, U.S. operating income included higher combined operating margin dollars, partly offset by higher selling, general & administrative expenses and higher other operating expenses (excluding impairment charges and lease accounting correction), compared to 2003 and 2002, respectively.

Europe's constant currency results in 2004 benefited from strong performances in France and Russia as well as improved performance in Italy, offset by weak results in the U.K. Germany's performance weakened during the second half of 2004, and we expect the economic challenges there to continue to impact our performance in the near-term. In 2003, Europe's constant currency results also benefited from strong performance in France and Russia; however, difficult economic conditions in Germany and weak results in the U.K. negatively impacted results.

In APMEA, operating income in constant currencies for 2004 benefited from Australia's performance as well as improved performance in Hong Kong and China, partially offset by poor results in South Korea. APMEA's 2003 operating income reflected strong results in Australia. However, weak results in most other markets, compounded by concerns about SARS in certain markets, negatively impacted the segment.

In 2004, Latin America's operating loss decreased as compared with 2003, due to significantly lower provisions for uncollectible receivables and improved performance in Venezuela and Argentina. In addition, operating income in 2004 included certain costs incurred to acquire restaurants owned by litigating franchisees in Brazil. Latin America's operating income significantly declined in 2003 due to the continuing difficult economic conditions experienced by several key markets in the segment and significantly higher provisions for uncollectible receivables.

Interest expense

Interest expense decreased in 2004 due to lower average debt levels and interest rates, partly offset by stronger foreign currencies. Interest expense increased in 2003 due to stronger foreign currencies, partly offset by lower average debt levels and interest rates.

Nonoperating (income) expense, net

Nonoperating (income) expense includes miscellaneous income and expense items such as interest income, minority interests, and gains and losses related to other investments, financings and foreign currency translation.

Nonoperating (income) expense in 2004 included a gain of \$49 million related to the sale of the Company's interest in a U.S. real estate partnership as well as higher interest income. Nonoperating expense in 2003 reflected an \$11 million loss on the early extinguishment of debt as well as higher foreign currency translation losses compared with 2002.

Provision for income taxes

The following table presents the reported effective income tax rates as well as the effective income tax rates before impairment and other charges.

Effective income tax rates

	2004	2003	2002
Reported effective income tax rates	28.9%	35.7%	40.3%
Impact of impairment and other charges, net ⁽¹⁾	(0.1)	(2.2)	(7.6)
Effective income tax rates before above charges	28.8%	33.5%	32.7%

(1) Certain items were not tax effected.

The effective income tax rate for the full year 2004 benefited from an international transaction and the utilization of certain previously unrealized capital loss carryforwards, both of which impacted 2004 only. In 2003 and 2002, the effective income tax rates were negatively impacted by certain asset impairment and other charges that were not tax effected, while 2004 has a lesser amount of such items.

Consolidated net deferred tax liabilities included tax assets, net of valuation allowance, of \$1,319 million in 2004 and \$1,032 million in 2003. Substantially all of the net tax assets arose in the U.S. and other profitable markets.

Cumulative effect of accounting changes

Effective January 1, 2003, the Company adopted SFAS No.143, *Accounting for Asset Retirement Obligations*, which requires legal obligations associated with the retirement of long-lived assets to be recognized at their fair value at the time that the obligations are incurred. Effective January 1, 2002, the Company adopted SFAS No.142, *Goodwill and Other Intangible Assets*, which eliminates the amortization of goodwill and instead subjects it to annual impairment tests. See Summary of significant accounting policies note to the consolidated financial statements for further discussion.

Cash flows

The Company generates significant cash from operations and has substantial credit capacity to fund operating and discretionary spending such as capital expenditures, debt repayments, dividends and share repurchase.

Cash from operations totaled \$3.9 billion and exceeded capital expenditures by \$2.5 billion in 2004, while cash from operations totaled \$3.3 billion and exceeded capital expenditures by \$2.0 billion in 2003. Cash provided by operations increased \$635 million in 2004 due to strong operating results, primarily in the U.S., and changes in working capital, partly offset by higher income tax payments. Cash provided by operations increased \$379 million in 2003 due to strong operating results, primarily in the U.S., partly offset by changes in working capital.

Cash provided by operations

DOLLARS IN MILLIONS	2004	2003	2002
Cash provided by operations	\$3,904	\$3,269	\$2,890
Cash provided by operations as a percent of capital expenditures	275%	250%	144%

Cash used for investing activities totaled \$1.4 billion in 2004 due to higher capital expenditures and lower sales of property, offset by lower purchases of restaurant business. Cash used for investing activities also totaled \$1.4 billion in 2003, a decrease of \$1.1 billion compared with 2002 primarily due to lower capital spending as a result of fewer restaurant openings and fewer purchases of restaurant businesses.

Cash used for financing activities totaled \$1.6 billion in 2004, a decrease of \$103 million primarily due to higher proceeds from employee stock option exercises, partly offset by higher share repurchases and an increase in the common stock dividend. In 2003, cash used for financing activities totaled \$1.7 billion, an increase of \$1.2 billion primarily due to net debt repayments.

As a result of the above activity, the Company's cash balance increased \$887 million from December 31, 2003 to \$1.4 billion at December 31, 2004, compared to an increase of \$162 million from December 31, 2002 to December 31, 2003.

In addition to its cash provided by operations, the Company can meet short-term funding needs through commercial paper borrowings and line of credit agreements. Accordingly, the Company purposefully maintains a relatively low current ratio, which was .81 at year-end 2004.

Restaurant development and capital expenditures

As a result of the Company's strategically shifting its focus in 2003 from adding new restaurants to building sales at existing restaurants, the Company again reduced restaurant openings in 2004. The Company opened 430 traditional McDonald's restaurants and 198 satellite restaurants (small, limited-menu restaurants for which the land and building are generally leased), and closed 185 traditional restaurants and 134 satellite restaurants. About 70% of McDonald's restaurant additions occurred in the major markets in 2004. In 2003, the Company opened 513 traditional McDonald's restaurants and 319 satellite restaurants, and closed 486 traditional restaurants and 184 satellite restaurants.

Systemwide restaurants at year end⁽¹⁾

	2004	2003	2002
U.S.	13,673	13,609	13,491
Europe	6,287	6,186	6,070
APMEA	7,567	7,475	7,555
Latin America	1,607	1,578	1,605
Canada	1,362	1,339	1,304
Other	1,065	942	1,083
Total	31,561	31,129	31,108

(1) Includes satellite units at December 31, 2004, 2003 and 2002 as follows: U.S.—1,341, 1,307, 1,159; Europe—181, 150, 102; APMEA (primarily Japan)—1,819, 1,841, 1,923; Latin America—13, 20, 19; and Canada—378, 350, 330.

In 2005, the Company expects to open about 550 traditional McDonald's restaurants and 150 satellite restaurants and close about 225 traditional restaurants and 125 satellite restaurants.

Approximately 60% of Company-operated restaurants and more than 85% of franchised restaurants were located in the major markets at the end of 2004. Franchisees and affiliates operated 73% of McDonald's restaurants at year-end 2004. Non-McDonald's brand restaurants are primarily Company-operated.

Capital expenditures increased \$112 million or 9% in 2004 and decreased \$697 million or 35% in 2003. The increase in capital expenditures in 2004 was consistent with the Company's strategy to increase investment in existing restaurants, primarily in the U.S. and Europe, partly offset by lower expenditures on restaurant openings. In addition, foreign currency translation increased capital expenditures by \$48 million. The decrease in capital expenditures in 2003 was primarily due to lower restaurant openings, consistent with our shift in strategic focus, partly offset by stronger foreign currencies (foreign currency translation increased capital expenditures by \$73 million). Capital expenditures for McDonald's restaurants in 2004, 2003 and 2002 reflected the leasing of a higher proportion of new sites.

Capital expenditures invested in major markets excluding Japan represented between 65% and 70% of the total in 2004, 2003 and 2002. Japan is accounted for under the equity method, and accordingly its capital expenditures are not included in consolidated amounts.

Capital expenditures

IN MILLIONS	2004	2003	2002
New restaurants	\$ 500	\$ 617	\$ 1,161
Existing restaurants	774	564	659
Other properties ⁽¹⁾	145	126	184
Total	\$ 1,419	\$ 1,307	\$ 2,004
Total assets	\$27,838	\$25,838	\$24,194

(1) Primarily corporate-related equipment and furnishings for office buildings.

Capital expenditures for new restaurants decreased \$117 million or 19% in 2004 and \$544 million or 47% in 2003 because the Company opened fewer restaurants in both years, concentrating new restaurant investments in markets with acceptable returns or opportunities for long-term growth. Capital expenditures for existing restaurants increased in 2004 due to the Company's focus on growing sales at existing restaurants including reinvestment initiatives such as restaurant reimagining in several markets around the world, including the U.S.

Average development costs vary widely by market depending on the types of restaurants built and the real estate and construction costs within each market. These costs, which include land, buildings and equipment, are managed through the use of optimally sized restaurants, construction and design efficiencies, leveraging best practices and sourcing globally. In addition, foreign currency fluctuations affect average development costs. In 2005, the Company is targeting 11 consolidated markets, including the U.S., for opening ten or more restaurants. Although the Company is not responsible for all costs on every restaurant opened, in 2004 total development costs (consisting of land,

buildings and equipment) for new traditional McDonald's restaurants averaged approximately \$1.8 million in the U.S. and approximately \$1.7 million in the 10 markets outside the U.S.

The Company and its affiliates owned about 37% of the land and 59% of the buildings for its restaurants at year-end 2004. In 2003, the Company and its affiliates owned about 37% of the land and 60% of the buildings for its restaurants at year end.

Share repurchases and dividends

During 2004, the Company acquired 22.2 million shares of McDonald's stock for approximately \$605 million under a \$5.0 billion share repurchase program authorized in 2001. Through 2004, 61.2 million shares for \$1.6 billion have been repurchased under this program.

The Company has paid dividends on its common stock for 29 consecutive years and has increased the dividend amount every year. In 2004, the Company declared a 38% increase in the annual dividend to \$0.55 per share or \$695 million, reflecting the Company's confidence in the ongoing strength and reliability of its cash flow and positive results from its revitalization efforts. As in the past, future dividends will be considered after reviewing returns to shareholders, profitability expectations and financing needs and will be declared at the discretion of the Board of Directors. Cash dividends are declared and paid on an annual basis.

Financial position and capital resources

Total assets and returns

Total assets grew by \$2.0 billion or 8% in 2004 and \$1.6 billion or 7% in 2003. Changes in foreign currency exchange rates increased total assets by approximately \$1.0 billion in 2004 and \$1.9 billion in 2003. At year-end 2004 and 2003, nearly 70% of consolidated assets were located in the major markets. Net property and equipment rose \$778.4 million in 2004 and represented 74% of total assets at year end.

Operating income is used to compute return on average assets, while income before the cumulative effect of accounting changes is used to calculate return on average common equity. Month-end balances are used to compute both average assets and average common equity.

Returns on assets and equity

	2004	2003	2002
Return on average assets	13.4%	11.4%	9.2%
Return on average common equity	17.8	13.3	9.8

Impairment and other charges reduced return on average assets by 0.9 percentage points in 2004, 1.4 percentage points in 2003 and 3.6 percentage points in 2002. In addition, these charges reduced return on average common equity by 1.3 percentage points in 2004, 2.8 percentage points in 2003 and 7.0 percentage points in 2002. In 2004, return on average assets and return on average common equity both increased due to strong operating results in the

U.S. and improved results in Europe. In 2003, return on average assets and return on average common equity both began to stabilize due to strong operating results in the U.S., partly offset by weak operating results in most markets in APMEA and Latin America. During 2005, the Company will continue to concentrate McDonald's restaurant openings and new capital invested in markets with acceptable returns or opportunities for long-term growth, such as China.

Financing and market risk

The Company generally borrows on a long-term basis and is exposed to the impact of interest rate changes and foreign currency fluctuations. Debt obligations at December 31, 2004 totaled \$9.2 billion, compared with \$9.7 billion at December 31, 2003. The net decrease in 2004 was due to net payments (\$815 million) and SFAS No.133 noncash fair value adjustments (\$19 million), partly offset by the impact of changes in exchange rates on foreign currency denominated debt (\$323 million).

