KELLOGG CO
Form 10-Q
August 03, 2007

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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)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2007

OR

o **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

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

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 Section 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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer þ Accelerated filero Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

Common Stock outstanding as of July 27, 2007 395,733,185 shares

KELLOGG COMPANY
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364-Day Credit Agreement dated as of June 13, 2007 with JPMorgan Chase Bank, N.A.
Rule 13a-14(e)/15d-14(a) Certification from A.D. David Mackay
Rule 13a-14(e)/15d-14(a) Certification from John A. Bryant
Section 1350 Certification from A.D. David Mackay
Section 1350 Certification from John A. Bryant
364-Day Credit Agreement
Certification
Certification
Section 1350 Certification
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Kellogg Company and Subsidiaries
CONSOLIDATED BALANCE SHEET
(millions, except per share data)

	June 30, 2007 *(unaudited)*	December 30, 2006 *
Current assets		
Cash and cash equivalents	**$ 574**	$ 411
Accounts receivable, net	**1,118**	945
Inventories:		
Raw materials and supplies	**219**	201
Finished goods and materials in process	**596**	623
Deferred income taxes	**149**	116
Other prepaid assets	**125**	131
Total current assets	**2,781**	2,427
Property, net of accumulated depreciation of $4,310 and $4,102	**2,845**	2,816
Goodwill	**3,448**	3,448
Other intangibles, net of accumulated amortization of $41 and $49	**1,412**	1,420
Pension	**383**	353
Other assets	**254**	250
Total assets	**$11,123**	$ 10,714
Current liabilities		
Current maturities of long-term debt	**$ 466**	$ 723
Notes payable	**1,969**	1,268
Accounts payable	**971**	910
Accrued advertising and promotion	**398**	338
Accrued income taxes	**92**	152
Accrued salaries and wages	**225**	311
Other current liabilities	**341**	318
Total current liabilities	**4,462**	4,020
Long-term debt	**2,588**	3,053
Deferred income taxes	**572**	619
Other liabilities	**1,100**	953
Shareholders equity		
Common stock, $.25 par value	**105**	105
Capital in excess of par value	**329**	292
Retained earnings	**4,011**	3,630
Treasury stock, at cost	**(1,044)**	(912)
Accumulated other comprehensive income (loss)	**(1,000)**	(1,046)
Total shareholders equity	**2,401**	2,069

Total liabilities and shareholders equity	**$11,123**	$ 10,714

* *Condensed from audited financial statements.*

Refer to Notes to Consolidated Financial Statements.

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

	Quarter ended		Year-to-date period ended	
(Results are unaudited)	**June 30, 2007**	July 1, 2006	**June 30, 2007**	July 1, 2006
Net sales	**$3,015**	$2,773	**$5,978**	$5,500
Cost of goods sold	**1,638**	1,538	**3,337**	3,068
Selling, general, and administrative expense	**859**	774	**1,624**	1,498
Operating profit	**518**	461	**1,017**	934
Interest expense	**76**	77	**154**	152
Other income (expense), net		4	**2**	9
Earnings before income taxes	**442**	388	**865**	791
Income taxes	**141**	121	**243**	250
Net earnings	**$ 301**	$ 267	**$ 622**	$ 541
Net earnings per share:				
Basic	**$ .76**	$ .68	**$ 1.56**	$ 1.36
Diluted	**$ .75**	$ .67	**$ 1.55**	$ 1.35
Dividends per share	**$.2910**	$.2775	**$.5820**	$.5550
Average shares outstanding:				
Basic	**397**	394	**397**	396
Diluted	**401**	397	**401**	399
Actual shares outstanding at period end			**396**	396

Refer to Notes to Consolidated Financial Statements.

