KELLOGG CO
Form 10-Q
August 08, 2003

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 28, 2003

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _______ to _______

Commission file number 1-4171

KELLOGG COMPANY

State of Incorporation--Delaware IRS Employer Identification No.38-0710690

One Kellogg Square, P.O. Box 3599, Battle Creek, MI 49016-3599

Registrant's telephone number: 269-961-2000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes X No

Common Stock outstanding July 25, 2003 - 408,233,387 shares

KELLOGG COMPANY

INDEX

PART I - Financial Information	Page
Item 1:	
Consolidated Balance Sheet - June 28, 2003, and December 28, 2002	2
Consolidated Statement of Earnings - quarters and year-to-date periods ended June 28, 2003 and June 29, 2002	3
Consolidated Statement of Cash Flows - year-to-date periods ended June 28, 2003 and June 29, 2002	4
Notes to Consolidated Financial Statements	5-11
Item 2:	
Management's Discussion and Analysis of Financial Condition and Results of Operations	12-17
Item 3:	
Quantitative and Qualitative Disclosures about Market Risk	18
Item 4:	
Controls and Procedures	18
PART II - Other Information	
Item 6:	
Exhibits and Reports on Form 8-K	19
Signatures	20-22
Exhibit Index	23

Kellogg Company and Subsidiaries
CONSOLIDATED BALANCE SHEET
(millions, except per share data)

	June 28, 2003 (unaudited)
Current assets	
Cash and cash equivalents	$160.7
Accounts receivable, net	829.1
Inventories:	
Raw materials and supplies	183.0
Finished goods and materials in process	406.9
Other current assets	301.9
Total current assets	1,881.6
Property, net of accumulated depreciation	

of $3,256.2 and $3,012.4	2,761.9
Goodwill	3,102.6
Other intangibles, net of accumulated amortization	
of $21.3 and $20.6	2,026.0
Other assets	491.0
Total assets	$10,263.1
Current liabilities	
Current maturities of long-term debt	$577.3
Notes payable	484.6
Accounts payable	605.1
Accrued advertising and promotion	360.1
Other current liabilities	803.9
Total current liabilities	2,831.0
Long-term debt	4,518.6
Deferred income taxes	999.8
Pension benefits	347.7
Nonpension postretirement benefits	344.5
Other liabilities	139.2
Shareholders' equity	
Common stock, $.25 par value	103.8
Capital in excess of par value	29.7
Retained earnings	2,035.2
Treasury stock, at cost	(261.9)
Accumulated other comprehensive income (loss)	(824.5)
Total shareholders' equity	1,082.3
Total liabilities and shareholders' equity	$10,263.1

Refer to Notes to Consolidated Financial Statements.

Kellogg Company and Subsidiaries
CONSOLIDATED EARNINGS
(millions, except per share data)

(Results are unaudited)	Quarter ended June 28, 2003	Quarter ended June 29, 2002	Year-to-date period ended June 28, 2003
Net sales	$2,247.4	$2,125.1	$4,394.9
Cost of goods sold	1,232.1	1,161.5	2,463.2
Selling and administrative expense	601.2	591.2	1,170.2
Operating profit	414.1	372.4	761.5

Interest expense	89.5	96.9	181.5
Other income (expense), net	(6.1)	2.0	(5.4)
Earnings before income taxes	318.5	277.5	574.6
Income taxes	114.6	103.7	206.8
Net earnings	$203.9	$173.8	$367.8
Net earnings per share:			
Basic	$.50	$.42	$.90
Diluted	$.50	$.42	$.90
Dividends per share	$.2525	$.2525	$.5050
Average shares outstanding:			
Basic	406.9	409.2	407.3
Diluted	409.2	412.6	409.3
Actual shares outstanding at period end			408.0

Refer to Notes to Consolidated Financial Statements.

Kellogg Company and Subsidiaries
CONSOLIDATED STATEMENT OF CASH FLOWS
(millions)

(unaudited)	Year-to-date period ended June 28, 2003
Operating activities	
Net earnings	$367.8
Adjustments to reconcile net earnings to operating cash flows:	
Depreciation and amortization	183.7
Deferred income taxes	37.9
Other	47.6
Postretirement benefit plan contributions	(59.3)
Changes in operating assets and liabilities	(117.3)
Net cash provided by operating activities	460.4
Investing activities	
Additions to properties	(68.5)

Acquisitions of businesses	-
Dispositions of businesses	14.0
Other	6.5
Net cash used in investing activities	(48.0)
Financing activities	
Net issuances (reductions) of notes payable	63.7
Issuances of long-term debt	498.1
Reductions of long-term debt	(708.2)
Net issuances of common stock	58.0
Common stock repurchases	(62.0)
Cash dividends	(205.6)
Other	(2.5)
Net cash used in financing activities	(358.5)
Effect of exchange rate changes on cash	6.2
Increase (decrease) in cash and cash equivalents	60.1
Cash and cash equivalents at beginning of period	100.6
Cash and cash equivalents at end of period	$160.7