Debt highlights⁽¹⁾

	2004	2003	2002
Fixed-rate debt as a percent of total debt ^(2,3)	59%	62%	62%
Weighted-average annual interest rate of total debt	3.9	4.1	4.1
Foreign currency-denominated debt as a percent of total debt ^(2,3)	72	71	64
Total debt as a percent of total capitalization (total debt and total shareholders' equity) ⁽²⁾	39	44	48
Cash provided by operations as a percent of total debt ⁽²⁾	44	35	30

(1) All percentages are as of December 31, except for the weighted-average annual interest rate, which is for the year.

(2) Based on debt obligations before the effect of SFAS No. 133 fair value adjustments. This effect is excluded, as these adjustments ultimately have no impact on the obligation at maturity. See Debt financing note to the consolidated financial statements.

(3) Includes the effect of interest rate and foreign currency exchange agreements.

Moody's, Standard & Poor's and Fitch currently rate the Company's commercial paper P-1, A-1 and F1, respectively; and its long-term debt A2, A and A, respectively. Historically, the Company has not experienced difficulty in obtaining financing or refinancing existing debt. The Company's key metrics for monitoring its credit structure are shown in the preceding table. While the Company targets these metrics for ease of focus, it also looks at similar credit ratios that incorporate capitalized operating leases to estimate total adjusted debt. Total adjusted debt is a term that is commonly used by the rating agencies referred to above, which includes debt outstanding on the Company's balance sheet plus an adjustment to capitalize operating leases. Two of the three agencies use a multiple of eight times rent expense. The Company also uses this methodology in combination with certain other adjustments to more accurately reflect its total net lease commitments. These adjustments include: excluding percent rents in excess of minimum rents; excluding certain Company-operated

restaurant lease agreements outside the U.S. that are cancelable with minimal penalties (representing approximately 20% of Company-operated restaurant leases outside the U.S., based on the Company's estimate); capitalizing non-restaurant leases using a multiple of three times rent expense; and reducing total rent expense by approximately half of the annual minimum rent payments due to the Company from franchisees operating on leased sites. Based on this calculation, for credit analysis purposes approximately \$4 billion of future operating lease payments would be capitalized.

Certain of the Company's debt obligations contain cross-acceleration provisions and restrictions on Company and subsidiary mortgages and the long-term debt of certain subsidiaries. There are no provisions in the Company's debt obligations that would accelerate repayment of debt as a result of a change in credit ratings or a material adverse change in the Company's business. The Company has \$1.3 billion available under a committed line of credit agreement (see Debt financing note to the consolidated financial statements) as well as approximately \$1.4 billion under a U.S. shelf registration and \$607 million under a Euro Medium-Term Notes program for future debt issuance.

The Company uses major capital markets, bank financings and derivatives to meet its financing requirements and reduce interest expense. The Company manages its debt portfolio in response to changes in interest rates and foreign currency rates by periodically retiring, redeeming and repurchasing debt, terminating exchange agreements and using derivatives. The Company does not use derivatives with a level of complexity or with a risk higher than the exposures to be hedged and does not hold or issue derivatives for trading purposes. All exchange agreements are over-the-counter instruments.

In managing the impact of interest rate changes and foreign currency fluctuations, the Company uses interest rate exchange agreements and finances in the currencies in which assets are denominated. All derivatives were recorded at fair value in the Company's Consolidated balance sheet at December 31, 2004 and 2003 as follows: miscellaneous other assets—\$102 million and \$102 million; other long-term liabilities (excluding accrued interest)—\$218 million and \$136 million; and accrued payroll and other liabilities—\$17 million and \$29 million. See Summary of significant accounting policies note to the consolidated financial statements related to financial instruments for additional information regarding their use and the impact of SFAS No. 133 regarding derivatives.

The Company uses foreign currency debt and derivatives to hedge the foreign currency risk associated with certain royalties, intercompany financings and long-term investments in foreign subsidiaries and affiliates. This reduces the impact of fluctuating foreign currencies on cash flows and shareholders' equity. Total foreign currency denominated debt, including the effects of foreign currency exchange agreements, was \$6.6 billion and \$6.8 billion for the years ended 2004 and 2003, respectively. In addition, where practical, the Company's restaurants purchase goods and services in local currencies resulting in natural hedges.

The Company does not have significant exposure to any individual counterparty and has master agreements that contain netting arrangements. Certain of these agreements also require each party to post collateral if credit ratings fall below, or aggregate exposures exceed, certain contractual limits. At December 31, 2004 and 2003, the Company was required to post collateral of \$46 million and \$12 million, respectively.

The Company's net asset exposure is diversified among a broad basket of currencies. The Company's largest net asset exposures (defined as foreign currency assets less foreign currency liabilities) at year end were as follows:

Foreign currency net asset exposures

<i>IN MILLIONS OF U.S. DOLLARS</i>	2004	2003
Euro	\$2,453	\$1,922
Canadian Dollars	1,382	1,086
British Pounds Sterling	1,086	741
Australian Dollars	880	781
Brazilian Reals	372	365

The Company prepared sensitivity analyses of its financial instruments to determine the impact of hypothetical changes in interest rates and foreign currency exchange rates on the Company's results of operations, cash flows and the fair value of its financial instruments. The interest rate analysis assumed a one percentage point adverse change in interest rates on all financial instruments but did not consider the effects of the reduced level of economic activity that could exist in such an environment. The foreign currency rate analysis assumed that each foreign currency rate would change by 10% in the same direction relative to the U.S. Dollar on all financial instruments; however, the analysis did not include the potential impact on sales levels, local currency prices or the effect of fluctuating currencies on the Company's anticipated foreign currency royalties and other payments received in the U.S. Based on the results of these analyses of the Company's financial instruments, neither a one percentage point adverse change in interest rates from 2004 levels nor a 10% adverse change in foreign currency rates from 2004 levels would materially affect the Company's results of operations, cash flows or the fair value of its financial instruments.

Contractual obligations and commitments

The Company has long-term contractual obligations primarily in the form of lease obligations (related to both Company-operated and franchised restaurants) and debt obligations. In addition, the Company has long-term revenue and cash flow streams that relate to its franchise arrangements. Cash provided by operations (including cash provided by these franchise arrangements) along with the Company's borrowing capacity and other sources of cash will be used to satisfy the obligations. The following table summarizes the Company's contractual obligations and their aggregate maturities as well as future minimum rent payments due to the Company under existing franchise arrangements as of December 31, 2004. (See discussions of Cash flows and Financial position and capital resources

as well as the Notes to the consolidated financial statements for further details.)

IN MILLIONS	Contractual cash outflows		Contractual cash inflows
	Operating leases	Debt obligations ⁽¹⁾	Minimum rent under franchise arrangements
2005	\$ 1,062	\$ 862	\$ 1,875
2006	1,000	1,262	1,829
2007	929	776	1,779
2008	865	831	1,724
2009	807	420	1,656
Thereafter	6,780	4,766	12,773
Total	\$11,443	\$8,917	\$21,636

(1) The maturities reflect reclassifications of short-term obligations to long-term obligations of \$1.3 billion, as they are supported by a long-term line of credit agreement expiring in 2010. Debt obligations do not include \$303 million of SFAS No. 133 noncash fair value adjustments. This effect is excluded as these adjustments ultimately have no impact on the obligation at maturity.

The Company maintains a nonqualified, unfunded Supplemental Plan that allows participants to (i) make tax-deferred contributions and (ii) receive Company-provided allocations that cannot be made under the Profit Sharing and Savings Plan because of Internal Revenue Service limitations. The investment alternatives and returns in the Supplemental Plan are based on certain market-rate investment alternatives under the Profit Sharing and Savings Plan. Total liabilities under the Supplemental Plan were \$350 million at December 31, 2004 and \$329 million at December 31, 2003, and were included in other long-term liabilities in the Consolidated balance sheet.

In addition to long-term obligations, the Company had guaranteed certain affiliate and other loans totaling \$70 million at December 31, 2004.

Other matters

Critical accounting policies and estimates

Management's discussion and analysis of financial condition and results of operations is based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires the Company to make estimates and judgements that affect the reported amounts of assets, liabilities, revenues and expenses as well as related disclosures. On an ongoing basis, the Company evaluates its estimates and judgements based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under various assumptions or conditions.

The Company reviews its financial reporting and disclosure practices and accounting policies quarterly to ensure that they provide accurate and transparent information relative to the current economic and business environment. The Company believes that of its significant accounting policies, the following involve a higher degree of judgement and/or complexity.

Property and Equipment

Property and equipment are depreciated or amortized on a straight-line basis over their useful lives based on management's estimates of the period over which the assets will generate revenue (not to exceed lease term plus options for leased property). The useful lives are estimated based on historical experience with similar assets, taking into account anticipated technological or other changes. The Company periodically reviews these lives relative to physical factors, economic factors and industry trends. If there are changes in the planned use of property and equipment or if technological changes occur more rapidly than anticipated, the useful lives assigned to these assets may need to be shortened, resulting in the recognition of increased depreciation and amortization expense in future periods.

Long-Lived Assets

Long-lived assets (including goodwill) are reviewed for impairment annually in the fourth quarter and whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In assessing the recoverability of the Company's long-lived assets, the Company considers changes in economic conditions and makes assumptions regarding estimated future cash flows and other factors. The biggest assumption impacting estimated future cash flows is the estimated change in comparable sales. Estimates of future cash flows are highly subjective judgements based on the Company's experience and knowledge of its operations. These estimates can be significantly impacted by many factors including changes in global and local business and economic conditions, operating costs, inflation, competition, and consumer and demographic trends. If the Company's estimates or underlying assumptions change in the future, the Company may be required to record impairment charges.

Restructuring and Litigation Accruals

The Company has recorded charges related to restructuring markets, closing restaurants, eliminating positions and other strategic changes. The accruals recorded included estimates pertaining to employee termination costs, number of restaurants to be closed and remaining lease obligations for closed facilities. Although the Company does not anticipate significant changes, the actual costs may differ from these estimates.

From time to time, the Company is subject to proceedings, lawsuits and other claims related to competitors, customers, employees, franchisees, intellectual property, shareholders and suppliers. The Company is required to assess the likelihood of any adverse judgements or outcomes to these matters as well as potential ranges of probable losses. A determination of the amount of accrual required, if any, for these contingencies is made after careful analysis of each matter. The required accrual may change in the future due to new developments in each matter or changes in approach such as a change in settlement strategy in dealing with these matters. The Company does not believe that any such matter will have a material adverse effect on its financial condition or results of operations.

■ *Income Taxes*

The Company records a valuation allowance to reduce its deferred tax assets if it is more likely than not that some portion or all of the deferred assets will not be realized. While the Company has considered future taxable income and ongoing prudent and feasible tax strategies in assessing the need for the valuation allowance, if these estimates and assumptions change in the future, the Company may be required to adjust its valuation allowance. This could result in a charge to, or an increase in, income in the period such determination is made.

In addition, the Company operates within multiple taxing jurisdictions and is subject to audit in these jurisdictions. The Company records accruals for the estimated outcomes of these audits, and the accruals may change in the future due to new developments in each matter. The Company expects to settle the audits of its 2000 through 2002 U.S. tax returns in the first half of 2005.

Deferred U.S. income taxes have not been recorded for basis differences totaling \$5.5 billion related to investments in certain foreign subsidiaries and corporate joint ventures. The basis differences consist primarily of undistributed earnings and other than the potential repatriation of earnings under the new tax law, as described below, these earnings are considered permanently invested in the businesses. If management's intentions change in the future, deferred taxes may need to be provided.

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (the "Act"). The Act creates a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85% dividends received deduction for certain dividends from controlled foreign corporations. The deduction is subject to a number of limitations and, as of today, uncertainty remains as to how to interpret numerous provisions in the Act. As such, we have not yet decided on whether, and to what extent, we might repatriate foreign earnings that have not yet been remitted to the U.S. Based on our analysis to date, however, it is reasonably possible that we may repatriate between \$0 and \$3.2 billion, with the respective tax liability ranging from \$0 to \$100 million. We expect to finalize our assessment once clarifying guidance is issued.