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

(unaudited)	Year-to-date period ended June 30, 2007	Year-to-date period ended July 1, 2006
Operating activities		
Net earnings	**$ 622**	$ 541
Adjustments to reconcile net earnings to operating cash flows:		
Depreciation and amortization	**185**	173
Deferred income taxes	**(92)**	(2)
Other (a)	**79**	74
Postretirement benefit plan contributions	**(34)**	(30)
Changes in operating assets and liabilities	**(10)**	(254)
Net cash provided by operating activities	**750**	502
Investing activities		
Additions to properties	**(181)**	(162)
Investments in joint ventures and other	**(4)**	(1)
Net cash used in investing activities	**(185)**	(163)
Financing activities		
Net issuances of notes payable	**699**	433
Reductions of long-term debt	**(729)**	
Issuances of common stock	**100**	116
Common stock repurchases	**(264)**	(580)
Cash dividends	**(232)**	(218)
Other	**10**	7
Net cash used in financing activities	**(416)**	(242)
Effect of exchange rate changes on cash	**14**	(1)
Increase in cash and cash equivalents	**163**	96
Cash and cash equivalents at beginning of period	**411**	219
Cash and cash equivalents at end of period	**$ 574**	$ 315

(a)

Consists principally of non-cash expense accruals for employee compensation and benefit obligations.

Refer to Notes to Consolidated Financial Statements.

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Notes to Consolidated Financial Statements
for the quarter and year-to-date periods ended June 30, 2007 (unaudited)

Note 1 Accounting policies

Basis of presentation

The unaudited interim financial information included in this report reflects normal recurring adjustments that management believes are necessary for a fair statement 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 27 to 56 of the Company s 2006 Annual Report on Form 10-K.

The condensed balance sheet data at December 30, 2006 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. The results of operations for the quarterly and year-to-date periods ended June 30, 2007 are not necessarily indicative of the results to be expected for other interim periods or the full year.

The Company s fiscal year normally ends on the Saturday closest to December 31 and as a result, a 53rd week is added approximately every sixth year. Under this convention, the Company s 2006 fiscal year ended on December 30 and its 2007 fiscal year will end on December 29, 2007. Each quarterly period in 2006 and 2007 includes thirteen weeks.

The accounting policies used in preparing these financial statements are the same as those applied in the prior year, except that the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48 Accounting for Uncertainty in Income Taxes, as of the beginning of its 2007 fiscal year, which is discussed in Note 10. Additionally, the Company adopted FASB Statement of Financial Accounting Standard (SFAS) No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, as of the end of its 2006 fiscal year, which affected only the year-end balance sheet presentation of postretirement and postemployment benefit obligations. Accordingly, the Company s 2007 fiscal year (and interim periods within that year) is the first reporting period for which total comprehensive income will be affected by the adoption of this standard. Refer to page 33 of the Company s 2006 Annual Report on Form 10-K for further information on SFAS No. 158. Lastly, the Company is continuing to evaluate the impact of adopting SFAS No. 157 Fair Value Measurements in the first quarter of its 2008 fiscal year. Refer to page 34 of the Company s 2006 Annual Report on Form 10-K for further information on SFAS No. 157.

Note 2 Acquisitions, other investments, and intangibles

Joint venture arrangement

During the quarter ended June 30, 2007, the Company contributed an additional $4 million in cash to its Turkish joint venture, in which it owns a 50% equity interest, bringing the total cumulative investment to approximately $7 million. Refer to page 35 of the Company s 2006 Annual Report on Form 10-K for further information on this arrangement.

Goodwill and other intangible assets

For the quarter ended June 30, 2007, the Company recorded impairment losses of $7 million in corporate selling, general, and administrative expense to write off the remaining carrying value of several individually-insignificant trademarks, which were abandoned as of June 30, 2007. As presented in the following table, associated gross

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carrying amounts and accumulated amortization of $16 million were retired from the Company s balance sheet during the second quarter of 2007.