Refer to Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements
for the quarter and year-to-date period ended June 28, 2003 (unaudited)

Note 1 Accounting policies

The unaudited interim financial information included in this report reflects normal recurring adjustments that management believes are necessary for a fair presentation of the results of operations, financial position, and cash flows for the periods presented. This interim information should be read in conjunction with the financial statements and accompanying notes contained on pages 30 to 48 of the Company's 2002 Annual Report. The accounting policies used in preparing these financial statements are the same as those summarized in the Company's 2002 Annual Report, except as discussed below. Certain amounts for 2002 have been reclassified to conform to current-period classifications. The results of operations for the quarter and year-to-date periods ended June 28, 2003, are not necessarily indicative of the results to be expected for other interim periods or the full year.

Interim reporting periods
Beginning in 2002, the Company has reported interim periods on a thirteen-week quarter basis, commonly referred to as "4-4-5" because of the number of weeks in each sub-period of the quarter. Interim results for 2003 are being reported for the periods ended March 29, June 28, September 27, and December 27. Interim results for 2002 were reported for the periods ended March 30, June 29, September 28, and December 28.

Accounting for exit costs
The Company has adopted SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal," with respect to exit or disposal activities initiated after December 31, 2002. This statement is intended to achieve consistency in timing of recognition between exit costs, such as one-time employee separation benefits and contract termination payments, and all other costs. Under pre-existing literature, certain costs associated with exit activities were recognized when management committed to a plan. Under SFAS No. 146, costs are recognized when a liability has been incurred under general concepts. For instance, under pre-existing literature, plant closure costs would be accrued at the plan commitment date. Under SFAS No. 146, these costs would be recognized as closure activities are performed. These provisions could be expected to have the general effect of delaying recognition of certain costs related to restructuring programs. However, management does not currently expect adoption of this standard to have a significant impact on the Company's 2003 financial results.

Guarantees
With respect to guarantees entered into or modified after December 31, 2002, the Company has applied guidance contained in FASB Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of indebtedness of Others." This interpretation clarifies the requirement for recognition of a liability by a guarantor at the inception of the guarantee, based on the fair value of the non-contingent obligation to perform. Management does not currently expect application of this guidance to have a significant impact on the Company's 2003 financial results.

Variable interest entities
During January 2003, the FASB issued Interpretation No. 46 "Consolidation of Variable Interest Entities." Under previous practice, entities were included in consolidated financial statements based on controlling voting interests. Under this interpretation, previously unconsolidated entities (often referred to as "special purpose entities") will be included in the consolidated financial statements of the "primary beneficiary" as a result of non-voting financial interests that are established through contractual or other means. For variable interest entities created after January 31, 2003, this interpretation is effective immediately. For any pre-existing variable interest entities, this interpretation was effective beginning with the Company's fiscal 2003 third quarter. Management does not currently believe these requirements are applicable to any existing financial arrangement of the Company.

Hedging activities
During April 2003, the FASB issued SFAS No. 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This statement amends and clarifies financial accounting and reporting for derivative instruments and hedging activities, resulting primarily from decisions reached by the FASB Derivatives Implementation Group subsequent to the original issuance of SFAS No. 133. This Statement is generally effective prospectively for contracts and hedging relationships entered into after June 30, 2003. Management currently believes that adoption of SFAS No. 149 will have minimal impact on the Company, except that cash flows associated with certain derivatives will be classified in the financing rather than the operating section of the cash flow statement. Such derivatives are generally limited to net investment hedges and those used by the Company to reduce volatility in the translation of foreign currency earnings to U.S. Dollars. Management believes that the impact of this classification change during 2003 will be insignificant.

Stock compensation
The Company uses various equity-based compensation programs to provide long-term

performance incentives for its global workforce. Currently, these incentives consist of stock options, performance units, restricted stock grants, and stock purchase plans with various preferred terms. These awards are administered through several plans, as described in Note 8 to Consolidated Financial Statements on pages 40 and 41 of the Company's 2002 Annual Report.

The Company uses the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," to account for its employee stock options and other stock-based compensation. Under this method, because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized. The table below presents pro forma results for the current and prior-year periods, as if the Company had used the alternate fair value method of accounting for stock-based compensation, prescribed by SFAS No. 123 "Accounting for Stock-Based Compensation" (as amended by SFAS No. 148). Under this pro forma method, the fair value of each option grant was estimated at the date of grant using the Black-Scholes option-pricing model and was recognized over the vesting period, generally two years. Pricing model assumptions included an expected term of three years; and risk-free interest rate, dividend yield, and volatility assumptions consistent with the expected term and particular grant date.