New accounting standards

In December 2004, the FASB issued Statement No.123(R), *Share-Based Payment*, effective third quarter 2005 for the Company, which is a revision of FASB Statement No.123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

As permitted by Statement 123, the Company currently accounts for share-based payments to employees using the intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of Statement 123(R)'s fair value method will have an impact on our results of operations.

The Company expects to adopt Statement 123(R) during the first quarter 2005 using the modified-retrospective method restating prior periods. Had we adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the pro forma disclosures in the Summary of significant accounting policies note to the consolidated financial statements.

Partly in anticipation of these new accounting rules, the Company modified its compensation plans to limit eligibility to receive share-based compensation and shifted a portion of share-based compensation primarily to cash-based incentive compensation. We expect the 2005 impact of the adoption of Statement 123(R) combined with the modifications to the Company's compensation plans to be about \$0.10 per share of expense.

Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under the current rules. This requirement will reduce net operating cash flow and increase net financing cash flow.

Effects of changing—inflation

The Company has demonstrated an ability to manage inflationary cost increases effectively. This is because of rapid inventory turnover, the ability to adjust menu prices, cost controls and substantial property holdings, many of which are at fixed costs and partly financed by debt made less expensive by inflation.

Forward-looking statements

This report includes forward-looking statements about our operating plans and future performance, including those under Outlook for 2005. These statements use such words as "may," "will," "expect," "believe," "plan" and other similar terminology. They reflect management's current expectations about future events and speak only as of the date of this report. We undertake no obligation to publicly update or revise them. Management's expectations may change or not be realized and, in any event, they are subject to risks, uncertainties and changes in circumstances that are difficult to predict and often beyond our control. For these reasons, you should not place undue reliance on forward-looking statements. The following are some of the considerations and factors that could change our expectations (or the underlying assumptions) or affect our ability to realize them:

- Our ability to anticipate and respond to changing trends in the informal eating out market, such as spending patterns, demographic changes and consumer food preferences, as well as expected increases in expenditures on initiatives to address these trends and other competitive pressures;

- The success of our product plans for 2005 to roll-out new products and product line extensions, and our ability to continue robust product development and manage the complexity of our restaurant operations;
- Our ability to achieve an overall product mix that differentiates the McDonald's experience and balances consumer value with margin expansion, including in markets where cost or pricing pressures may be significant;
- The impact of pricing, marketing and promotional plans on product sales and margins and on our ability to target these efforts effectively to maintain or expand market share;
- The success of initiatives to support menu choice, physical activity and consumer education;
- Our ability to continue to drive service improvements, recruit qualified restaurant personnel and motivate our employees to achieve sustained high service levels throughout the McDonald's System;
- Whether restaurant remodeling and rebuilding efforts will foster sustained increases in comparable sales for the affected restaurants and yield our desired return on our capital investment;
- Our ability to leverage promotional or operating successes in local markets into additional markets in a timely and cost-effective way;
- Our ability to develop effective initiatives in challenging markets, such as the U.K., which is experiencing a contracting informal eating out market, or Germany and South Korea, which are experiencing prolonged adverse economic conditions and low consumer confidence levels;
- Decisions by management to curtail or cease investment in underperforming markets or assets, which can result in material impairment charges that reduce our earnings;
- Unexpected disruptions in our supply chain or adverse consumer perceptions about the reliability of our supply chain and the safety of the commodities we use, particularly beef and chicken;
- The success of our strategy for growth in China and our ability to manage the costs of our development plans in that market, where competitive pressures and other operating conditions may limit pricing flexibility;
- Information security risks, as well as other costs or exposures associated with information security and the use of cashless payments, such as increased investment in technology, costs of compliance with privacy, consumer protection and other laws and consumer credit fraud;
- Our ability to manage the impact on our business of fluctuations in global and local economic conditions, including commodity prices, interest and foreign exchange rates and the effects of governmental initiatives to manage national economic conditions such as consumer spending and inflation rates;
- Changes in accounting principles or practices (or related legal or regulatory interpretations or our critical accounting estimates);
- Adverse results of pending or future litigation challenging our products or the appropriateness or accuracy of our advertising;
- Trends in litigation, such as class actions involving consumers and shareholders and litigation involving labor and employment matters or landlord liability, the relative level of defense costs, which vary from period to period depending on the number, nature and procedural status of pending proceedings and the possibility of settlements or judgements;
- The risks of operating in markets, such as Brazil and China, in which there are significant uncertainties about the application of legal requirements and the enforceability of laws and contractual obligations;
- The costs and other effects of operating in an increasingly regulated environment worldwide, including the costs of compliance with often conflicting regulations in multiple national markets and the impact of new or changing regulation that affects or restricts elements of our business, such as possible changes in regulations relating to advertising to children; and
- Our ability to manage the impact on our business of disruptions such as regional political instability, war, terrorist activities, severe or prolonged adverse weather conditions and health epidemics or pandemics.





Consolidated statement of income

IN MILLIONS, EXCEPT PER SHARE DATA	Years ended December 31, 2004			2003	2002
REVENUES					
Sales by Company-operated restaurants	\$14,223.8	\$12,795.4	\$11,499.6		
Revenues from franchised and affiliated restaurants	4,840.9	4,345.1	3,906.1		
Total revenues	19,064.7	17,140.5	15,405.7		
OPERATING COSTS AND EXPENSES					
Company-operated restaurant expenses					
Food & paper	4,852.7	4,314.8	3,917.4		
Payroll & employee benefits	3,726.3	3,411.4	3,078.2		
Occupancy & other operating expenses	3,520.8	3,279.8	2,911.0		
Franchised restaurants—occupancy expenses	1,003.2	937.7	840.1		
Selling, general & administrative expenses	1,980.0	1,833.0	1,712.8		
Other operating expense, net	441.2	531.6	833.3		
Total operating costs and expenses	15,524.2	14,308.3	13,292.8		
Operating income	3,540.5	2,832.2	2,112.9		
Interest expense—net of capitalized interest of \$4.1, \$7.8 and \$14.3	358.4	388.0	374.1		
Nonoperating (income) expense, net	(20.3)	97.8	76.7		
Income before provision for income taxes and cumulative effect of accounting changes	3,202.4	2,346.4	1,662.1		
Provision for income taxes	923.9	838.2	670.0		
Income before cumulative effect of accounting changes	2,278.5	1,508.2	992.1		
Cumulative effect of accounting changes, net of tax benefits of \$9.4 and \$17.6		(36.8)	(98.6)		
Net income	\$ 2,278.5	\$ 1,471.4	\$ 893.5		
Per common share—basic:					
Income before cumulative effect of accounting changes	\$ 1.81	\$ 1.19	\$.78		
Cumulative effect of accounting changes		(.03)	(.08)		
Net income	\$ 1.81	\$ 1.16	\$.70		
Per common share—diluted:					
Income before cumulative effect of accounting changes	\$ 1.79	\$ 1.18	\$.77		
Cumulative effect of accounting changes		(.03)	(.07)		
Net income	\$ 1.79	\$ 1.15	\$.70		
Dividends per common share	\$.55	\$.40	\$.24		
Weighted-average shares outstanding—basic	1,259.7	1,269.8	1,273.1		
Weighted-average shares outstanding—diluted	1,273.7	1,276.5	1,281.5		

See Notes to consolidated financial statements.

Consolidated balance sheet

IN MILLIONS, EXCEPT PER SHARE DATA

December 31, 2004

2003

ASSETS

Current assets

Cash and equivalents	\$ 1,379.8	\$ 492.8
Accounts and notes receivable	745.5	734.5
Inventories, at cost, not in excess of market	147.5	129.4
Prepaid expenses and other current assets	585.0	528.7

Total current assets

2,857.8 1,885.4

Other assets

Investments in and advances to affiliates	1,109.9	1,089.6
Goodwill, net	1,828.3	1,665.1
Miscellaneous	1,338.4	1,273.2

Total other assets

4,276.6 4,027.9

Property and equipment

Property and equipment, at cost	30,507.8	28,740.2
Accumulated depreciation and amortization	(9,804.7)	(8,815.5)

Net property and equipment

20,703.1 19,924.7

Total assets

\$27,837.5 \$25,838.0

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities

Accounts payable	\$ 714.3	\$ 577.4
Income taxes	331.3	334.2
Other taxes	245.1	222.0
Accrued interest	179.4	193.1
Accrued restructuring and restaurant closing costs	71.5	115.7
Accrued payroll and other liabilities	1,116.7	918.1
Current maturities of long-term debt	862.2	388.0

Total current liabilities

3,520.5 2,748.5

Long-term debt

8,357.3 9,342.5

Other long-term liabilities

976.7 699.8

Deferred income taxes

781.5 1,065.3

Shareholders' equity

Preferred stock, no par value; authorized—165.0 million shares; issued—none

Common stock, \$.01 par value; authorized—3.5 billion shares;
issued—1,660.6 million shares

16.6 16.6

Additional paid-in capital

2,186.0 1,837.5

Unearned ESOP compensation

(82.8) (90.5)

Retained earnings

21,755.8 20,172.3

Accumulated other comprehensive income (loss)

(96.0) (635.5)

Common stock in treasury, at cost; 390.7 and 398.7 million shares

(9,578.1) (9,318.5)

Total shareholders' equity

14,201.5 11,981.9

Total liabilities and shareholders' equity

\$27,837.5 \$25,838.0

See Notes to consolidated financial statements.

Consolidated statement of cash flows

IN MILLIONS	Years ended December 31, 2004	2003	2002
Operating activities			
Net income	\$ 2,278.5	\$ 1,471.4	\$ 893.5
Adjustments to reconcile to cash provided by operations			
Cumulative effect of accounting changes		36.8	98.6
Depreciation and amortization	1,201.0	1,148.2	1,050.8
Deferred income taxes	(171.9)	181.4	(44.6)
Changes in working capital items			
Accounts receivable	(35.9)	64.0	1.6
Inventories, prepaid expenses and other current assets	(14.9)	(30.2)	(38.1)
Accounts payable	86.7	(77.6)	(11.2)
Income taxes	84.2	23.5	139.0
Other accrued liabilities	70.2	(170.7)	309.0
Other (including noncash portion of impairment and other charges)	405.7	622.0	491.5
Cash provided by operations	3,903.6	3,268.8	2,890.1
Investing activities			
Property and equipment expenditures	(1,419.3)	(1,307.4)	(2,003.8)
Purchases of restaurant businesses	(149.7)	(375.8)	(548.4)
Sales of restaurant businesses and property	306.3	390.6	369.5
Other	(120.4)	(77.0)	(283.9)
Cash used for investing activities	(1,383.1)	(1,369.6)	(2,466.6)
Financing activities			
Net short-term borrowings (repayments)	35.9	(533.5)	(606.8)
Long-term financing issuances	225.6	398.1	1,502.6
Long-term financing repayments	(1,077.0)	(756.2)	(750.3)
Treasury stock purchases	(621.0)	(391.0)	(670.2)
Common stock dividends	(695.0)	(503.5)	(297.4)
Proceeds from stock option exercises	580.5	171.2	195.0
Other	(82.5)	(121.9)	115.9
Cash used for financing activities	(1,633.5)	(1,736.8)	(511.2)
Cash and equivalents increase (decrease)	887.0	162.4	(87.7)
Cash and equivalents at beginning of year	492.8	330.4	418.1
Cash and equivalents at end of year	\$ 1,379.8	\$ 492.8	\$ 330.4
Supplemental cash flow disclosures			
Interest paid	\$ 370.2	\$ 426.9	\$ 359.7
Income taxes paid	1,017.6	608.5	572.2

See Notes to consolidated financial statements.