Intangible assets subject to amortization

	Gross carrying amount		Accumulated amortization	
(millions)	**June 30, 2007**	December 30, 2006	**June 30, 2007**	December 30, 2006
Trademarks	**$14**	$ 30	**$ 13**	$ 22
Other	**29**	29	**28**	27
Total	**$43**	$ 59	**$ 41**	$ 49

Amortization expense	**June 30, 2007**	July 1, 2006
Year-to-date	**$ 8**	$1

For intangible assets in the preceding table, amortization (excluding the aforementioned impairment losses) was less than $1 million for each of the current and prior-year quarterly periods. The currently-estimated aggregate amortization expense for full-year 2007 and each of the three succeeding fiscal years is approximately $1 million per year and less than $1 million per year for the fourth and fifth succeeding years.

Intangible assets not subject to amortization

	Total carrying amount	
(million)	**June 30, 2007**	December 30, 2006
Trademarks	**$1,410**	$ 1,410

There were no changes in the carrying amount of goodwill for the year-to-date period ended June 30, 2007.

Carrying amount of goodwill

(millions)	United States	Europe	Latin America	Asia Pacific (a)	Consolidated
December 30, 2006 and June 30, 2007	**$ 3,446**			**$ 2**	**$ 3,448**

(a) Includes Australia, Asia and South Africa.

Note 3 Exit or disposal plans

The Company views its continued spending on cost-reduction initiatives as part of its ongoing operating principles to reinvest earnings so as to provide greater visibility in meeting long-term growth targets. Initiatives undertaken are currently expected to recover cash implementation costs within a five-year period of completion (expected pay-back target). Each cost-reduction initiative is normally one to three years in duration. Upon completion (or as each major stage is completed in the case of multi-year programs), the project begins to deliver cash savings and/or reduced depreciation, which is then used to fund new initiatives. Certain of these initiatives represent exit or disposal plans for which material charges will be incurred.

In 2006, the Company commenced a multi-year European manufacturing optimization plan to improve utilization of its facility in Manchester, England and to better align production in Europe. Based on forecasted foreign exchange rates, the Company currently expects to incur approximately $60 million in total project costs (including those already incurred in 2006), largely comprised of voluntary early retirement and severance benefits to eliminate approximately 220 hourly and salaried employee positions from the Manchester facility by the end of 2008. For 2006, the Company incurred approximately $28 million of total project costs and currently expects to incur approximately $17 million in 2007, with the remainder to be incurred in 2008. (Refer to page 36 of the Company s 2006 Annual Report on Form 10-K for further information on this initiative.)

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

Project costs to date (in millions)	Employee severance	Other cash costs (a)	Asset write-offs	Retirement benefits (b)	Total
Year ended December 30, 2006	$ 12	$ 2	$ 5	$ 9	$28
Quarter ended March 30, 2007	3	1	1		5
Quarter ended June 30, 2007	4	1	2		7
Total project to date	**$ 19**	**$ 4**	**$ 8**	**$ 9**	**$40**

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

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

Employee severance reserves to date (in millions)	Beginning of period	Accruals	Payments	End of period

Year ended December 30, 2006	$	$12	$	$12
Quarter ended March 30, 2007	12	3	(9)	6
Quarter ended June 30, 2007	6	4	(5)	5
Total project to date		**$19**	**$(14)**	

On June 27, 2007, the Company began to extend offers to exit approximately 517 distribution route franchise agreements with independent contractors, which were substantially accepted as of July 13, 2007. Based on these acceptances, management then commenced a plan to reorganize the Company s direct store-door delivery (DSD) operations in the southeastern United States by the end of 2007. Certain elements of this plan are conditional, pending the completion of consultations with union representatives at certain facilities. This DSD reorganization plan is intended to integrate the Company s southeastern sales and distribution regions with the rest of its U.S. direct store-door operations, resulting in greater efficiency across the nationwide network. The plan is expected to result in the involuntary termination or relocation of approximately 300 employee positions. To complete this initiative, management currently expects to incur $75-$85 million of total project costs, principally consisting of cash expenditures for route franchise settlements and to a lesser extent, for employee separation, relocation, and reorganization. Based on acceptances received through June 30, 2007, the Company accrued $38 million of charges for route franchise settlements during the second quarter of 2007, which were in reserve as of quarter end. These charges were recorded in selling, general, and administrative expense within the Company s North America operating segment.