(millions except per share data)	Quarter ended		Year-to-date p
	June 28, 2003	June 29, 2002	June 28, 2003
Stock-based compensation expense, net of tax:			
As reported	$ 2.4	$ 2.7	$ 5.1
Pro forma	$ 10.0	$ 13.2	$ 19.9
Net earnings:			
As reported	$ 203.9	$ 173.8	$ 367.8
Pro forma	$ 196.3	$ 163.3	$ 353.0
Basic net earnings per share:			
As reported	$ 0.50	$ 0.42	$ 0.90
Pro forma	$ 0.48	$ 0.40	$ 0.87
Diluted net earnings per share:			
As reported	$ 0.50	$ 0.42	$ 0.90
Pro forma	$ 0.48	$ 0.40	$ 0.86

Note 2 Exit activities

Keebler

On March 26, 2001, the Company acquired Keebler Foods Company ("Keebler") in a cash transaction valued at $4.56 billion. The final purchase price allocation included $71.3 million of liabilities related to management's plans, as of the acquisition date, to exit certain activities and operations of the acquired company. As presented in the table below, remaining reserves of $19.3 million existed at year-end 2002, to be spent principally during 2003. Acquisition-date exit plans were substantially completed during the first quarter of 2003, with remaining reserves consisting primarily of contractual obligations for severance and leases. During the year-to-date period ended June 28, 2003, $4.5 million of excess reserves were reversed and recorded as a credit to other income (expense), net. This excess resulted primarily from lower than projected facility closure costs and employee severance payments, and higher than projected proceeds from sale of leased vehicles and sub-lease revenue.

(millions)	Employee severance benefits	Employee relocation	Lease & othe contract termination
Remaining reserve at December 28, 2002	$ 7.2	$ 0.6	$ 9.6
2003 year-to-date activity:			
Utilized	(3.5)	(0.1)	(1.7)
Reversed	(1.2)	(0.4)	(1.7)
Remaining reserve at June 28, 2003	$ 2.5	$ 0.1	$ 6.2

During April 2002, the Company sold certain assets of Keebler's Bake-Line private-label unit, including a bakery in Marietta, Oklahoma, to Atlantic Baking Group, Inc. for approximately $65 million in cash and a $10 million note to be paid at a later date. In January 2003, the Company sold additional private-label operations for approximately $14 million in cash. For both of these transactions, the carrying value of net assets sold, including allocated goodwill, approximated the net sales proceeds.

Other

Cost of goods sold for the quarter ended June 28, 2003, includes charges of approximately $15 million, attributable primarily to equipment disposals associated with manufacturing network optimization efforts in the Company's U.S. snacks business, which have been ongoing since the Company's acquisition of Keebler in 2001.

Also during the current quarter, management decided to increase investment in various productivity initiatives during the remainder of 2003 and 2004. Most of these initiatives are still in the planning stages and individual actions are being announced as plans are finalized. Actions implemented during the current quarter included commencement of a wholesome snack plant consolidation in Australia, which involves the exit of a leased facility and separation of approximately 140 employees by year-end 2003. Management expects to incur approximately $6 million in exit costs and asset write-offs during the second half of 2003 related to this initiative.

Cost of goods sold for the quarter ended June 29, 2002, includes an impairment loss of $5.0 million related to the Company's manufacturing facility in China, representing a decline in real estate market value subsequent to an original impairment loss recognized for this property in 1997. The Company began marketing this facility for sale in early 2003, and is currently in the final stages of closing a sales transaction for an amount that approximates the carrying value.

Note 3 Other income (expense), net

Other income (expense), net includes non-operating items such as interest income, foreign exchange gains and losses, charitable donations, and gains on asset sales. Other income (expense), net for the year-to-date period ended June 28, 2003, includes a credit of approximately $13 million related to favorable legal settlements; a $4.5 million credit related to a reversal of Keebler exit liabilities (refer to Note 2); a charge of $8 million for a contribution to the Kellogg's Corporate Citizenship Fund, a private trust established for charitable giving; and a charge of $6.5 million to recognize the impairment of a cost-basis investment in an e-commerce business venture. Other income (expense), net for the year-to-date period ended June 29, 2002, includes a $16.5 million credit ($10.2 million after tax or $.02 per share), related to favorable legal settlements. The aforementioned charges and credits recognized in 2003 and 2002 were incurred largely during the first quarter of both years.

Note 4 Equity

Earnings per share
Basic net earnings per share is determined by dividing net earnings by the weighted average number of common shares outstanding during the period. Diluted net earnings per share is similarly determined, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all dilutive potential common shares had been issued. Dilutive potential common shares are comprised principally of employee stock options issued by the Company. Basic net earnings per share is reconciled to diluted net earnings per share as follows:

Quarter (millions, except per share data)	Net earnings	Average shares outstanding	Net earnings per share
2003			
Basic	$203.9	406.9	$.
Dilutive employee stock options	-	2.3	
Diluted	$203.9	409.2	$.
2002			
Basic	$173.8	409.2	$.
Dilutive employee stock options	-	3.4	
Diluted	$173.8	412.6	$.

