

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders of  
Foot Locker, Inc.:

We have audited the accompanying consolidated balance sheets of Foot Locker, Inc. and subsidiaries as of February 2, 2008 and February 3, 2007, and the related consolidated statements of operations, comprehensive income, shareholders' equity, and cash flows for each of the years in the three-year period ended February 2, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Foot Locker, Inc. and subsidiaries as of February 2, 2008 and February 3, 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended February 2, 2008 in conformity with U.S. generally accepted accounting principles.

As discussed in the Notes to Consolidated Financial Statements, effective February 4, 2007, the Company adopted Statement of Financial Accounting Standards Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes." Effective February 3, 2007, the Company adopted Statement of Financial Accounting Standards ("SFAS") No 158, "Employers' Accounting for Defined Benefit Pension and Other Post Retirement Plans – An Amendment of FASB Statements No. 87, 88, 106, and 132(R)." In addition, effective January 29, 2006, the Company adopted SFAS No. 123(R), "Share-Based Payment," and SFAS No. 151, "Inventory Costs – An Amendment of ARB No. 43, Chapter 4," as well as changed their method for quantifying errors based on SEC Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements."

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Foot Locker, Inc.'s internal control over financial reporting as of February 2, 2008, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 31, 2008 expressed an unqualified opinion on the effectiveness of internal control over financial reporting.

**KPMG LLP**

New York, New York  
March 31, 2008

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	<u>2007</u>	<u>2006</u> (in millions)	<u>2005</u>
<b>Net income</b> .....	\$ 51	\$ 251	\$ 264
<i>Other comprehensive income, net of tax</i>			
<i>Foreign currency translation adjustment:</i>			
Translation adjustment arising during the period, net of tax .....	60	27	(25)
<i>Cash flow hedges:</i>			
Change in fair value of derivatives, net of income tax .....	1	—	2
Reclassification adjustments, net of income tax .....	<u>—</u>	<u>—</u>	<u>(1)</u>
<i>Net change in cash flow hedges:</i> .....	1	—	1
<i>Minimum pension liability adjustment:</i>			
Minimum pension liability adjustment, net of deferred tax expense of \$-, \$120 and \$10 million, respectively .....	—	181	15
Pension and postretirement plan adjustments, net of income tax benefit of \$11 million .....	(20)	—	—
Unrealized loss on available-for-sale securities .....	<u>(2)</u>	<u>—</u>	<u>—</u>
<b>Comprehensive income</b> .....	<u>\$ 90</u>	<u>\$ 459</u>	<u>\$ 255</u>