In summary, operating profit for the quarter ended June 30, 2007 included total exit plan-related charges of $45 million, comprised of $7 million recorded in cost of goods sold and $38 million recorded in selling, general, and administrative expense. The operating segment impact of these costs was (in millions): North America-$38; Europe-$7. On a year-to-date basis, operating profit included total exit plan-related charges of $50 million, comprised of $12 million recorded in cost of goods sold and $38 million recorded in selling, general, and administrative expense. The operating segment impact of these costs was (in millions): North America-$38; Europe-$12.

Cost of goods sold for the quarter and year-to-date periods ended July 1, 2006, included total exit plan-related charges of approximately $20 million and $27 million, respectively. The total year-to-date amount for 2006 was comprised of $12 million of asset write-offs, $4 million attributable to a multiemployer pension plan withdrawal liability, and $11 million of cash expenditures, which consisted principally of production relocation and severance costs. These costs were recorded in the Company s North America operating segment and related to a U.S. bakery consolidation initiative, which was completed in 2006. The details of this initiative are provided on page 37 of the Company s 2006 Annual Report on Form 10-K.

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Note 4 Other income (expense), net

Other income (expense), net includes non-operating items such as interest income, charitable donations, and foreign exchange gains and losses. Net foreign exchange transaction gains (losses) recognized were ($7) million, for both the quarter and year-to-date periods ended June 30, 2007, as compared to $2 million and $4 million, respectively, for the quarter and year-to-date periods ended July 1, 2006.

Note 5 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, and to a lesser extent, certain contingently issuable performance shares. Basic net earnings per share is reconciled to diluted net earnings per share in the following table. The total number of anti-dilutive potential common shares excluded from the reconciliation was 5 million and 4 million, respectively, for the quarter and year-to-date periods ended June 30, 2007, as compared to 10 million for both the quarter and year-to-date periods ended July 1, 2006.

Quarter (millions, except per share data)	Net earnings	Average shares outstanding	Net earnings per share
2007			
Basic	$301	397	$ .76
Dilutive potential common shares		4	(.01)
Diluted	$301	401	$ .75
2006			
Basic	$267	394	$ .68
Dilutive potential common shares		3	(.01)
Diluted	$267	397	$ .67

Year-to-date (millions, except per share data)	Net earnings	Average shares outstanding	Net earnings per share
2007			
Basic	$622	397	$1.56
Dilutive potential common shares		4	(.01)
Diluted	$622	401	$1.55
2006			
Basic	$541	396	$1.36
Dilutive potential common shares		3	(.01)
Diluted	$541	399	$1.35

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During the year-to-date period ended June 30, 2007, the Company issued 2 million shares to employees and directors under various benefit plans and stock purchase programs, as further discussed in Note 8. To offset these issuances and for general corporate purposes, the Company s Board of Directors has authorized management to repurchase up to $650 million of the Company s common stock during 2007. In connection with this authorization, during the year-to-date period ended June 30, 2007, the Company spent $264 million to repurchase approximately 5 million shares.

Comprehensive Income

Comprehensive income includes net earnings and all other changes in equity during a period except those resulting from investments by or distributions to shareholders. Other comprehensive income for all periods presented consists of foreign currency translation adjustments pursuant to SFAS No. 52 Foreign Currency Translation and fair value adjustments associated with cash flow hedges pursuant to SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities. Additionally, other comprehensive income for 2007 includes adjustments for net experience losses and prior service cost pursuant to SFAS No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. The Company adopted SFAS No. 158 as of the end of its 2006 fiscal year; however, comprehensive income for interim periods of 2006 continued to include minimum pension liability adjustments pursuant to SFAS No. 87 Employers Accounting for Pensions.