Year-to-date (millions, except per share data)	Net earnings	Average shares outstanding	Net earnings per share
2003			
Basic	$367.8	407.3	$.
Dilutive employee stock options	-	2.0	
Diluted	$367.8	409.3	$.
2002			

Basic	$326.4	408.1	$.
Dilutive employee stock options	-	2.8	(.
Diluted	$326.4	410.9	$.

Comprehensive Income

Comprehensive income includes net earnings and all other changes in equity during a period except those resulting from investments by or distributions to shareholders. Accumulated other comprehensive income for the periods presented consists of foreign currency translation adjustments pursuant to SFAS No. 52 "Foreign Currency Translation," unrealized gains and losses on cash flow hedges pursuant to SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," and minimum pension liability adjustments pursuant to SFAS No. 87 "Employers' Accounting for Pensions."

Quarter (millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2003			
Net earnings			$203.9
Other comprehensive income:			
Foreign currency translation adjustments	31.4	-	$31.4
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	(6.4)	2.0	(4.4)
Reclassification to net earnings	1.5	(0.6)	0.9
Minimum pension liability adjustments	-	-	-
	26.5	1.4	27.9
Total comprehensive income			$231.8

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2002			
Net earnings			$173.8
Other comprehensive income:			
Foreign currency translation adjustments	(8.4)	-	(8.4)
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	8.7	(3.7)	$5.0
Reclassification to net earnings	3.1	(1.2)	1.9
Minimum pension liability adjustments	-	-	-
	3.4	(4.9)	(1.5)
Total comprehensive income			$172.3

Year-to-date (millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2003			
Net earnings			$367.8
Other comprehensive income:			
Foreign currency translation adjustments	33.5	-	$33.5
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	(16.0)	5.5	(10.5)
Reclassification to net earnings	9.2	(3.3)	5.9
Minimum pension liability adjustments	-	-	-
	26.7	2.2	28.9
Total comprehensive income			$396.7

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2002			
Net earnings			$326.4
Other comprehensive income:			
Foreign currency translation adjustments	(24.0)	-	(24.0)
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	1.7	(1.4)	$0.3
Reclassification to net earnings	4.6	(1.8)	2.8
Minimum pension liability adjustments	-	-	-
	(17.7)	(3.2)	(20.9)
Total comprehensive income			$305.5

Accumulated other comprehensive income (loss) as of June 28, 2003, and December 28, 2002, consisted of the following:

(millions)	June 28, 2003	December 28, 2002
Foreign currency translation adjustments	$ (454.1)	$ (487.6)
Cash flow hedges -- unrealized net loss	(50.9)	(46.3)
Minimum pension liability adjustments	(319.5)	(319.5)
Total accumulated other comprehensive income (loss)	$ (824.5)	$ (853.4)

Note 5 Debt

On April 1, 2003, the Company repaid $699.3 million of maturing 5.50% U.S. Dollar Notes and initially replaced this debt with U.S. short-term debt. On June 5, 2003, the Company issued $500 million of five-year 2.875% fixed rate U.S. Dollar Notes, using the proceeds from these Notes to repay a portion of the U.S. short-term debt. These Notes were issued under an existing shelf registration statement. In conjunction with this issuance, the Company settled $250 million notional amount of forward interest rate contracts for a loss of $11.8 million, which is being amortized to interest expense over the term of the debt. Taking into account this amortization and issuance discount, the effective interest rate on these five-year Notes is 3.35%.

Note 6 Operating segments

Kellogg Company is the world's leading producer of cereal and a leading producer of convenience foods such as cereal bars, frozen waffles, toaster pastries, cookies, and crackers. The Company also produces natural and vegetarian foods. Kellogg products are manufactured in 18 countries and marketed in more than 180 countries around the world. Principal markets for these products include the United States and United Kingdom. The Company is managed in two major divisions - the United States and International - with International further delineated into Europe, Latin America, Canada, Australia, and Asia. This organizational structure is the basis of the operating segment data presented below.

(millions) (Results are unaudited)	Quarter ended June 28, 2003	Quarter ended June 29, 2002	Year- perio Jun 2
Net sales			
United States	$1,416.2	$1,399.4	
Europe	462.9	382.7	
Latin America	166.3	169.6	
All other operating segments	202.0	173.4	
Corporate	-	-	
Consolidated	$2,247.4	$2,125.1	
Segment operating profit			
United States	$267.9	$262.9	
Europe	82.5	67.2	
Latin America	46.5	47.0	
All other operating segments	36.9	20.8	
Corporate	(19.7)	(25.5)	
Consolidated	$414.1	$372.4	

Note 7 Supplemental information on goodwill and other intangible assets

Intangible assets subject to amortization:
(millions)

	Gross carrying amount		Accumula
	June 28, 2003	December 28, 2002	June 28, 2003
Trademarks	$ 29.5	$ 29.5	$ 17.7
Other	6.6	6.7	3.6
Total	$ 36.1	$ 36.2	$ 21.3