Consolidated statement of shareholders' equity

IN MILLIONS, EXCEPT PER SHARE DATA	Common stock issued		Additional paid-in capital	Unearned ESOP compensation	Retained earnings	Accumulated other comprehensive income (loss)		Common stock in treasury		Total shareholders' equity
	Shares	Amount				Deferred hedging adjustment	Foreign currency translation	Shares	Amount	
Balance at December 31, 2001	1,660.6	\$16.6	\$1,591.2	\$(106.7)	\$18,608.3	\$ (9.3)	\$(1,699.5)	(379.9)	\$(8,912.2)	\$ 9,488.4
Net income					893.5					893.5
Translation adjustments (including tax benefits of \$150.5)							106.7			106.7
Fair value adjustments—cash flow hedges (including tax benefits of \$3.5)						0.8				0.8
Comprehensive income										1,001.0
Common stock cash dividends (\$.24 per share)					(297.4)					(297.4)
ESOP loan payment				7.4						7.4
Treasury stock purchases								(25.6)	(686.9)	(686.9)
Common equity put option expirations and forward contracts settled									500.8	500.8
Stock option exercises and other (including tax benefits of \$61.3)			156.1	0.9				13.1	110.6	267.6
Balance at December 31, 2002	1,660.6	16.6	1,747.3	(98.4)	19,204.4	(8.5)	(1,592.8)	(392.4)	(8,987.7)	10,280.9
Net income					1,471.4					1,471.4
Translation adjustments (including tax benefits of \$203.2)							957.8			957.8
Fair value adjustments—cash flow hedges (including taxes of \$1.6)						8.0				8.0
Comprehensive income										2,437.2
Common stock cash dividends (\$.40 per share)					(503.5)					(503.5)
ESOP loan payment				7.2						7.2
Treasury stock purchases								(18.9)	(438.7)	(438.7)
Stock option exercises and other (including tax benefits of \$20.5)			90.2	0.7				12.6	107.9	198.8
Balance at December 31, 2003	1,660.6	16.6	1,837.5	(90.5)	20,172.3	(0.5)	(635.0)	(398.7)	(9,318.5)	11,981.9
Net income					2,278.5					2,278.5
Translation adjustments (including tax benefits of \$106.3)							554.7			554.7
Fair value adjustments—cash flow hedges (including tax benefits of \$3.3)						(15.2)				(15.2)
Comprehensive income										2,818.0
Common stock cash dividends (\$.55 per share)					(695.0)					(695.0)
ESOP loan payment				7.9						7.9
Treasury stock purchases								(22.2)	(605.3)	(605.3)
Stock option exercises and other (including tax benefits of \$87.3)			348.5	(0.2)				30.2	345.7	694.0
Balance at December 31, 2004	1,660.6	\$16.6	\$2,186.0	\$ (82.8)	\$21,755.8	\$(15.7)	\$ (80.3)	(390.7)	\$(9,578.1)	\$14,201.5

See Notes to consolidated financial statements.

Summary of significant accounting policies

Nature of business

The Company primarily operates and franchises McDonald's restaurants in the food service industry. The Company also operates Boston Market and Chipotle Mexican Grill in the U.S. and has a minority ownership in U.K.-based Pret A Manger. In December 2003, the Company sold its Donatos Pizzeria business.

All restaurants are operated either by the Company, by independent entrepreneurs under the terms of franchise arrangements (franchisees), or by affiliates operating under license agreements.

Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. Substantially all investments in affiliates owned 50% or less (primarily McDonald's Japan) are accounted for by the equity method.

Estimates in financial statements

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications

Certain prior period amounts have been reclassified to conform to current year presentation.

Revenue recognition

The Company's revenues consist of sales by Company-operated restaurants and fees from restaurants operated by franchisees and affiliates. Sales by Company-operated restaurants are recognized on a cash basis. Fees from franchised and affiliated restaurants include continuing rent and service fees, initial fees and royalties received from foreign affiliates and developmental licensees. Continuing fees and royalties are recognized in the period earned. Initial fees are recognized upon opening of a restaurant, which is when the Company has performed substantially all initial services required by the franchise arrangement.

Foreign currency translation

The functional currency of substantially all operations outside the U.S. is the respective local currency, except for a small number of countries with hyperinflationary economies, where the functional currency is the U.S. Dollar.

Advertising costs

Advertising costs included in costs of Company-operated restaurants primarily consist of contributions to advertising cooperatives and were (in millions): 2004-\$619.5; 2003-\$596.7; 2002-\$532.3. Production costs for radio and television advertising, primarily in the U.S., are expensed when the commercials are initially aired. These

production costs as well as other marketing-related expenses included in selling, general & administrative expenses were (in millions): 2004-\$103.1; 2003-\$113.1; 2002-\$115.3. In addition, significant advertising costs are incurred by franchisees through advertising cooperatives in individual markets.

Stock-based compensation

The Company accounts for all stock-based compensation as prescribed by Accounting Principles Board Opinion No. 25. The Company discloses pro forma net income and net income per common share, as provided by Statement of Financial Accounting Standards (SFAS) No.123, as amended by SFAS No.148, *Accounting for Stock-Based Compensation*.

The pro forma information was determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No.123. The fair value of these options was estimated at the date of grant using an option pricing model. For pro forma disclosures, the options' estimated fair value was amortized over their vesting period. The following tables present the pro forma disclosures and the weighted-average assumptions used to estimate the fair value of these options.

Pro forma disclosures

IN MILLIONS, EXCEPT PER SHARE DATA	2004	2003	2002
As reported-net income	\$2,278.5	\$1,471.4	\$893.5
Add: Total stock-based employee compensation included in reported net income, net of related tax effects	6.8	4.4	-
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(156.3)	(224.1)	(251.7)
Pro forma-net income	\$2,129.0	\$1,251.7	\$641.8
Net income per share:			
As reported-basic	\$ 1.81	\$ 1.16	\$.70
Pro forma-basic	\$ 1.69	\$.99	\$.50
As reported-diluted	\$ 1.79	\$ 1.15	\$.70
Pro forma-diluted	\$ 1.68	\$.98	\$.50

Weighted-average assumptions

	2004	2003	2002
Expected dividend yield	1.51%	.75%	.75%
Expected stock price volatility	28.6%	28.1%	27.5%
Risk-free interest rate	3.93%	3.46%	5.25%
Expected life of options IN YEARS	7	7	7
Fair value per option granted	\$ 8.44	\$ 5.09	\$10.88

In December 2004, the FASB issued Statement No. 123(R), *Share-Based Payment*, effective third quarter 2005 for the Company, which is a revision of FASB Statement No.123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach

in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

As permitted by Statement 123, the Company currently accounts for share-based payments to employees using the intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of Statement 123(R)'s fair value method will have an impact on our results of operations.

The Company expects to adopt Statement 123(R) during the first quarter 2005 using the modified-retrospective method restating prior periods. Had the Company adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the table above.

Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under the current rules. This requirement will reduce net operating cash flow and increase net financing cash flow.

Property and equipment

Property and equipment are stated at cost, with depreciation and amortization provided using the straight-line method over the following estimated useful lives: buildings—up to 40 years; leasehold improvements—the lesser of useful lives of assets or lease terms which generally include option periods; and equipment—three to 12 years.

Goodwill

Goodwill represents the excess of cost over the net tangible assets and identifiable intangible assets of acquired restaurant businesses. The Company's goodwill primarily results from purchases of McDonald's restaurants from franchisees and ownership increases in international subsidiaries or affiliates.

In 2001, the FASB issued SFAS No.141, *Business Combinations*, and No.142, *Goodwill and Other Intangible Assets*. SFAS No.141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 and includes guidance on the initial recognition and measurement of goodwill and other intangible assets arising from business combinations. SFAS No. 142, effective January 1, 2002, eliminates the amortization of goodwill (and intangible assets deemed to have indefinite lives) and instead subjects it to annual impairment tests. Other intangible assets continue to be amortized over their useful lives.

Under SFAS No.142, goodwill is generally assigned to the reporting units expected to benefit from the synergies of the combination. If a Company-operated restaurant is sold within 24 months of acquisition, the goodwill associated with the acquisition is written off in its entirety. If a restaurant is sold beyond 24 months from the acquisition, the amount of goodwill written off is based on the relative fair value of the business sold compared to the portion of the reporting unit (defined as each individual country for McDonald's restaurant business as well as each individual non-McDonald's brand) that will be retained.

The annual goodwill impairment test in the fourth quarter compares the fair value of a reporting unit, generally based on discounted future cash flows, with its carrying amount including goodwill. If the carrying amount of a reporting unit exceeds its fair value, an impairment loss is measured as the difference between the fair value of the reporting unit's goodwill and the carrying amount of goodwill.

The Company performed the initial required goodwill impairment test as of January 1, 2002 and recorded a non-cash charge of \$98.6 million after tax (\$0.07 per diluted share) for the cumulative effect of this accounting change. The impaired goodwill resulted primarily from businesses in Argentina, Uruguay and other markets in Latin America and the Middle East, where economies had weakened significantly.

The following table presents the 2004 activity in goodwill by segment.

IN MILLIONS	U.S	Europe	APMEA ⁽¹⁾	Latin America	Canada	Other ⁽²⁾	Consolidated
Balance at December 31, 2003	\$733.0	\$510.7	\$211.6	\$62.3	\$ 96.6	\$50.9	\$1,665.1
Net restaurant purchases	59.6	17.5	4.6	22.4	10.1	—	114.2
Ownership increases in subsidiaries/affiliates	—	—	15.6	4.1	—	2.6	22.3
Impairment charges	—	(2.4)	(25.9)	—	—	—	(28.3)
Currency Translation	—	39.8	8.2	(1.3)	8.3	—	55.0
Balance at December 31, 2004	\$792.6	\$565.6	\$214.1	\$87.5	\$115.0	\$53.5	\$1,828.3

(1) APMEA represents Asia/Pacific, Middle East and Africa.

(2) Other represents non-McDonald's brands.

Long-lived assets

In accordance with SFAS No.144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, long-lived assets are reviewed for impairment annually in the fourth quarter and whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. For purposes of annually reviewing McDonald's restaurant assets for potential impairment, assets are initially grouped together at a television market level in the U.S. and at a country level for each of the international markets. If an indicator of impairment (e.g., negative operating cash flows for the most recent trailing 24-month period) exists for any grouping of assets, an estimate of undiscounted future cash flows produced by each individual restaurant within the asset grouping is compared to its carrying value. If an asset is determined to be impaired, the loss is measured by the excess of the carrying amount of the asset over its fair value as determined by an estimate of discounted future cash flows.

Losses on assets held for disposal are recognized when management has approved and committed to a plan to dispose of the assets, and the assets are available for disposal. Generally, such losses relate to either restaurants that have closed and ceased operations or businesses or restaurants that are available for sale.

Financial instruments

The Company generally borrows on a long-term basis and is exposed to the impact of interest rate changes and foreign currency fluctuations. The Company uses foreign currency denominated debt and derivative instruments to manage the impact of these changes. The Company does not use derivatives with a level of complexity or with a risk higher than the exposures to be hedged and does not hold or issue derivatives for trading purposes.

The counterparties to these agreements consist of a diverse group of financial institutions. The Company continually monitors its positions and the credit ratings of its counterparties and adjusts positions as appropriate. The Company did not have significant exposure to any individual counterparty at December 31, 2004 and has master agreements that contain netting arrangements. Certain of these agreements also require each party to post collateral if credit ratings fall below, or aggregate exposures exceed, certain contractual limits. At December 31, 2004 and 2003, the Company was required to post collateral of \$45.6 million and \$11.6 million, respectively.

SFAS No.133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, requires companies to recognize all derivatives as either assets or liabilities in the balance sheet at fair value. SFAS No.133 also requires companies to designate all derivatives that qualify as hedging instruments as fair value hedges, cash flow hedges or hedges of net investments in foreign operations. This designation is based upon the exposure being hedged.

All derivatives, primarily interest rate exchange agreements and foreign currency exchange agreements, were classified in the Consolidated balance sheet at December 31, 2004 and 2003 respectively, as follows: miscellaneous other

assets—\$101.6 and \$102.4 million; other long-term liabilities (excluding accrued interest)—\$218.1 and \$135.5 million; and accrued payroll and other liabilities—\$16.7 and \$29.2 million.

There was no significant impact to the Company's earnings related to the ineffective portion of any hedging instruments for the three years ended December 31, 2004.