See Accompanying Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	2007		2006		2005	
	Shares	Amount	Shares	Amount	Shares	Amount
	(shares in thousands, amounts in millions)					
<b>Common Stock and Paid-In Capital</b>						
Par value \$0.01 per share, 500 million shares authorized						
Issued at beginning of year	157,810	\$ 653	157,280	\$ 635	156,155	\$ 608
Restricted stock issued under stock option and award plans	513	—	—	(3)	225	—
Forfeitures of restricted stock	—	—	—	—	—	2
Share-based compensation expense	—	10	—	10	—	6
Issued under director and employee stock plans, net of tax	674	13	530	11	900	19
Issued at end of year	<u>158,997</u>	<u>676</u>	<u>157,810</u>	<u>653</u>	<u>157,280</u>	<u>635</u>
Common stock in treasury at beginning of year	(2,107)	(47)	(1,776)	(38)	(64)	(2)
Reissued under employee stock plans	—	—	122	3	90	2
Restricted stock issued under stock option and award plans	—	—	157	3	—	—
Forfeitures/cancellations of restricted stock	(25)	—	(30)	(1)	(135)	(2)
Shares of common stock used to satisfy tax withholding obligations	(95)	(2)	(241)	(6)	(49)	(1)
Stock repurchases	(2,283)	(50)	(334)	(8)	(1,590)	(35)
Exchange of options	(13)	—	(5)	—	(28)	—
Common stock in treasury at end of year	<u>(4,523)</u>	<u>(99)</u>	<u>(2,107)</u>	<u>(47)</u>	<u>(1,776)</u>	<u>(38)</u>
	<u>154,474</u>	<u>577</u>	<u>155,703</u>	<u>606</u>	<u>155,504</u>	<u>597</u>
<b>Retained Earnings</b>						
Balance at beginning of year		1,785		1,601		1,386
Cumulative effect of adjustments resulting from the adoption of SAB 108, net of tax (see note 3)		—		(6)		—
Cumulative effect of adjustments resulting from the adoption of FIN 48, net of tax (see note 1)		1		—		—
Adjusted balance at beginning of year		1,786		1,595		1,386
Net income		51		251		264
Cash dividends declared on common stock \$0.50, \$0.40 and \$0.32 per share, respectively		(77)		(61)		(49)
Balance at end of year		<u>1,760</u>		<u>1,785</u>		<u>1,601</u>
<b>Accumulated Other Comprehensive Loss</b>						
<i>Foreign Currency Translation Adjustment</i>						
Balance at beginning of year		37		10		35
Translation adjustment arising during the period, net of tax		60		27		(25)
Balance at end of year		<u>97</u>		<u>37</u>		<u>10</u>
<i>Cash Flow Hedges</i>						
Balance at beginning of year		—		—		(1)
Change during year, net of tax		1		—		1
Balance at end of year		<u>1</u>		<u>—</u>		<u>—</u>
<i>Minimum Pension Liability Adjustment</i>						
Balance at beginning of year		—		(181)		(196)
Change during year, net of tax		—		181		15
Balance at end of year		<u>—</u>		<u>—</u>		<u>(181)</u>
<i>Pension Adjustments</i>						
Balance at beginning of year		(133)		—		—
Adoption of SFAS No. 158		—		(133)		—
Change during year, net of tax		(29)		—		—
Balance at end of year		<u>(162)</u>		<u>(133)</u>		<u>—</u>
Unrealized loss on available-for-sale securities		(2)		—		—
Total Accumulated Other Comprehensive Loss		<u>(66)</u>		<u>(96)</u>		<u>(171)</u>
Total Shareholders' Equity		<u>\$ 2,271</u>		<u>\$ 2,295</u>		<u>\$ 2,027</u>

See Accompanying Notes to Consolidated Financial Statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**1. Summary of Significant Accounting Policies***Cash and Cash Equivalents*

The Company considers all highly liquid investments with original maturities of three months or less, including commercial paper and money market funds, to be cash equivalents. Amounts due from third party credit card processors for the settlement of debit and credit cards transactions are included as cash equivalents as they are generally collected within three business days. Cash equivalents at February 2, 2008 and February 3, 2007 were \$472 million and \$208 million, respectively.

*Short-Term Investments*

The Company accounts for its short-term investments in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." At February 2, 2008, the Company's auction rate security was classified as available-for-sale, and accordingly is reported at fair value. Auction rate securities are perpetual preferred or long-dated securities whose dividend/coupon resets periodically through a Dutch auction process. A Dutch auction is a competitive bidding process designed to determine a rate for the next term. As of February 2, 2008, the carrying value of the Company's short-term investment of \$7 million was reduced by \$2 million. The unrealized loss of \$2 million was recorded to accumulated comprehensive loss without tax benefit. There were no unrealized gains or losses recognized in 2006 and 2005. Realized losses recognized in 2007 were not significant.

*Merchandise Inventories and Cost of Sales*

Merchandise inventories for the Company's Athletic Stores are valued at the lower of cost or market using the retail inventory method. Cost for retail stores is determined on the last-in, first-out (LIFO) basis for domestic inventories and on the first-in, first-out (FIFO) basis for international inventories. The retail inventory method is commonly used by retail companies to value inventories at cost and calculate gross margins due to its practicality. Under the retail method, cost is determined by applying a cost-to-retail percentage across groupings of similar items, known as departments. The cost-to-retail percentage is applied to ending inventory at its current owned retail valuation to determine the cost of ending inventory on a department basis. The Company provides reserves based on current selling prices when the inventory has not been marked down to market. Merchandise inventories of the Direct-to-Customers business are valued at the lower of cost or market using weighted-average cost, which approximates FIFO. Transportation, distribution center and sourcing costs are capitalized in merchandise inventories. In 2006, the Company adopted SFAS No. 151, "Inventory Costs- An Amendment of ARB 43, Chapter 4." This standard amends the guidance to clarify that abnormal amount of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges. With the adoption of this standard the Company no longer capitalized the freight associated with transfers between its store locations. The Company maintains an accrual for shrinkage based on historical rates.