Amortization expense (millions) (a):	June 28, 2003
Quarter ended	$ 0.4
Year-to-date	$ 0.8

Intangible assets not subject to amortization:
(millions)

	Total carrying amount	
	June 28, 2003	December 28, 2002
Trademarks	$ 1,404.0	$ 1,404.0
Direct store door (DSD) delivery system	578.9	578.9
Other	28.3	27.5
Total	$ 2,011.2	$ 2,010.4

Changes in the carrying amount of goodwill for the year-to-date period ended June 28, 2003:

(millions)	United States	Europe	Latin America
December 28, 2002	$ 3,103.2	$ -	$ 2.0
Dispositions	(4.9)	-	-
Foreign currency remeasurement impact and other	-	-	0.4
June 28, 2003	$ 3,098.3	$ -	$ 2.4

KELLOGG COMPANY

PART I - FINANCIAL INFORMATION

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of operations

Overview
Kellogg Company is the world's leading producer of cereal and a leading producer of convenience foods such as cereal bars, frozen waffles, toaster pastries, cookies, and crackers. The Company also produces natural and vegetarian foods. Kellogg products are manufactured and marketed globally. The Company is managed in two major divisions - the United States and International - with International further delineated into Europe, Latin America, Canada, Australia, and Asia. This organizational structure is the basis of the operating segment data presented in this report.

During the current quarter, our Company continued to demonstrate business momentum with solid financial performance, achieving broad-based sales and operating profit growth, despite substantial reinvestment in brand building and productivity initiatives. For the quarter ended June 28, 2003, our Company reported net earnings per share of $.50, a 19% increase over the prior-year amount of $.42. For the year-to-date period, net earnings per share were $.90 versus the prior period amount of $.79. This year-over-year increase of $.11 was comprised of $.09 of business growth, $.01 from reduced interest expense, $.02 from a lower effective income tax rate, and $.01 from favorable foreign currency movements; partially offset by $.02 of favorable legal settlements in the prior-year period.

Net sales and operating profit
The following tables provide an analysis of net sales and operating profit performance for the second quarter of 2003 versus 2002:

(dollars in millions)	United States	Europe	Latin America	Other Operating (b)
2003 net sales	$1,416.2	$ 462.9	$ 166.3	$ 202.0
2002 net sales	$1,399.4	$ 382.7	$ 169.6	$ 173.4
% change - 2003 vs. 2002:				
Volume	-1.7%	-0.8%	3.0%	-3.2%
Pricing/mix	4.1%	5.1%	5.5%	8.1%
Subtotal - internal business	2.4%	4.3%	8.5%	4.9%
Dispositions (a)	-1.2%	0.0%	0.0%	0.0%
Foreign currency impact	0.0%	16.7%	-10.4%	11.6%
Total change	1.2%	21.0%	-1.9%	16.5%

(dollars in millions)	United States	Europe	Latin America	Other Operating (b)
2003 operating profit	$ 267.9	$ 82.5	$ 46.5	$ 36.9
2002 operating profit	$ 262.9	$ 67.2	$ 47.0	$ 20.8
% change - 2003 vs. 2002:				
Internal business	2.6%	7.1%	9.3%	58.6%
Dispositions (a)	-0.7%	0.0%	0.0%	0.0%
Foreign currency impact	0.0%	15.6%	-10.4%	18.0%
Total change	1.9%	22.7%	-1.1%	76.6%

During the second quarter of 2003, we achieved consolidated internal net sales growth of 3.5%, against a strong year-ago growth rate of 4.2%. U.S. net sales in the retail cereal channel increased approximately 3%, aided by successful innovation and strong growth in heritage brands. Excluding the impact of private-label business divestitures during the past year, internal net sales of our U.S. snacks business, (which includes cereal bars and other wholesome snacks, cookies, and crackers), increased approximately 1%, as growth in both wholesome snacks and crackers offset several unfavorable factors. These factors included discontinuance of a low-margin contract manufacturing relationship, an acceleration of stock-keeping unit (SKU) rationalization, and declining cookie sales. The decline in cookie sales was a result of aggressive promotional activities by competitors, category contraction, and a relative lack of innovation. Given this environment, as well as SKU rationalization, we expect this soft performance in cookie sales to continue during the balance of the year. Internal net sales for our other U.S. businesses, (which include frozen waffles, toaster pastries, natural and vegetarian foods, and the foodservice channel), increased approximately 3%, with growth across all major product groups.

Total international net sales increased over 5% in local currencies, with growth across all segments. Importantly, our European operating segment exhibited strong sales and category share performance in the quarter, benefiting from double-digit growth in brand-building investment and innovation activities across the region. Internal net sales growth in Latin America was driven by a strong performance by our Mexican business unit in both cereal and snacks. Our other non-U.S. segments, which include Canada, Australia, and Asia, collectively delivered solid internal net sales growth, as significant pricing/mix improvements offset the volume impact of discontinuing product lines in Australia and Asia in late 2002.