Pursuant to SFAS No. 158, during the second quarter of 2007, the Company recorded an increase to its defined benefit pension and postretirement plan obligations of $40 million, comprised of $27 million for a census-related valuation update and $13 million for foreign currency remeasurement. As presented in the following schedule, this resulted in a corresponding net-of-tax increase in net experience loss of $26 million and prior service cost of $1 million within other comprehensive income. The year-to-date impact on other comprehensive income was similar.

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Quarter

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2007			
Net earnings			$ 301
Other comprehensive income:			
Foreign currency translation adjustments	34		34
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges			
Reclassification to net earnings			
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience loss	(39)	13	(26)
Prior service cost	(1)		(1)
Reclassification to net earnings:			
Net experience loss	23	(8)	15
Prior service cost	3	(1)	2
	20	4	24
Total comprehensive income			$ 325

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2006			
Net earnings			$ 267
Other comprehensive income:			
Foreign currency translation adjustments	(24)		(24)
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	2	(1)	1
Reclassification to net earnings	3	(1)	2
Minimum pension liability adjustments			
	(19)	(2)	(21)
Total comprehensive income			$ 246

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Year-to-date

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2007			
Net earnings			$ 622
Other comprehensive income:			
Foreign currency translation adjustments	27		27
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	17	(6)	11
Reclassification to net earnings	1		1
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience loss	(38)	13	(25)
Prior service cost	(1)		(1)
Reclassification to net earnings:			
Net experience loss	45	(15)	30
Prior service cost	5	(2)	3
	56	(10)	46
Total comprehensive income			$ 668

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2006			
Net earnings			$ 541
Other comprehensive income:			
Foreign currency translation adjustments	(38)		(38)
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	5	(2)	3
Reclassification to net earnings	5	(2)	3
Minimum pension liability adjustments			
	(28)	(4)	(32)
Total comprehensive income			$ 509

Accumulated other comprehensive income (loss) as of June 30, 2007 and December 30, 2006 consisted of the following:

(millions)	**June 30, 2007**	December 30, 2006
Foreign currency translation adjustments	**$ (382)**	$ (409)
Cash flow hedges unrealized net loss	**(21)**	(33)
Postretirement and postemployment benefits:		

Net experience loss		**(535)**		(540)
Prior service cost		**(62)**		(64)
Total accumulated other comprehensive income (loss)		**$ (1,000)**	$	(1,046)

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Note 6 Leases and other commitments

The Company was subject to a maximum residual value guarantee on one operating lease of a snacks manufacturing facility in Chicago, Illinois, for approximately $13 million, which was scheduled to expire in July 2007. During the first quarter of 2007, the Company recognized a liability in connection with this guarantee of approximately $5 million, which was recorded in cost of goods sold within the Company s North America operating segment. During the second quarter of 2007, the Company terminated the lease agreement and purchased the facility for approximately $16 million, which discharged the residual value guarantee obligation.

Note 7 Debt

On February 28, 2007, a subsidiary of the Company redeemed Euro 550 million of Guaranteed Floating Rate Notes otherwise due May 2007 for $728 million. To partially refinance this redemption, the Company and two of its subsidiaries (the Issuers) established a program under which the Issuers may issue euro-commercial paper notes up to a maximum aggregate amount outstanding at any time of $750 million or its equivalent in alternative currencies. The notes may have maturities ranging up to 364 days and are senior unsecured obligations of the applicable Issuer. Notes issued by subsidiary Issuers are guaranteed by the Company. The notes may be issued at a discount or may bear fixed or floating rate interest or a coupon calculated by reference to an index or formula. On June 13, 2007, management also increased the aggregate principal amount of notes that may be outstanding at any time under the Company s U.S. commercial paper program from $2.0 billion to $2.5 billion.