Cost of sales is comprised of the cost of merchandise, occupancy, buyers' compensation and shipping and handling costs. The cost of merchandise is recorded net of amounts received from vendors for damaged product returns, markdown allowances and volume rebates, as well as cooperative advertising reimbursements received in excess of specific, incremental advertising expenses. Occupancy reflects the amortization of amounts received from landlords for tenant improvements.

#### *Fair Value of Financial Instruments*

The fair value of financial instruments is determined by reference to various market data and other valuation techniques as appropriate. The carrying value of cash and cash equivalents, and other current receivables and payables approximates fair value due to the short-term nature of these assets and liabilities. Quoted market prices of the same or similar instruments are used to determine fair value of long-term debt and forward foreign exchange contracts. Discounted cash flows are used to determine the fair value of long-term investments and notes receivable if quoted market prices on these instruments are unavailable.

#### *Income Taxes*

On February 4, 2007, the Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). Interpretation No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Upon the adoption of FIN 48, the Company recognized a \$1 million increase to retained earnings to reflect the change of its liability for the unrecognized income tax benefits as required. At February 4, 2007, the total amount of gross unrecognized tax benefits was \$33 million. The Company recognizes interest and penalties related to unrecognized tax benefits in income tax expense.

The Company determines its deferred tax provision under the liability method, whereby deferred tax assets and liabilities are recognized for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts using presently enacted tax rates. Deferred tax assets are recognized for tax credits and net operating loss carryforwards, reduced by a valuation allowance, which is established when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

A taxing authority may challenge positions that the Company adopted in its income tax filings. Accordingly, the Company may apply different tax treatments for transactions in filing its income tax returns than for income tax financial reporting. The Company regularly assesses its tax position for such transactions and records reserves for those differences when considered necessary.

Provision for U.S. income taxes on undistributed earnings of foreign subsidiaries is made only on those amounts in excess of the funds considered to be permanently reinvested.

#### *Pension and Postretirement Obligations*

The discount rate selected to measure the present value of the Company's U.S. benefit obligations as of February 2, 2008 was derived using a cash flow matching method whereby the Company compares the plans' projected payment obligations by year with the corresponding yield on the Citibank Pension Discount Curve. The cash flows are then discounted to their present value and an overall discount rate is determined. The discount rate selected to measure the present value of the Company's Canadian benefit obligations as of February 2, 2008 was developed by using the plan's bond portfolio indices which match the benefit obligations.

#### *Insurance Liabilities*

The Company is primarily self-insured for health care, workers' compensation and general liability costs. Accordingly, provisions are made for the Company's actuarially determined estimates of discounted future claim costs for such risks for the aggregate of claims reported and claims incurred but not yet reported. Self-insured liabilities totaled \$17 million and \$16 million at February 2, 2008 and February 3, 2007. The Company discounts its workers' compensation and general liability using a risk-free interest rate. Imputed interest expense related to these liabilities was \$1 million in each of 2007, 2006 and 2005.

Additionally, in the third quarter of 2007, the Company identified 66 unproductive stores for closure. Accordingly, the Company evaluated the recoverability of long-lived assets considering the revised estimated future cash flows. The Company recorded an additional non-cash impairment charge of \$7 million as a result of this analysis. Of the total stores identified for closure in the third quarter of 2007, 13 will remain in operation as the Company was able to negotiate more favorable lease terms. Exit costs related to 33 stores which closed during 2007, comprising primarily lease termination costs of \$4 million, were recognized in accordance with SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." During 2008, the Company currently expects to close the remaining 20 unproductive stores prior to normal lease expiration, depending on the Company's success in negotiating agreements with its landlords. The lease exit costs associated with these remaining closures is expected to total \$5 million to \$10 million. These charges will be recorded during 2008 in accordance with SFAS No. 146. The cash impact of the 2008 store closings is expected to be minimal, as the related cash lease costs are expected to be offset by associated inventory reductions. Under SFAS No. 144, store closings may constitute discontinued operations if migration of customers and cash flows are not expected. The Company has concluded that no store closings have met the criteria for discontinued operations treatment.

Included in the Athletic Stores division profit for 2006 is an impairment charge of \$17 million related to the Company's European operations to write-down long-lived assets in 69 stores to their estimated fair value. During 2006, division profit declined primarily due to the fashion shift from higher priced marquee footwear to lower priced low-profile footwear styles and a highly competitive retail environment, particularly for the sale of low-profile footwear styles. The charge was comprised primarily of stores located in the U.K. and France.