Consolidated internal operating profit increased 9% during the quarter, driven by double-digit local currency growth in international operating profit, which was achieved despite a significant increase in brand-building expenditures. Cost of goods sold for the quarter includes charges of approximately $15 million, attributable primarily to equipment disposals associated with manufacturing network optimization efforts in the Company's U.S. snacks business, which have been ongoing since the Company's acquisition of Keebler in 2001. These charges, in combination with increased brand-building expenditures and the continuation of higher commodity, energy, and employee benefit costs, held U.S. internal operating profit growth for the quarter to less than 3%.

As a result of our Company's strong first-half 2003 performance and favorable foreign currency movements, we have decided to increase investment in various productivity initiatives during the remainder of 2003 and 2004. Most of these initiatives are still in the planning stages and individual actions are being announced as plans are finalized. Actions implemented during the current quarter included commencement of a wholesome snack plant consolidation in Australia, which involves the exit of a leased facility and separation of approximately 140 employees by year-end 2003. Management expects to incur approximately $6 million in exit costs and asset write-offs during the second half of 2003 related to this initiative.

The productivity initiatives that we are undertaking could potentially result in a yet-undetermined amount of exit costs and asset write-offs during the remainder of 2003 and into 2004. Additionally, we expect to continue with manufacturing network optimization efforts in our U.S. snacks business. These initiatives, and others to be announced later in the year, are all designed to position our Company for sustained reliable growth in earnings and cash flow for the long-term.

The following tables provide an analysis of net sales and operating profit performance for the year-to-date periods of 2003 versus 2002:

(dollars in millions)	United States	Europe	Latin America	Other Operating (b)
2003 net sales	$2,852.1	$ 857.4	$ 306.0	$ 379.4
2002 net sales	$2,826.2	$ 708.5	$ 320.1	$ 332.1
% change - 2003 vs. 2002:				
Volume	-0.2%	-1.4%	3.4%	-5.4%
Pricing/mix	2.8%	4.9%	7.4%	8.6%
Subtotal - internal business	2.6%	3.5%	10.8%	3.2%
Dispositions (a)	-1.7%	0.0%	0.0%	0.0%
Foreign currency impact	0.0%	17.5%	-15.2%	11.0%
Total change	0.9%	21.0%	-4.4%	14.2%

(dollars in millions)	United States	Europe	Latin America	Other Operating (b)
2003 operating profit	$ 508.2	$ 140.8	$ 86.1	$ 72.7
2002 operating profit	$ 505.0	$ 112.7	$ 84.2	$ 41.0
% change - 2003 vs. 2002:				
Internal business	2.4%	8.2%	17.6%	59.7%
Dispositions (a)	-1.8%	0.0%	0.0%	0.0%
Foreign currency impact	0.0%	16.7%	-15.4%	17.4%
Total change	0.6%	24.9%	2.2%	77.1%

Margin performance

Margin performance for the second quarter and year-to-date periods of 2003 versus 2002 are presented in the following tables:

Quarter	2003	2002	Change vs. prior year (pts.)
Gross margin	45.2%	45.3%	-0.1
SGA% (a)	26.8%	27.8%	1.0
Operating margin	18.4%	17.5%	0.9

Year-to-date	2003	2002	Change vs. prior year (pts.)
Gross margin	44.0%	44.1%	-0.1
SGA% (a)	26.7%	27.4%	0.7
Operating margin	17.3%	16.7%	0.6

The consolidated gross margin in both the quarter and year-to-date periods was unfavorably impacted by asset write-offs and higher commodity, energy, and employee benefit costs. These unfavorable factors were nearly offset by the favorable impact of operating leverage, pricing and mix improvements, and savings from supply chain productivity initiatives, resulting in only a 10 basis point decline in gross margin versus the prior periods. As we increase our investment in productivity initiatives during the remainder of the year, recognition of upfront costs associated with these initiatives could limit gross margin expansion, resulting in a full-year gross margin that is in line with the 2002 level of 45.0%.

The decline in gross margin during the quarter and year-to-date periods was more than offset by a reduction in SGA%, attributable principally to lower overhead expenses. Solid expansion of our operating margin was achieved despite an increase in consolidated brand-building expenditures that exceeded the rate of sales growth.

Interest expense

We currently expect total year 2003 interest expense to be slightly less than $360 million, down from the total year 2002 amount of $391.2 million, due primarily to continuing pay-down of our debt balances. The year-to-date 2003 interest expense of $181.5 million is consistent with expectations. Gross interest expense, prior to amounts capitalized to construction projects, was not significantly different from reported interest expense in either the current or prior-year periods.