In connection with these financing activities, the Company increased its short-term lines of credit from $2.2 billion at December 30, 2006 to approximately $3.3 billion at June 30, 2007. This increase was achieved via a $400 million unsecured 364-Day Credit Agreement effective January 31, 2007 and a $700 million 364-Day Credit Agreement effective June 13, 2007. These 364-Day Agreements contain customary covenants, warranties, and restrictions similar to those described for the Five-Year Credit Agreement on page 41 of the Company s 2006 Annual Report on Form 10-K. The Company s credit facilities are available for general corporate purposes, including commercial paper back-up, although management does not currently anticipate any draw-down of the facilities.

As of June 30, 2007, notes outstanding under the Company s commercial paper programs were (in millions): U.S.-$1,796; Europe-$127; Canada-$0. Refer to page 40 of the Company s 2006 annual report on Form 10-K for comparable information as of December 30, 2006.

Note 8 Stock compensation

The Company uses various equity-based compensation programs to provide long-term performance incentives for its global workforce. Currently, these incentives consist principally of stock options, and to a lesser extent, executive performance shares and restricted stock grants. Additionally, the Company awards stock options and restricted stock to its outside directors. These awards are administered through several plans, as described on pages 41 to 44 of the Company s 2006 Annual Report on Form 10-K.

Beginning in 2006, the Company has followed SFAS No. 123(R) Share-Based Payment to account for its equity-based compensation programs. For the periods presented, the Company classified pre-tax stock compensation expense in selling, general, and administrative expense principally within its corporate operations. For further information on the Company s stock compensation accounting methods, refer to pages 32 and 33 of the Company s 2006 Annual Report on Form 10-K.

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For the quarter ended June 30, 2007, compensation expense for all types of equity-based programs and the related income tax benefit recognized were $22 million and $8 million, respectively. Year-to-date, pre-tax stock- based compensation expense was $47 million and the related tax benefit was $17 million. For the quarter ended July 1, 2006, compensation expense for all types of equity-based programs and the related income tax benefit recognized were $23 million and $8 million, respectively. Year-to-date, pre-tax stock-based compensation expense was $45 million and the related tax benefit was $16 million.

As of June 30, 2007, total stock-based compensation cost related to nonvested awards not yet recognized was approximately $54 million and the weighted-average period over which this amount is expected to be recognized was approximately 1.4 years.

Stock Options

During the year-to-date periods ended June 30, 2007 and July 1, 2006, the Company granted non-qualified stock options to eligible employees and outside directors as presented in the following activity tables. Terms of these grants and the Company s methods for determining grant-date fair value of the awards were consistent with that described on page 43 of the Company s 2006 Annual Report on Form 10-K.

Year-to-date period ended June 30, 2007:

Employee and director stock options	Shares (millions)	Weighted-average exercise price	Weighted-average remaining contractual term (yrs.)	Aggregate intrinsic value (millions)
Outstanding, beginning of period	27	$ 41		
Granted	6	50		
Exercised	(5)	41		
Forfeitures and expirations				
Outstanding, end of period	28	$ 43	6.4	$ 252
Exercisable, end of period	22	$ 42	5.5	$ 220

Year-to-date period ended July 1, 2006:

Employee and director stock options	Shares (millions)	Weighted-average exercise price	Weighted-average remaining contractual term (yrs.)	Aggregate intrinsic value (millions)
Outstanding, beginning of period	29	$ 38		
Granted	7	45		
Exercised	(5)	36		
Forfeitures and expirations				
Outstanding, end of period	31	$ 40	6.4	$ 246
Exercisable, end of period	23	$ 39	5.5	$ 209

The weighted-average fair value of options granted was $7.52 per share for the year-to-date period ended June 30, 2007 and $7.14 per share for the year-to-date period ended July 1, 2006. The total intrinsic value of options exercised was $56 million for the year-to-date period ended June 30, 2007 and $48 million for the

year-to-date period ended July 1, 2006.