## 6. Short-Term Investments

The Company's auction rate security investments are accounted for as available-for-sale securities. The following represents the composition of the Company's auction rate securities by underlying investment.

	<u>2007</u>	<u>2006</u>
	(in millions)	
Tax exempt municipal bonds .....	\$ —	\$ 44
Equity securities .....	<u>5</u>	<u>205</u>
	<u>\$ 5</u>	<u>\$ 249</u>

With the liquidity issues experienced in the global credit and capital markets, the Company's preferred stock auction rate security, having a face value of \$7 million, has experienced failed auctions. The Company determined that a temporary impairment has occurred and therefore has recorded a charge of \$2 million, with no tax benefit, to accumulated other comprehensive loss as of February 2, 2008. This security will continue to accrue interest at the contractual rate and will be auctioned every 90 days until the auction succeeds. Based on the relatively small size of this investment and the Company's ability to access cash and other short-term investments, and expected operating cash flows, we do not anticipate the lack of liquidity on this investment will affect our ability to operate our business as usual.

## 7. Merchandise Inventories

	<u>2007</u>	<u>2006</u>
	(in millions)	
LIFO inventories .....	\$ 907	\$ 967
FIFO inventories .....	<u>374</u>	<u>336</u>
Total merchandise inventories .....	<u>\$ 1,281</u>	<u>\$ 1,303</u>

The value of the Company's LIFO inventories, as calculated on a LIFO basis, approximates their value as calculated on a FIFO basis.

## 8. Other Current Assets

	<u>2007</u>	<u>2006</u>
	(in millions)	
Net receivables .....	\$ 50	\$ 59
Prepaid expenses and other current assets .....	34	36
Prepaid rent .....	65	62
Prepaid income taxes .....	70	67
Deferred taxes .....	53	21
Investments .....	—	14
Northern Group note receivable .....	14	1
Current tax asset .....	1	—
Fair value of derivative contracts .....	<u>3</u>	<u>1</u>
	<u>\$ 290</u>	<u>\$ 261</u>

### 15. Long-Term Debt and Obligations under Capital Leases

In May 2004, the Company obtained a 5-year, \$175 million amortizing term loan from the bank group participating in its existing revolving credit facility to finance a portion of the purchase price of the Footaction stores. The interest rate on the LIBOR-based, floating-rate loan was 5.4 percent on February 2, 2008 and 6.5 percent on February 3, 2007. The loan requires minimum principal payments each May, equal to a percentage of the original principal amount of 10 percent in 2006, 15 percent in years 2007 and 2008 and 50 percent in year 2009. Closing and upfront fees totaling approximately \$1 million were paid for the term loan and these fees are being amortized using the interest rate method as determined by the principal repayment schedule. During 2007, 2006 and 2005 the Company repaid \$2 million, \$50 million, and \$35 million, respectively, with the outstanding amount of \$88 million due in 2009.

The Company purchased and retired \$38 million of the \$200 million 8.50 percent debentures payable in 2022 at a \$2 million discount from face value during 2006. During 2007, the Company purchased and retired an additional \$5 million bringing the outstanding amount to \$129 million as of February 2, 2008. The Company has various interest rate swap agreements, which convert \$100 million of the 8.50 percent debentures from a fixed interest rate to a variable interest rate, which are collectively classified as a fair value hedge. The net fair value of the interest rate swaps at February 2, 2008 was an asset of \$4 million, which was included in other assets, the carrying value of the 8.50 percent debentures was increased by the corresponding amount. The net fair value of the interest rate swaps at February 3, 2007 was a liability of \$4 million, which was included in other liabilities, the carrying value of the 8.50 percent debentures was decreased by the corresponding amount.

During 2007, the Company's \$14 million Industrial Revenue Bond, which was accounted for as a capital lease matured. Accordingly, the Company repaid this amount.

Following is a summary of long-term debt and obligations under capital leases:

	2007	2006
	(in millions)	
8.50% debentures payable 2022 .....	\$ 133	\$ 130
\$175 million term loan .....	88	90
Total long-term debt .....	221	220
Obligations under capital leases .....	—	14
	221	234
Less: Current portion .....	—	14
	<u>\$ 221</u>	<u>\$ 220</u>

Maturities of long-term debt in future periods are:

	Long-Term Debt
	(in millions)
2008 .....	\$ —
2009 .....	88
2010 -2012 .....	—
Thereafter .....	133
Less: Current portion .....	—
	<u>\$ 221</u>