Other income (expense), net

Other income (expense), net includes non-operating items such as interest income, foreign exchange gains and losses, charitable donations, and gains on asset sales. Other income (expense), net for the year-to-date period ended June 28, 2003, includes a credit of approximately $13 million related to favorable legal settlements; a $4.5 million credit related to a reversal of Keebler exit liabilities (refer to Note 2 within Notes to Consolidated Financial Statements); a charge of $8 million for a contribution to the Kellogg's Corporate Citizenship Fund, a private trust established for charitable giving; and a charge of $6.5 million to recognize the impairment of a cost-basis investment in an e-commerce business venture. Other income (expense), net for the year-to-date period ended June 29, 2002, includes a $16.5 million credit ($10.2 million after tax or $.02 per share), related to favorable legal settlements. The aforementioned charges and credits recognized in 2003 and 2002 were incurred largely during the first quarter of both years

Income taxes

We currently expect the total year 2003 consolidated effective income tax rate to be approximately 36%, down from the total year 2002 rate of 37%, due primarily to the implementation of various foreign and state tax planning initiatives. The year-to-date 2003 consolidated effective tax rate of 36% is consistent with these full-year expectations.

Liquidity and capital resources

Our principal source of liquidity is operating cash flows resulting from net earnings, supplemented by borrowings for major acquisitions and other significant transactions. This cash-generating capability is one of our fundamental strengths and provides us with substantial financial flexibility in meeting operating and investing needs.

Our measure of year-to-date 2003 cash flow (defined as net cash provided by operating activities reduced by expenditures for property additions) was $391.9 million compared to $478.1 million in the prior-year period. We use this measure of cash flow to focus management and investors on the amount of cash available for debt repayment, dividend distributions, acquisition opportunities, and share repurchase. Our cash flow metric is reconciled to GAAP-basis operating cash flow as follows:

(millions)	Year-to-date period ended	
	June 28, 2003	June 29, 2002
Net cash provided by operating activities	$ 460.4	$ 563.7
Additions to properties	(68.5)	(85.6)
Cash flow	$ 391.9	$ 478.1

Year-to-date 2003 cash flow was lower than the prior-year period, due primarily to a difficult working capital comparison in the first quarter of 2002, as well as timing of tax and interest payments. Although lower than the prior-year period, our year-to-date 2003 cash flow is consistent with expectations, which are based on continuing, but slowing improvement in core working capital (inventory and trade receivables less trade payables). For the twelve months ended June 28, 2003, core working capital as a percentage of sales was 8.6%, as compared to 9.1% for the year-ago period and 8.8% for full-year 2002. The second quarter of 2002 marked the eighth consecutive quarter in which our Company has achieved sequential improvement in this metric.

We are targeting full-year 2003 cash flow of $800-$850 million, compared to the 2002 amount of $746.4 million, (which was net of the after-tax impact of year-end 2002 voluntary benefit plan contributions of approximately $254 million).

During April 2003, the FASB issued SFAS No. 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This statement amends and clarifies financial accounting and reporting for derivative instruments and hedging activities, resulting primarily from decisions reached by the FASB Derivatives Implementation Group subsequent to the original issuance of SFAS No. 133. This Statement is generally effective prospectively for contracts and hedging relationships entered into after June 30, 2003. We currently believe that adoption of SFAS No. 149 will have minimal impact on the Company, except that cash flows associated with certain derivatives will be classified in the financing rather than the operating section of the cash flow statement. Such derivatives are generally limited to net investment hedges and those used by the Company to reduce volatility in the translation of foreign currency earnings to U.S. Dollars. We believe that the impact of this classification change during 2003 will be insignificant.

Our Board of Directors has authorized management to repurchase up to $250 million of stock during 2003, generally to offset or partially offset issuances under employee benefit programs. Under this authorization, we paid approximately $62 million during the first quarter of 2003 to repurchase approximately 2.1 million shares. We did not repurchase any shares during the second quarter. On a full-year basis, this repurchase program is expected to be funded principally by proceeds from employee stock option exercises.

On April 1, 2003, we repaid $699.3 million of maturing 5.50% U.S. Dollar Notes and initially replaced this debt with U.S. short-term debt. On June 5, 2003, we issued $500 million of five-year 2.875% fixed rate U.S. Dollar Notes, using the proceeds from these Notes to repay a portion of the U.S. short-term debt. These Notes were issued under an existing shelf registration statement. In conjunction with this issuance, we settled $250 million notional amount of forward interest rate contracts for a loss of $11.8 million, which is being amortized to interest expense over the term of the debt. Taking into account this amortization and issuance discount, the effective interest rate on these five-year Notes is 3.35%.

We believe that we will be able to meet our interest and principal repayment obligations and maintain our debt covenants for the foreseeable future, while still meeting our operational needs through our strong cash flow, our program of issuing short-term debt, and maintaining credit facilities on a global basis. Our significant long-term debt issues do not contain acceleration of maturity clauses that are dependent on credit ratings. A change in the Company's credit ratings could limit its access to the U.S. short-term debt market and/or increase the cost of refinancing long-term debt in the future. However, even under these circumstances, we would continue to have access to our credit facilities, which are in amounts sufficient to cover the outstanding short-term debt balance and debt principal repayments through 2003.