Other stock-based awards

During the periods presented, other stock-based awards consisted principally of executive performance shares granted under the Company's 2003 Long-Term Incentive Plan.

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In the first quarter of 2007, the Company granted performance shares to a limited number of senior executive-level employees, which entitle these employees to receive a specified number of shares of the Company s common stock on the vesting date, provided cumulative three-year cash flow targets are achieved. The 2007 target grant currently corresponds to approximately 206,000 shares, with a grant-date fair value of approximately $46 per share. The actual number of shares issued on the vesting date could range from zero to 200% of target, depending on actual performance achieved. For information on similar performance share awards in 2005 and 2006, refer to page 44 of the Company s 2006 Annual Report on Form 10-K. Based on the market price of the Company s common stock at June 30, 2007, the maximum future value that could be awarded to employees on the vesting date is (in millions): 2005 award-$28; 2006 award-$26; and 2007 award-$21.

Note 9 Employee benefits

The Company sponsors a number of U.S. and foreign pension, other postretirement and postemployment plans to provide various benefits for its employees. These plans are described on pages 44 to 48 of the Company s 2006 Annual Report on Form 10-K. Components of Company plan benefit expense for the periods presented are included in the tables below.

Pension

	Quarter ended		Year-to-date period ended	
(millions)	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Service cost	$ 24	$ 22	$ 48	$ 46
Interest cost	46	43	92	84
Expected return on plan assets	(69)	(63)	(138)	(125)
Amortization of unrecognized prior service cost	3	3	5	6
Recognized net loss	16	20	32	39
Total pension expense Company plans	$ 20	$ 25	$ 39	$ 50

Other nonpension postretirement

	Quarter ended		Year-to-date period ended	
(millions)	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Service cost	$ 4	$ 4	$ 8	$ 9
Interest cost	17	16	34	32
Expected return on plan assets	(15)	(14)	(30)	(29)
Amortization of unrecognized prior service cost		(1)		(2)
Recognized net loss	6	8	12	16
Postretirement benefit expense	$ 12	$ 13	$ 24	$ 26

Postemployment

	Quarter ended		Year-to-date period ended	
(millions)	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Service cost	$ 1	$ 1	$ 2	$ 2

Interest cost	1		2	1
Recognized net loss	1	1	1	2
Postemployment benefit expense	$ 3	$ 2	$ 5	$ 5

Management currently plans to contribute approximately $33 million to its defined benefit pension plans and $15 million to its retiree health and welfare benefit plans during 2007, for a total of $48 million. During 2006, the Company contributed approximately $86 million to defined benefit pension plans and $13 million to retiree health and welfare benefit plans, for a total of $99 million. Plan funding strategies are periodically modified to reflect management s current evaluation of tax deductibility, market conditions, and competing investment alternatives.

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Note 10 Income taxes

Effective income tax rate

The consolidated effective income tax rate was 32% for the quarter ended June 30, 2007, as compared to 31% for the quarter ended July 1, 2006. The second quarter 2006 provision for income taxes included two significant, but partially-offsetting, discrete adjustments. First, during that period, the Company revised its repatriation plan for certain foreign earnings, giving rise to an incremental net tax cost of $18 million. Secondly, the Company reduced its reserves for uncertain tax positions by $25 million, related principally to closure of several domestic tax audits.

For the year-to-date period ended June 30, 2007, the consolidated effective income tax rate was 28%, as compared to approximately 32% for the comparable prior year-to-date period. During the first quarter of 2007, management implemented an international restructuring initiative, which eliminated a foreign tax liability of approximately $40 million. Accordingly, the first quarter reversal is reflected in the Company s consolidated income tax provision for the year-to-date period ended June 30, 2007.