■ Fair value hedges

The Company enters into fair value hedges to reduce the exposure to changes in the fair values of certain assets or liabilities. The types of fair value hedges the Company enters into include: (1) interest rate exchange agreements to convert a portion of its fixed-rate debt to floating-rate debt and (2) foreign currency exchange agreements for the exchange of various currencies and interest rates. The foreign currency exchange agreements are entered into to hedge the currency risk associated with debt and intercompany loans denominated in foreign currencies, and essentially result in floating-rate assets or liabilities denominated in U.S. Dollars or appropriate functional currencies.

For fair value hedges, the gains or losses on derivatives as well as the offsetting gains or losses on the related hedged items are recognized in current earnings.

■ Cash flow hedges

The Company enters into cash flow hedges to reduce the exposure to variability in certain expected future cash flows. The types of cash flow hedges the Company enters into include: (1) interest rate exchange agreements that effectively convert a portion of floating-rate debt to fixed-rate debt and are designed to reduce the impact of interest rate changes on future interest expense, (2) forward foreign exchange contracts and foreign currency options that are designed to protect against the reduction in value of forecasted foreign currency cash flows such as royalties and other payments denominated in foreign currencies, and (3) foreign currency exchange agreements for the exchange of various currencies and interest rates. The foreign currency exchange agreements hedge the currency risk associated with debt and intercompany loans denominated in foreign currencies, and essentially result in fixed-rate assets or liabilities denominated in U.S. Dollars or appropriate functional currencies.

For cash flow hedges, the effective portion of the gains or losses on derivatives is reported in the deferred hedging adjustment component of accumulated other comprehensive income in shareholders' equity and reclassified into earnings in the same period or periods in which the hedged transaction affects earnings. The remaining gain or loss in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized in earnings during the period of change.

The Company recorded after tax adjustments related to cash flow hedges to the deferred hedging adjustment component of accumulated other comprehensive income in shareholders' equity. The Company recorded a net decrease of \$15.2 million for the year ended December 31, 2004

and net increases of \$8.0 million and \$0.8 million for the years ended December 31, 2003 and 2002, respectively. Based on interest rates and foreign currency exchange rates at December 31, 2004, no significant amount of deferred hedging adjustments, after tax, included in accumulated other comprehensive income in shareholders' equity at December 31, 2004, will be recognized in earnings in 2005 as the underlying hedged transactions are realized. The maximum maturity date of any cash flow hedge of forecasted transactions at December 31, 2004 was 15 months, excluding instruments hedging forecasted payments of variable interest on existing financial instruments that have various maturity dates through 2015.

■ *Hedges of net investments in foreign operations*

The Company uses forward foreign exchange contracts and foreign currency denominated debt to hedge its investments in certain foreign subsidiaries and affiliates. Realized and unrealized translation adjustments from these hedges are included in shareholders' equity in the foreign currency translation component of accumulated other comprehensive income and offset translation adjustments on the underlying net assets of foreign subsidiaries and affiliates, which also are recorded in accumulated other comprehensive income.

During the year ended December 31, 2004, the Company recorded a decrease in translation adjustments in accumulated other comprehensive income of \$190.7 million after tax (included in the net increase of \$554.7 million of translation adjustments in the Consolidated statement of shareholders' equity), related primarily to foreign currency denominated debt designated as hedges of net investments. During the years ended December 31, 2003 and 2002, the Company recorded a decrease in translation adjustments in accumulated other comprehensive income of \$378.1 million and \$312.0 million, respectively, after tax, related to hedges of net investments.

Asset retirement obligations

The FASB SFAS No. 143, *Accounting for Asset Retirement Obligations*, became effective January 1, 2003 and requires legal obligations associated with the retirement of long-lived assets to be recognized at their fair value at the time that the obligations are incurred. Upon initial recognition of a liability, the cost is capitalized as part of the related long-lived asset and allocated to expense over the useful life of the asset. In first quarter 2003, the Company recorded a noncash charge of \$36.8 million after tax (\$0.03 per diluted share) related to lease obligations in certain international markets to reflect the cumulative effect of this accounting change. There is not a material effect to the Company's ongoing results of operations or financial position related to SFAS No. 143.

Common equity put options and forward contracts

During 2001, the Company sold 12.2 million common equity put options in connection with its share repurchase program. Premiums received of \$31.8 million were recorded in shareholders' equity as a reduction of the cost of treasury stock purchased. In 2002, 10.1 million common equity

put options were exercised and 2.1 million options expired unexercised, while 21.0 million options were exercised in 2001. The total amount paid to acquire these shares as a result of the options being exercised was \$286 million in 2002 and \$700 million in 2001. No common equity put options were sold in 2004, 2003 or 2002; therefore, at December 31, 2004, 2003 and 2002, there were no common equity put options outstanding.

During 2001, the Company also entered into equity forward contracts in connection with its share repurchase program. The forward contracts for 5.5 million shares settled in March 2002. No additional equity forward contracts were entered into subsequent to March 2002.

Sales of stock by subsidiaries and affiliates

As permitted by Staff Accounting Bulletin No. 51 issued by the Securities and Exchange Commission, when a subsidiary or affiliate sells unissued shares in a public offering, the Company records an adjustment to reflect an increase or decrease in the carrying value of its investment and a resulting nonoperating gain or loss.

Income tax contingencies

The Company like other multi-national companies is regularly audited by federal, state and foreign tax authorities, and tax assessments may arise several years after tax returns have been filed. Accordingly, tax reserves have been recorded when in management's judgement it is not probable that the Company's tax position will ultimately be sustained. While predicting the outcome of the audits involves uncertainty and requires estimates and informed judgements, we believe that the recorded tax liabilities are adequate and appropriate. The judgements and estimates made at a point in time may change based on the outcome of tax audits, as well as changes to or further interpretation of regulations. Income tax expense is adjusted in the period in which these events occur or when the statute of limitations for a specific exposure item has expired.

Per common share information

Diluted net income per common share is calculated using net income divided by diluted weighted-average shares. Diluted weighted-average shares include weighted-average shares outstanding plus the dilutive effect of primarily stock-based employee compensation calculated using the treasury stock method. The dilutive effect of stock options was (in millions of shares): 2004-14.0; 2003-6.7; 2002-8.4. Stock options that were not included in diluted weighted-average shares because they would have been antidilutive were (in millions of shares): 2004-85.5; 2003-159.1; 2002-148.0.

Statement of cash flows

The Company considers short-term, highly liquid investments with a maturity of 90 days or less to be cash equivalents. The impact of fluctuating foreign currencies on cash and equivalents was not material.

Other operating (income) expense, net

IN MILLIONS	2004	2003	2002
Gains on sales of restaurant businesses	\$ (45.0)	\$(54.5)	\$(113.6)
Equity in earnings of unconsolidated affiliates	(60.0)	(36.9)	(24.1)
Other expense	255.8	215.4	117.8
Impairment and other charges:			
Restaurant closings/impairment	130.5	135.5	402.4
Restructuring	-	272.1	266.9
Current year's lease accounting correction	20.8	-	-
Prior years' lease accounting correction	139.1	-	-
Other	-	-	183.9
Total impairment and other charges	290.4	407.6	853.2
Other operating expense, net	\$441.2	\$531.6	\$ 833.3

Other expense

Other expense primarily consists of gains or losses on excess property and other asset dispositions and provisions for uncollectible receivables. Other expense for 2004 also includes certain costs incurred to acquire restaurants operated by litigating franchisees in Brazil and provisions for certain contingencies.

Restaurant closings/impairment

In 2004, the Company recorded \$130.5 million of pretax charges for asset and goodwill impairment, primarily in South Korea driven by its significant decline in performance over the past few years.

In 2003, the \$135.5 million of net charges consisted of: \$147.7 million primarily related to asset/goodwill impairment in Latin America; \$29.6 million for about 50 restaurant closings associated with strategic actions in Latin America; and a \$41.8 million favorable adjustment to the 2002 charge for restaurant closings, primarily due to about 85 fewer closings than originally anticipated.

In 2002, the \$402.4 million of charges consisted of: \$302.3 million related to management's decision to close about 750 underperforming restaurants primarily in the U.S. and Japan; and \$100.1 million primarily related to the impairment of assets for certain existing restaurants in Europe and Latin America.

Restructuring

In 2003, the \$272.1 million of charges consisted of: \$237.0 million related to the loss on the sale of Donatos Pizzeria, the closing of Donatos and Boston Market restaurants outside the U.S. and the exit of a domestic joint venture with Fazoli's; and \$35.1 million related to the revitalization plan actions of McDonald's Japan, including headcount reductions, the closing of Pret A Manger stores in Japan and the early termination of a long-term management services agreement.

In 2002, the \$266.9 million of net charges consisted of: \$201.4 million related to the anticipated transfer of ownership in five countries in the Middle East and Latin America to developmental licensees and ceasing operations in two countries in Latin America; \$80.5 million primarily related to eliminating approximately 600 positions (about half of which were in the U.S. and half of which were in international markets), reallocating resources and consolidating certain home office facilities to control costs; and a \$15.0 million favorable adjustment to the 2001 restructuring charge due to lower employee-related costs than originally anticipated.

Lease accounting correction

Like other companies in the restaurant and retail industries, McDonald's recently reviewed its accounting practices and policies with respect to leasing transactions. Following this review and in consultation with its external auditors, McDonald's has corrected an error in its prior practices to conform the lease term used in calculating straight-line rent expense with the term used to amortize improvements on leased property. The result of the correction is primarily to accelerate the recognition of rent expense under certain leases that include fixed-rent escalations by revising the computation of straight-line rent expense to include these escalations for certain option periods. As the correction relates solely to accounting treatment, it does not affect McDonald's historical or future cash flows or the timing of payments under the related leases and its effect on the Company's current or prior years' earnings per share, cash from operations and shareholders' equity is immaterial. These adjustments primarily impact the U.S., China, Boston Market and Chipotle. Other markets were less significantly impacted, as many of the leases outside of the U.S. do not contain fixed-rent escalations.

Other

In 2002, the \$183.9 million of charges consisted of \$170.0 million primarily related to the write-off of software development costs as a result of management's decision to terminate a long-term technology project; and \$13.9 million primarily related to the write-off of receivables and inventory in Venezuela as a result of the temporary closure of all McDonald's restaurants due to a national strike.

The following table presents the activity included in accrued restructuring and restaurant closing costs in the Consolidated balance sheet.

IN MILLIONS	Liability at Dec 31, 2002	2003 activity			Liability at Dec 31, 2003	2004 activity			Liability at Dec 31, 2004
		Provision	Cash	Noncash		Provision	Cash	Noncash	
Restaurant closings/impairment:									
Asset write-offs	–	\$144.4		\$(144.4)	–	\$130.5		\$(130.5)	–
Lease termination and other	\$128.4	(8.9)	\$ (85.8)		\$ 33.7		\$(16.5)		\$17.2
	128.4	135.5	(85.8)	(144.4)	33.7	130.5	(16.5)	(130.5)	17.2
Restructuring:									
Asset write-offs	–	249.5		(249.5)	–				–
Employee-related costs	72.3		(34.0)		38.3		(12.0)		26.3
Lease termination and other	103.3	22.6	(47.1)	(35.1)	43.7		(15.7)		28.0
	175.6	272.1	(81.1)	(284.6)	82.0		(27.7)		54.3
Other:									
Asset write-offs	–				–				–
Other	24.5		(24.5)		–				–
	24.5		(24.5)		–				–
Total accrued restructuring and restaurant closing costs	\$328.5	\$407.6	\$(191.4)	\$(429.0)	\$115.7	\$130.5	\$(44.2)	\$(130.5)	\$71.5

Employee severance is generally paid in installments over a period of up to one year after termination, and the remaining lease payments for closed facilities will be paid over the next several years.

Franchise arrangements

Individual franchise arrangements generally include a lease and a license and provide for payment of initial fees, as well as continuing rent and service fees to the Company based upon a percent of sales with minimum rent payments that parallel the Company's underlying leases and escalations (on properties that are leased). McDonald's franchisees are granted the right to operate a restaurant using the McDonald's System and, in most cases, the use of a restaurant facility, generally for a period of 20 years. Franchisees pay related occupancy costs including property taxes, insurance and maintenance. In addition, franchisees outside the U.S. generally pay a refundable, noninterest-bearing security deposit. Foreign affiliates and developmental licensees pay a royalty to the Company based upon a percent of sales.