Future outlook

During 2003, our Company faces several important challenges, including

- higher employee benefits expense;
- significant increases in the prices of certain grains, cocoa, other ingredients, packaging, and energy;
- increased cost and reduced availability of certain types of insurance such as natural disasters or incidents of terrorism;
- economic volatility in Latin America; and
- a fundamental change in strategy for our snacks business, from an "acquire-and-integrate" approach to one of sustainable, organic growth.

During the remainder of 2003, we believe these cost increases and risks can continue to be largely offset with pricing and mix improvements, savings from implemented productivity improvements, and the momentum in operating performance and cash flow expansion we established in 2002 and have continued to sustain during the first half of 2003. As a result, we currently believe we will achieve full-year 2003 net earnings per share of $1.88-$1.90, as compared to 2002 net earnings per share of $1.75, which included $.02 from favorable legal settlements in the first quarter.

Forward-looking statements

Our Management's Discussion and Analysis contain "forward-looking statements" with projections concerning, among other things, our strategy and plans; gross margins, brand-building, and earnings per share; exit plans and costs related to productivity initiatives; the impact of accounting changes; our ability to meet interest and debt principal repayment obligations; future common stock repurchases; effective income tax rate; cash flow and core working capital improvements; interest expense; commodity and energy prices; and employee benefit plan costs and funding. Forward-looking statements include predictions of future results or activities and may contain the words "expect," "believe," "will," "will deliver," "anticipate," "project," "should," or words or phrases of similar meaning. Our actual results or activities may differ materially from these predictions. In particular, future results or activities could be affected by factors related to the Keebler acquisition, including integration problems, failures to achieve savings, unanticipated liabilities, and the substantial amount of debt incurred to finance the acquisition, which could, among other things, hinder our ability to adjust rapidly to changing market conditions, make us more vulnerable in the event of a downturn, and place us at a competitive disadvantage relative to less-leveraged competitors. In addition, our future results could be affected by a variety of other factors, including

- the impact of competitive conditions;
- the effectiveness of pricing, advertising, and promotional programs;
- the success of innovation and new product introductions;
- the recoverability of the carrying value of goodwill and other intangibles;
- the success of productivity improvements and business transitions;
- commodity and energy prices, and labor costs;
- the availability of and interest rates on short-term financing;
- actual market performance of benefit plan trust investments;
- the levels of spending on systems initiatives, properties, business opportunities, integration of acquired businesses, and other general and administrative costs;
- changes in consumer behavior and preferences;
- the effect of U.S. and foreign economic conditions on items such as interest rates, statutory tax rates, currency conversion and availability;
- legal and regulatory factors; and,

- business disruption or other losses from war, terrorist acts, or political unrest.

Forward-looking statements speak only as of the date they were made, and we undertake no obligation to publicly update them.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Refer to disclosures contained on pages 50-52 of the Company's 2002 Annual Report.

Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure based on management's interpretation of the definition of "disclosure controls and procedures," in Rule 13a-14(c). In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable, rather than absolute, assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Within 90 days prior to the date of this report, management carried out an evaluation under the supervision and with the participation of the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

There have been no significant changes in the Company's internal controls or in the other factors that could significantly affect the internal controls subsequent to the date the Company completed its evaluation. Therefore, no corrective actions were taken.

KELLOGG COMPANY

PART II - OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

32 - Section 906 Certification from Carlos M. Gutierrez
32 - Section 906 Certification from John A. Bryant

(b) Reports on Form 8-K:

The Company filed a Report on Form 8-K dated April 24, 2003, in which it furnished a press release announcing its first quarter results under items 9 and 12 of such Report. The Company also filed a Report on Form 8-K dated July 28, 2003, in which it furnished a press release announcing its second quarter results under Items 9 and 12 of such Report.

KELLOGG COMPANY

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KELLOGG COMPANY

/s/ J.A. Bryant

J.A. Bryant
Principal Financial Officer;
Executive Vice President -
Chief Financial Officer

/s/ J. M. Boromisa

J. M. Boromisa
Principal Accounting Officer;
Senior Vice President - Corporate Controller

Date: August 8, 2003

CERTIFICATION

I, Carlos M. Gutierrez, Chairman of the Board, President and Chief Executive Officer of Kellogg Company, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Kellogg Company;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ Carlos M. Gutierrez

Date: August 8, 2003 ________________________________

Chairman of the Board,
President and Chief
Executive Officer

CERTIFICATION

I, John A. Bryant, Executive Vice President and Chief Financial Officer of Kellogg Company, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Kellogg Company;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective

actions with regard to significant deficiencies and material weaknesses.

/s/ John A. Bryant

Date: August 8, 2003

Executive Vice President
and Chief Financial Officer

KELLOGG COMPANY

EXHIBIT INDEX

Exhibit No.	Description	Electronic (E) Paper (P) Incorp. By Ref. (IBRF)
32	Section 906 Certification from Carlos M. Gutierrez	E
32	Section 906 Certification from John A. Bryant	E