The results of operations of restaurant businesses purchased and sold in transactions with franchisees, affiliates and others were not material to the consolidated financial statements for periods prior to purchase and sale.

Revenues from franchised and affiliated restaurants consisted of:

IN MILLIONS	2004	2003	2002
Rents and service fees	\$4,804.8	\$4,302.1	\$3,855.0
Initial fees	36.1	43.0	51.1
Revenues from franchised and affiliated restaurants	\$4,840.9	\$4,345.1	\$3,906.1

Future minimum rent payments due to the Company under existing franchise arrangements are:

IN MILLIONS	Owned sites	Leased sites	Total
2005	\$ 1,063.4	\$ 811.7	\$ 1,875.1
2006	1,038.9	790.3	1,829.2
2007	1,006.7	772.1	1,778.8
2008	972.2	751.3	1,723.5
2009	933.0	722.9	1,655.9
Thereafter	7,241.7	5,531.7	12,773.4
Total minimum payments	\$12,255.9	\$9,380.0	\$21,635.9

At December 31, 2004, net property and equipment under franchise arrangements totaled \$10.4 billion (including land of \$3.0 billion) after deducting accumulated depreciation and amortization of \$4.8 billion.

Leasing arrangements

At December 31, 2004, the Company was the lessee at 15,235 restaurant locations through ground leases (the Company leases the land and the Company or franchisee owns the building) and through improved leases (the Company leases land and buildings). Lease terms for most restaurants are generally for 20 years and, in many cases, provide for rent escalations and renewal options, with certain leases providing purchase options. Escalation terms vary by geographic segment with examples including fixed-rent escalations, escalations based on an inflation index, and fair-value market adjustments. The timing of these escalations generally ranges from annually to every five years. For most locations, the Company is obligated for the related

occupancy costs including property taxes, insurance and maintenance. However, for franchised sites, the Company requires the franchisees to pay these costs. In addition, the Company is the lessee under noncancelable leases covering certain offices and vehicles.

Future minimum payments required under existing operating leases with initial terms of one year or more are:

IN MILLIONS	Restaurant	Other	Total
2005	\$ 996.0	\$ 65.7	\$ 1,061.7
2006	945.2	54.5	999.7
2007	885.2	43.9	929.1
2008	828.7	36.3	865.0
2009	773.5	33.1	806.6
Thereafter	6,590.6	189.9	6,780.5
Total minimum payments	\$11,019.2	\$423.4	\$11,442.6

The following table provides detail of rent expense:

IN MILLIONS	2004	2003	2002
Company-operated restaurants:			
U.S.	\$ 136.8	\$ 136.9	\$ 124.0
Outside the U.S.	446.0	398.4	358.4
Total	582.8	535.3	482.4
Franchised restaurants:			
U.S.	296.0	279.6	254.4
Outside the U.S.	280.2	250.7	210.9
Total	576.2	530.3	465.3
Other	94.5	87.3	84.8
Total rent expense	\$1,253.5	\$1,152.9	\$1,032.5

Rent expense included percent rents in excess of minimum rents (in millions) as follows—Company-operated restaurants: 2004—\$84.4; 2003—\$73.2; 2002—\$64.1. Franchised restaurants: 2004—\$97.3; 2003—\$80.3; 2002—\$67.2.

The 2004 rent expense above excludes a correction of \$159.9 million (\$20.8 million for the current year and \$139.1 million for prior years) in the Company's lease accounting practices made in 2004. See Other operating expense, net note to the consolidated financial statements for further discussion.

Income taxes

Income before provision for income taxes and cumulative effect of accounting changes, classified by source of income, was as follows:

IN MILLIONS	2004	2003	2002
U.S.	\$1,575.2	\$1,150.8	\$ 876.3
Outside the U.S.	1,627.2	1,195.6	785.8
Income before provision for income taxes and cumulative effect of accounting changes	\$3,202.4	\$2,346.4	\$1,662.1

The provision for income taxes, classified by the timing and location of payment, was as follows:

IN MILLIONS	2004	2003	2002
U.S. federal	\$ 557.9	\$177.9	\$307.0
U.S. state	56.4	58.8	54.6
Outside the U.S.	481.5	420.1	353.0
Current tax provision	\$1,095.8	656.8	714.6
U.S. federal	(178.6)	180.1	(47.4)
U.S. state	10.9	12.6	(7.6)
Outside the U.S.	(4.2)	(11.3)	10.4
Deferred tax provision (benefit)	(171.9)	181.4	(44.6)
Provision for income taxes	\$ 923.9	\$838.2	\$670.0

Net deferred tax liabilities consisted of:

IN MILLIONS	December 31, 2004	2003
Property and equipment	\$ 1,407.9	\$ 1,447.5
Other	211.0	161.5
Total deferred tax liabilities	1,618.9	1,609.0
Intangible assets	(301.5)	(236.2)
Operating loss carryforwards	(269.9)	(228.1)
Employee benefit plans	(134.1)	(123.2)
Property and equipment	(184.4)	(132.5)
Capital loss carryforwards	(182.7)	(197.0)
Unrealized foreign exchange losses	(383.7)	(280.6)
Foreign tax credit carryforwards	(32.2)	(86.9)
Other	(361.8)	(230.5)
Total deferred tax assets before valuation allowance	(1,850.3)	(1,515.0)
Valuation allowance	531.7	483.2
Net deferred tax liabilities	\$ 300.3	\$ 577.2
Balance sheet presentation:		
Deferred income taxes	\$ 781.5	\$ 1,065.3
Other assets—miscellaneous	(380.1)	(312.9)
Current assets—prepaid expenses and other current assets	(101.1)	(175.2)
Net deferred tax liabilities	\$ 300.3	\$ 577.2

The statutory U.S. federal income tax rate reconciles to the effective income tax rates as follows:

	2004	2003	2002
Statutory U.S. federal income tax rate	35.0%	35.0%	35.0%
State income taxes, net of related federal income tax benefit	1.4	2.3	2.2
Benefits and taxes related to foreign operations	(7.6)	(2.7)	(6.3)
Impairment and other charges, net ⁽¹⁾	.5	2.5	8.7
Other, net	(.4)	(1.4)	.7
Effective income tax rates	28.9%	35.7%	40.3%

(1) Certain of these items were not tax effected.

Deferred U.S. income taxes have not been recorded for basis differences related to investments in certain foreign subsidiaries and corporate joint ventures. These basis differences were approximately \$5.5 billion at December 31, 2004 and consisted primarily of undistributed earnings. Other than the potential repatriation of earnings under the new tax law, as described below, these earnings are considered permanently invested in the businesses. Determination of the deferred income tax liability on these unremitted earnings is not practicable because such liability, if any, is dependent on circumstances existing if and when remittance occurs.

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (the "Act"). The Act creates a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85% dividends received deduction for certain dividends from controlled foreign corporations. The deduction is subject to a number of limitations and, as of today, uncertainty remains as to how to interpret numerous provisions in the Act. As such, we have not decided whether, and to what extent, we might repatriate foreign earnings that have not yet been remitted to the U.S. Based on our analysis to date, however, it is reasonably possible that we may repatriate between \$0 and \$3.2 billion, with the respective tax liability ranging from \$0 to \$100 million. We expect to finalize our assessment once clarifying guidance is issued.

Segment and geographic information

The Company operates in the food service industry. Revenues consist of sales by Company-operated restaurants and fees from restaurants operated by franchisees and affiliates. Fees from franchised and affiliated restaurants include continuing rent and service fees, initial fees, and royalties received from foreign affiliates and developmental licensees. All intercompany revenues and expenses are eliminated in computing revenues and operating income. Operating income includes the Company's share of operating results of affiliates after interest expense and income taxes, except for U.S. affiliates, which are reported before income taxes. Royalties and other payments from subsidiaries outside the U.S. were (in millions): 2004—\$781.1, 2003—\$684.5; 2002—\$644.1.

Corporate general & administrative expenses are included in the corporate segment of operating income and consist of home office support costs in areas such as facilities, finance, human resources, information technology, legal, marketing, supply chain management and training. Corporate assets include corporate cash and equivalents, asset portions of financing instruments and home office facilities.

IN MILLIONS	2004	2003	2002
U.S.	\$ 6,525.6	\$ 6,039.3	\$ 5,422.7
Europe	6,736.3	5,874.9	5,136.0
APMEA	2,721.3	2,447.6	2,367.7
Latin America	1,007.9	858.8	813.9
Canada	898.1	777.9	633.6
Other	1,175.5	1,142.0	1,031.8
Total revenues	\$19,064.7	\$17,140.5	\$15,405.7
U.S.	\$ 2,181.4	\$ 1,982.1	\$ 1,673.3
Europe	1,471.1	1,339.1	1,021.8
APMEA	200.4	226.3	64.3
Latin America	(19.6)	(170.9)	(133.4)
Canada	178.0	163.2	125.4
Other	(16.4)	(295.1)	(66.8)
Corporate	(454.4)	(412.5)	(571.7)
Total operating income	\$ 3,540.5 ⁽¹⁾	\$ 2,832.2 ⁽²⁾	\$ 2,112.9 ⁽³⁾
U.S.	\$ 8,551.5	\$ 8,549.2	\$ 8,687.4
Europe	10,389.5	9,462.2	8,333.2
APMEA	3,853.0	3,773.3	3,465.0
Latin America	1,496.6	1,412.4	1,425.5
Canada	1,162.4	1,007.0	770.6
Other	653.7	574.8	780.4
Corporate	1,730.8	1,059.1	731.6
Total assets	\$27,837.5	\$25,838.0	\$24,193.7
U.S.	\$ 486.7	\$ 482.4	\$ 752.7
Europe	445.0	404.8	579.4
APMEA	157.8	122.1	230.4
Latin America	62.6	78.4	119.9
Canada	87.5	63.9	111.6
Other	115.4	132.8	190.4
Corporate	64.3	23.0	19.4
Total capital expenditures	\$ 1,419.3	\$ 1,307.4	\$ 2,003.8
U.S.	\$ 394.6	\$ 395.1	\$ 383.4
Europe	422.6	382.4	334.9
APMEA	165.6	156.5	141.7
Latin America	66.3	64.3	59.6
Canada	51.9	46.7	35.6
Other	51.0	53.1	40.3
Corporate	49.0	50.1	55.3
Total depreciation and amortization	\$ 1,201.0	\$ 1,148.2	\$ 1,050.8

See Other operating expense, net note for further discussion of the following items:

- (1) Includes \$290.4 million of charges (U.S.—\$79.8; Europe—\$27.0; APMEA—\$138.7; Latin America—\$2.1; Canada—\$3.8; and Other—\$39.0) related to a correction in the Company's lease accounting practices and policies and asset/goodwill impairment.
- (2) Includes \$407.6 million of charges (adjustments) [U.S.—(\$11.4); Europe—(\$20.0); APMEA—\$54.9; Latin America—\$108.9; Canada—(\$1.2); Other—\$266.1; and Corporate—\$10.3] primarily related to the disposition of certain non-McDonald's brands and asset/goodwill impairment.
- (3) Includes \$853.2 million of charges (U.S.—\$99.2; Europe—\$147.8; APMEA—\$222.3; Latin America—\$142.3; Canada—\$9.7; Other—\$34.0; and Corporate—\$197.9) primarily related to restructuring markets and eliminating positions, restaurant closings/asset impairment and the write-off of technology costs.

Total long-lived assets, primarily property and equipment, were (in millions)—Consolidated: 2004—\$24,390.8; 2003—\$23,405.9; 2002—\$21,976.6. U.S. based: 2004—\$9,219.0; 2003—\$9,067.2; 2002—\$9,241.2.

Debt financing

Line of credit agreements

At December 31, 2004, the Company had several line of credit agreements with various banks totaling \$1.3 billion, all of which remained unused. Subsequent to year end, the Company renegotiated the agreements into a single \$1.3 billion line of credit agreement expiring in 2010 with fees based on current credit ratings of 0.08% per annum on the total commitment. Fees and interest rates on this line are based on the Company's long-term credit rating assigned by Moody's and Standard & Poor's. In addition, certain subsidiaries outside the U.S. had unused lines of credit totaling \$690.0 million at December 31, 2004; these were principally short-term and denominated in various currencies at local market rates of interest.

The weighted-average interest rate of short-term borrowings was 4.4% at December 31, 2004 (based on \$397.2 million of foreign currency bank line borrowings) and 4.3% at December 31, 2003 (based on \$341.1 million of foreign currency bank line borrowings).

Fair values

At December 31, 2004, the fair value of the Company's debt obligations was estimated at \$9.7 billion, compared to a carrying amount of \$9.2 billion. This fair value was estimated using various pricing models or discounted cash flow analyses that incorporated quoted market prices. The Company has no current plans to retire a significant amount of its debt prior to maturity.

The carrying amounts for both cash and equivalents and notes receivable approximate fair value. Foreign currency and interest rate exchange agreements, foreign currency options and forward foreign exchange contracts were recorded in the Consolidated balance sheet at fair value estimated using various pricing models or discounted cash flow analyses that incorporated quoted market prices. No fair value was estimated for noninterest-bearing security deposits by franchisees, because these deposits are an integral part of the overall franchise arrangements.

Debt obligations

The Company has incurred debt obligations principally through public and private offerings and bank loans. There are no provisions in the Company's debt obligations that would accelerate repayment of debt as a result of a change in credit ratings or a material adverse change in the Company's business. Certain of the Company's debt obligations contain cross-acceleration provisions, and restrictions on Company and subsidiary mortgages and the long-term debt of certain subsidiaries. Under certain agreements, the Company has the option to retire debt prior to maturity, either at par or at a premium over par.

The following table summarizes the Company's debt obligations. (Interest rates reflected in the table include the effects of interest rate and foreign currency exchange agreements.)

IN MILLIONS OF U.S. DOLLARS	Maturity dates	Interest rates ⁽¹⁾ December 31		Amounts outstanding December 31	
		2004	2003	2004	2003
Fixed-original issue ⁽²⁾		4.9%	5.0%	\$ 3,338.1	\$ 3,615.5
Fixed-converted via exchange agreements ⁽³⁾		3.9	4.6	(1,694.9)	(1,503.6)
Floating		2.6	.8	916.1	643.2
Total U.S. Dollars	2005-2028			2,559.3	2,755.1
Fixed		4.2	4.3	1,024.7	895.5
Floating		2.4	2.0	1,867.2	2,217.4
Total Euro	2005-2013			2,891.9	3,112.9
Total British Pounds Sterling- fixed	2005-2032	6.0	6.0	1,147.0	1,258.7
Fixed		7.1	6.1	99.1	131.6
Floating		1.1	.8	275.4	250.1
Total other European currencies ⁽⁴⁾	2005-2007			374.5	381.7
Total Japanese Yen-fixed	2005-2030	1.9	1.9	1,076.4	1,028.1
Fixed		5.6	6.4	195.1	383.4
Floating		4.3	4.2	672.7	489.4
Total other currencies ⁽⁵⁾	2005-2016			867.8	872.8
Debt obligations before fair value adjustments ⁽⁶⁾				8,916.9	9,409.3
Fair value adjustments ⁽⁷⁾				302.6	321.2
Total debt obligations ⁽⁸⁾				\$ 9,219.5	\$ 9,730.5

(1) Weighted-average effective rate, computed on a semiannual basis.

(2) Includes \$150 million of debentures that mature in 2027, which are subordinated to senior debt and provide for the ability to defer interest payments up to five years under certain conditions.

(3) A portion of U.S. Dollar fixed-rate debt effectively has been converted into other currencies and/or into floating-rate debt through the use of exchange agreements. The rates shown reflect the fixed rate on the receivable portion of the exchange agreements. All other obligations in this table reflect the net effects of these and other exchange agreements.

(4) Primarily consists of Swiss Francs, Swedish Kronor and Danish Kroner.

(5) Primarily consists of Korean Won, Chinese Renminbi, Australian Dollars, Hong Kong Dollars, and Singapore Dollars.

(6) Aggregate maturities for 2004 debt balances, before fair value adjustments, were as follows (in millions): 2005-\$862.2; 2006-\$1,262.1; 2007-\$775.6; 2008-\$830.5; 2009-\$420.0; thereafter-\$4,766.5. These amounts include a reclassification of short-term obligations totaling \$1.3 billion to long-term obligations as they are supported by a long-term line of credit agreement expiring in 2010.

(7) SFAS No. 133 requires that the underlying items in fair value hedges, in this case debt obligations, be recorded at fair value. The related hedging instrument is also recorded at fair value in either miscellaneous other assets or other long-term liabilities. A portion (\$106.4 million) of the adjustments at December 31, 2004 related to interest rate exchange agreements that were terminated in December 2002 and will amortize as a reduction of interest expense over the remaining life of the debt.

(8) Includes current maturities of long-term debt and long-term debt included in the Consolidated balance sheet. The decrease in debt obligations from December 31, 2003 to December 31, 2004 was due to net repayments (\$815.5 million) and SFAS No. 133 non-cash fair value adjustments (\$18.6 million), partly offset by the impact of changes in exchange rates on foreign currency denominated debt (\$323.1 million).

ESOP loans and other guarantees

At December 31, 2004, the Company has guaranteed and included in total debt \$7.5 million of Notes issued by the Leveraged Employee Stock Ownership Plan (ESOP) with payments through 2006. Borrowings related to the ESOP at December 31, 2004, which include \$85.9 million of loans from the Company to the ESOP and the \$7.5 million of Notes guaranteed by the Company, are reflected as long-term debt with a corresponding reduction of shareholders' equity (unearned ESOP compensation). The ESOP is repaying the loans and interest through 2018 using Company contributions and dividends from its McDonald's common stock holdings. As the principal amount of the borrowings is repaid, the debt and the unearned ESOP compensation are being reduced.

The Company also has guaranteed certain affiliate and other loans totaling \$69.9 million at December 31, 2004. These guarantees are contingent commitments generally issued by the Company to support borrowing arrangements of certain U.S. partnerships and franchisees, and certain affiliates. The terms of the guarantees vary and are equal to the remaining term of the related debt. At December 31, 2004, there was no carrying value for obligations under these guarantees in the Consolidated balance sheet.

Employee benefit plans

The Company's Profit Sharing and Savings Plan for U.S.-based employees includes profit sharing, 401(k) and leveraged employee stock ownership (ESOP) features. The 401(k) feature allows participants to make pretax contributions that are partly matched from shares released under the ESOP. McDonald's executives, staff and restaurant managers participate in any additional ESOP allocations and profit sharing contributions, based on their compensation. The profit sharing contribution is discretionary, and the Company determines the amount each year.

Effective March 31, 2003, all contributions and related earnings can be invested in McDonald's common stock or among several other investment alternatives in accordance with each participant's elections. Prior to March 31, 2003, ESOP allocations and earnings were generally invested in McDonald's common stock and all other contributions and related earnings could be among several investment alternatives, including McDonald's common stock.

In addition, the Company maintains a nonqualified, unfunded Supplemental Plan that allows participants to (i) make tax-deferred contributions and (ii) receive Company-provided allocations that cannot be made under the Profit Sharing and Savings Plan because of Internal Revenue Service limitations. The investment alternatives and returns in the Supplemental Plan are based on certain market-rate investment alternatives under the Profit Sharing and Savings Plan. Total liabilities under the Supplemental Plan were \$350.2 million at December 31, 2004 and \$329.3 million at December 31, 2003 and were included in other long-term liabilities in the Consolidated balance sheet.

The Company has entered into derivative contracts to hedge market-driven changes in certain of the Supplemental Plan liabilities. At December 31, 2004, derivatives with a fair value of \$66.8 million indexed to the Company's stock and \$54.7 million indexed to certain market indices were included in miscellaneous other assets in the Consolidated balance sheet. All changes in Plan liabilities and in the fair value of the derivatives are recorded in selling, general & administrative expenses. Changes in fair value of the derivatives indexed to the Company's stock are recorded in the income statement because the contracts provide the counterparty with a choice to settle in cash or shares.

Total U.S. costs for the Profit Sharing and Savings Plan, including nonqualified benefits and related hedging activities, were (in millions): 2004—\$58.5; 2003—\$60.3; 2002—\$50.1.

Certain subsidiaries outside the U.S. also offer profit sharing, stock purchase or other similar benefit plans. Total plan costs outside the U.S. were (in millions): 2004—\$47.8; 2003—\$43.9; 2002—\$36.8.

Other postretirement benefits and postemployment benefits, excluding severance benefits related to the 2002 restructuring charge, were immaterial.

Property and equipment

Net property and equipment consisted of:

<i>IN MILLIONS</i>	December 31, 2004	2003
Land	\$ 4,661.1	\$ 4,483.0
Buildings and improvements on owned land	10,260.3	9,693.4
Buildings and improvements on leased land	10,520.7	9,792.1
Equipment, signs and seating	4,426.1	4,090.5
Other	639.6	681.2
	30,507.8	28,740.2
Accumulated depreciation and amortization	(9,804.7)	(8,815.5)
Net property and equipment	\$20,703.1	\$19,924.7

Depreciation and amortization expense was (in millions): 2004—\$1,138.3; 2003—\$1,113.3; 2002—\$971.1.

Stock-based compensation

At December 31, 2004, the Company had stock-based compensation plans for employees and nonemployee directors which authorized the granting of various equity-based incentives including stock options, restricted stock and restricted stock units. The number of shares of common stock reserved for issuance under the plans was 224.1 million at December 31, 2004, including 57.2 million available for future grants.

Stock options

Options to purchase common stock are granted at the fair market value of the stock on the date of grant. Substantially all of the options become exercisable in four equal installments, beginning a year from the date of the grant, and generally expire 10 years from the grant date. Approximately 44 million options granted between May 1, 1999 and December 31, 2000 expire 13 years from the date of grant.

In 2001, the Board of Directors approved a special grant of 11.9 million options at a price of \$28.90 as an incentive to meet an operating income performance goal for calendar year 2003. The options vested on January 31, 2004 and substantially all expired on June 30, 2004 because the Company did not meet the performance goal.

A summary of the status of the Company's stock option grants as of December 31, 2004, 2003 and 2002, and changes during the years then ended, is presented in the following table.

Options	2004		2003		2002	
	Shares IN MILLIONS	Weighted- average exercise price	Shares IN MILLIONS	Weighted- average exercise price	Shares IN MILLIONS	Weighted- average exercise price
Outstanding at beginning of year	194.2	\$26.90	198.9	\$27.57	192.9	\$26.65
Granted	20.1	26.10	23.6	14.96	26.3	28.26
Exercised	(30.0)	20.16	(12.6)	15.19	(13.1)	14.91
Forfeited/expired	(17.4)	28.99	(15.7)	27.07	(7.2)	29.22
Outstanding at end of year	166.9	\$27.80	194.2	\$26.90	198.9	\$27.57
Exercisable at end of year	114.7		122.9		110.9	

Options granted each year were 1.6%, 1.9% and 2.1% of weighted-average common shares outstanding for 2004, 2003 and 2002, respectively, representing grants to approximately 13,000, 14,300, and 13,900 employees in those three years.

The following table presents information related to options outstanding and options exercisable at December 31, 2004, based on ranges of exercise prices.

Range of exercise prices	Options outstanding			Options exercisable	
	Number of options IN MILLIONS	Weighted-average remaining contractual life IN YEARS	Weighted-average exercise price	Number of options IN MILLIONS	Weighted-average exercise price
\$14 to 24	48.2	4.1	\$19.77	32.6	\$21.98
25 to 27	38.0	6.0	26.11	15.5	26.24
28 to 34	41.3	6.4	29.18	27.2	29.24
35 to 46	39.4	7.4	37.80	39.4	37.80
\$14 to 46	166.9	5.9	\$27.80	114.7	\$29.71

Restricted stock/restricted stock units

The Company granted 0.2 million restricted stock units (RSUs) in 2004, a majority of which have performance conditions, and 1.8 million in 2003. The RSUs generally vest 100% at the end of three years and are payable in either shares of common stock or cash, at the Company's option. At December 31, 2004, 1.7 million remained outstanding. Compensation expense related to the RSUs is amortized over the vesting period in selling, general & administrative expenses in the Consolidated statement of income.

Quarterly results (unaudited)

IN MILLIONS, EXCEPT PER SHARE DATA	Quarters ended December 31		Quarters ended September 30		Quarters ended June 30		Quarters ended March 31	
	2004	2003	2004	2003	2004	2003	2004	2003
Revenues								
Sales by Company-operated restaurants	\$3,764.1	\$3,398.4	\$3,664.8	\$3,351.2	\$3,511.9	\$3,189.7	\$3,283.0	\$2,856.1
Revenues from franchised and affiliated restaurants	1,246.2	1,157.0	1,260.9	1,153.4	1,217.1	1,091.1	1,116.7	943.6
Total revenues	5,010.3	4,555.4	4,925.7	4,504.6	4,729.0	4,280.8	4,399.7	3,799.7
Company-operated margin	563.5	486.4	578.5	510.6	526.4	445.7	455.6	346.7
Franchised margin	988.0	909.6	1,008.0	917.4	971.4	860.1	870.3	720.3
Operating income	617.3⁽¹⁾	367.5⁽³⁾	1,098.9	963.9	965.9	826.2	858.4	674.6
Income before cumulative effect of accounting change	\$ 397.9⁽²⁾	\$ 125.7⁽³⁾	\$ 778.4⁽⁴⁾	\$ 547.4	\$ 590.7	\$ 470.9	\$ 511.5	\$ 364.2
Cumulative effect of accounting change, net of tax								(36.8)
Net income	\$ 397.9⁽²⁾	\$ 125.7⁽³⁾	\$ 778.4⁽⁴⁾	\$ 547.4	\$ 590.7	\$ 470.9	\$ 511.5	\$ 327.4
Per common share—basic:								
Income before cumulative effect of accounting change	\$.31⁽²⁾	\$.10⁽³⁾	\$.62⁽⁴⁾	\$.43	\$.47	\$.37	\$.41	\$.29
Cumulative effect of accounting change								(.03)
Net income	\$.31⁽²⁾	\$.10⁽³⁾	\$.62⁽⁴⁾	\$.43	\$.47	\$.37	\$.41	\$.26
Per common share—diluted:								
Income before cumulative effect of accounting change	\$.31⁽²⁾	\$.10⁽³⁾	\$.61⁽⁴⁾	\$.43	\$.47	\$.37	\$.40	\$.29
Cumulative effect of accounting change								(.03)
Net income	\$.31⁽²⁾	\$.10⁽³⁾	\$.61⁽⁴⁾	\$.43	\$.47	\$.37	\$.40	\$.26
Dividends declared per common share	\$ —	\$ —	\$.55	\$.40	\$ —	\$ —	\$ —	\$ —
Weighted-average shares—basic	1,264.3	1,266.2	1,256.7	1,271.5	1,256.0	1,272.5	1,261.7	1,269.6
Weighted-average shares—diluted	1,280.9	1,277.9	1,268.4	1,281.0	1,268.0	1,277.5	1,275.5	1,270.3
Market price per common share:								
High	\$ 32.96	\$ 27.01	\$ 28.25	\$ 24.37	\$ 29.43	\$ 22.95	\$ 29.98	\$ 17.38
Low	27.31	23.01	25.64	20.40	25.05	13.88	24.54	12.12
Close	32.06	24.83	28.03	23.54	26.00	22.06	28.57	14.46

(1) Includes the following pretax charges totaling \$0.08 per share each:

- > \$159.9 million (\$104.5 million after tax) related to a correction in the Company's lease accounting practices and policies.
- > \$117.2 million (\$107.6 million after tax) related to asset/goodwill impairment primarily in South Korea.

(2) Includes net pretax charges of \$227.8 million (\$180.1 million after tax or \$0.14 per share) consisting of the \$277.1 million pretax charges discussed in note 1 above and a \$49.3 million nonoperating gain related to the sale of the Company's interest in a U.S. real estate partnership.

(3) Includes the following net charges totaling \$0.25 per share:

- > \$272.1 million (\$183.2 million after tax) related to the disposition of certain non-McDonald's brands and the revitalization plan actions of our Japanese affiliate.
- > \$135.5 million (\$140.0 million after tax) primarily related to asset/goodwill impairment mainly in Latin America, restaurant closings associated with strategic actions in Latin America and a favorable adjustment to the 2002 charge for restaurant closings, primarily due to about 85 fewer closings than originally anticipated.

(4) The effective income tax rate for the third quarter of 2004 benefited from an international transaction and the utilization of certain previously unrealized capital loss carryforwards (the Company was able to reverse a valuation allowance related to the carryforwards due to the gain discussed in note 2 above).

Management's Report

Management is responsible for the preparation, integrity and fair presentation of the consolidated financial statements and Notes to the consolidated financial statements. The financial statements were prepared in accordance with the accounting principles generally accepted in the U.S. and include certain amounts based on management's judgement and best estimates. Other financial information presented is consistent with the financial statements.

Management is also responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is designed under the supervision of the Company's principal executive and financial officers in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that:

- (i) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the Company;
- (ii) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- (iii) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

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

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on our assessment and those criteria, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2004.

The Company's independent registered public accounting firm, Ernst & Young LLP, has issued an attestation report on management's assessment of the Company's internal control over financial reporting. That report appears on page 46 of this Report and expresses unqualified opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting.

McDonald's Corporation

February 22, 2005

The Board of Directors and Shareholders
McDonald's Corporation

We have audited the accompanying Consolidated balance sheets of McDonald's Corporation as of December 31, 2004 and 2003, and the related Consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of McDonald's Corporation management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of McDonald's Corporation at December 31, 2004 and 2003, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

As discussed in the Notes to the consolidated financial statements, effective January 1, 2003, the Company changed its method for accounting for asset retirement obligations to conform with SFAS No.143, *Accounting for Asset Retirement Obligations*. Effective January 1, 2002, the Company changed its method for accounting for goodwill to conform with SFAS No.142, *Goodwill and Other Intangible Assets*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of McDonald's Corporation's internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 22, 2005 expressed an unqualified opinion thereon.

Ernst & Young LLP

Chicago, Illinois
February 22, 2005

Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting

We have audited management's assessment, included in the accompanying Management's Report, that McDonald's Corporation maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Standards Board (United States), the Consolidated balance sheets of McDonald's Corporation as of December 31, 2004 and 2003, and the related Consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2004 and our report dated February 22, 2005 expressed an unqualified opinion thereon.

Ernst & Young LLP

Chicago, Illinois
February 22, 2005

Exhibit A. McDonald's Corporation One-year Return on Incremental Invested Capital (ROIIC)

Return on incremental invested capital (ROIIC) is a measure reviewed by management to determine the effectiveness of capital deployed. One-year ROIIC is calculated as a percentage. The numerator is the Company's constant rate (constant rate excludes the impact of foreign currency translation) incremental operating income plus depreciation and amortization, based on a comparison of the current and prior year periods. The denominator is the constant rate weighted average adjusted cash used for investing activities during the two-year period. Adjusted cash used for investing activities is defined as cash used for investing activities less net cash (collections) and issuances of notes receivable, which do not generate operating income. Constant rate weighted average adjusted cash used for investing activities is based on a weighting applied on a quarterly basis detailed in the following table.

AS A PERCENT	2004	2003
Weightings:		
Quarters ended March 31	87.5%	12.5%
Quarters ended June 30	62.5	37.5
Quarters ended September 30	37.5	62.5
Quarters ended December 31	12.5	87.5

In determining the denominator used to calculate one-year ROIIC, weightings are applied to adjusted cash used for investing activities for each of the eight quarters in the applicable two-year period. These weightings reflect the relative contribution of each quarter's investing activities to constant rate incremental operating income. Thus, the weighting assigned in the first quarter of 2003 is substantially less than that assigned to the comparable 2004 period. Once the weightings are applied to the adjusted cash used for investing activities in each quarter, the results are aggregated to arrive at the one-year weighted average adjusted cash used for investing activities. Management believes that weighting cash used for investing activities provides a more accurate reflection of the relationship between its investments and returns than a simple average.

The reconciliations to the most comparable measurements, in accordance with accounting principles generally accepted in the U.S., for the numerator and denominator of ROIIC are as follows:

	Years ended December 31, 2004	2003	Incremental change
NUMERATOR:			
Operating income	\$3,540.5	\$2,832.2	\$ 708.3
Depreciation and amortization	1,201.0	1,148.2	52.8
Effect of currency translation ⁽¹⁾			(258.3)
Constant rate incremental operating income plus depreciation and amortization			\$ 502.8
DENOMINATOR:			
Cash used for investing activities	\$1,383.1	\$1,369.6	
Less: Net cash (collection)/issuances of notes receivable	(11.2)	(2.1)	
Adjusted cash used for investing activities	\$1,394.3	\$1,371.7	
Weighted average adjusted cash used for investing activities ⁽²⁾	\$1,233.2		
Effect of currency translation ⁽¹⁾	(6.3)		
Constant rate weighted average adjusted cash used for investing activities⁽²⁾	\$1,226.9		
One-year ROIIC⁽³⁾			41.0%

(1) Represents the effect of foreign currency translation by translating results at an average exchange rate for the periods presented.

(2) Represents one-year adjusted cash used for investing activities, determined by applying the weightings described above to each quarter in the two-year period ended December 31, 2004.

(3) The decrease in impairment and other charges included in the increase in operating income between 2004 and 2003 benefited ROIIC by 10 percentage points.

Executive Officers

The following list sets forth the names of our Executive Officers, their ages and their positions as of March 4, 2005:

Ralph Alvarez

Age: 49. President, McDonald's North America

M. Lawrence Light

Age: 63. Corporate Executive Vice President—Global Chief Marketing Officer

Matthew H. Paull

Age: 53. Corporate Senior Executive Vice President and Chief Financial Officer

David M. Pojman

Age: 45. Corporate Senior Vice President—Controller

Michael J. Roberts

Age: 54. President and Chief Operating Officer

Gloria Santona

Age: 54. Corporate Executive Vice President, General Counsel and Secretary

James A. Skinner

Age: 60. Vice Chairman and Chief Executive Officer

Russell P. Smyth

Age: 48. President, McDonald's Europe

Available information

The Company's then Chief Executive Officer, Charles H. Bell, certified to the New York Stock Exchange (NYSE) on June 16, 2004, pursuant to Section 303A.12 of the NYSE's listing standards, that he was not aware of any violation by the Company of the NYSE's corporate governance listing standards as of that date.

Copies of Certifications dated March 4, 2005 of the Company's Chief Executive Officer, James A. Skinner, and Chief Financial Officer, Matthew H. Paull, pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, are attached as Exhibits 31.1 and 31.2, respectively, to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004. Shareholders may obtain a copy of these certifications and/or a complete copy of the Company's Annual Report on Form 10-K by going to the investor section of McDonald's website at www.mcdonalds.com, by going to the SEC's website at www.sec.gov or by calling us at 1-630-623-7428. This information is also available at no charge by sending a request to the Company's Investor Relations Service Center, Department 300, McDonald's Plaza, Oak Brook, Illinois 60523.

McDonald's Annual Report on Form 10-K

This financial report was excerpted from the Company's Annual Report on Form 10-K for the period ended December 31, 2004, that was filed with the Securities and Exchange Commission (SEC) on March 4, 2005. Shareholders may obtain a complete copy of the Company's 2004 Annual Report to the SEC on Form 10-K by going to the investor section of McDonald's website at www.mcdonalds.com, by going to the SEC's website at www.sec.gov or by calling us at 1-630-623-7428. This information is also available at no charge by sending a request to the Company's Investor Relations Service Center, Department 300, McDonald's Plaza, Oak Brook, Illinois 60523.

Home Office

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