In July 2007, the government of the United Kingdom enacted a statutory rate reduction of two percentage points, applicable from April 1, 2008. During the third quarter of 2007, management also expects the government of Germany to enact a federal statutory income tax rate reduction of ten percentage points effective in 2008, partially offset by the effect of other German tax law changes. Accordingly, during the third quarter of 2007, management plans to reduce the Company s net deferred income tax liabilities in these jurisdictions to reflect the lower rates; the current estimate of the resulting earnings benefit is approximately $16 million.

Uncertain tax positions

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

Prior to adopting FIN No. 48, the Company s policy was to establish reserves that reflected the probable outcome of known tax contingencies. Favorable resolution was recognized as a reduction to the effective income tax rate in the period of resolution. As compared to a contingency approach, FIN No. 48 is based on a benefit recognition model. Provided that the tax position is deemed more likely than not of being sustained, FIN No. 48 permits a company to recognize the largest amount of tax benefit that is greater than 50 percent likely of being ultimately realized upon settlement. The tax position must be derecognized when it is no longer more likely than not of being sustained. The initial application of FIN No. 48 resulted in a net decrease to the Company s consolidated accrued income tax and related interest liabilities of approximately $2 million, with an offsetting increase to retained earnings.

The Company files income taxes in the U.S. federal jurisdiction, and in various state, local, and foreign jurisdictions. The Company s annual provision for U.S. federal income taxes has recently represented approximately 70% of the Company s consolidated income tax provision. With limited exceptions, the Company is no longer subject to U.S. federal examinations by the Internal Revenue Service (IRS) for years prior to 2004. During the first quarter of 2007, the IRS commenced an examination of the Company s 2004 and 2005 U.S. federal income tax returns, which is anticipated to be completed during the second half of 2008. The Company is also under examination for income and non-income tax filings in various state and foreign jurisdictions, most notably: 1) a U.S.-Canadian transfer pricing issue pending international arbitration (Competent Authority) with a related advanced pricing agreement for years 1997-2008; and 2) an on-going examination of 2002-2004 U.K. income tax filings, with an examination of the 2005 filing, which began in July 2007.

As of June 30, 2007, the Company has classified approximately $24 million of unrecognized tax benefits as a current liability, representing several individually insignificant income tax positions under examination in various jurisdictions. Management s estimate of reasonably possible changes in unrecognized tax benefits during the next twelve months is comprised of the aforementioned current liability balance expected to be settled within one year, offset by approximately $25 million of projected additions related primarily to ongoing intercompany transfer pricing activity. Management is currently unaware of any issues under review that could result in significant additional payments, accruals, or other material deviation in this estimate.

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Following is a reconciliation of the Company s total gross unrecognized tax benefits for the year-to-date period ended June 30, 2007. Approximately $145 million of this total represents the amount that, if recognized, would affect the Company s effective income tax rate in future periods. This amount differs from the gross unrecognized tax benefits presented in the table due to the decrease in U.S. federal income taxes which would occur upon recognition of the state tax benefits included therein.

(millions)	
Balance at December 31, 2006	$ 143
Tax positions related to current year:	
Additions	15
Reductions	
Tax positions related to prior years:	
Additions	8
Reductions	(1)
Settlements	
Lapses in statutes of limitation	
Balance at June 30, 2007	$ 165

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

The Company classifies income tax-related interest and penalties as interest expense and selling, general, and administrative expense, respectively. For the year-to-date period ended June 30, 2007, the Company recognized $4 million of tax-related interest and penalties and had approximately $24 million accrued at June 30, 2007.

Note 11 Operating segments

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

	Quarter ended		Year-to-date period ended	
(millions) *(Results are unaudited)*	**June 30, 2007**	July 1, 2006	**June 30, 2007**	July 1, 2006
Net sales				
North America	**$ 1,980**	$ 1,859	**$ 3,982**	$ 3,724
Europe	**623**	538	**1,197**	1,028
Latin America	**253**	225	**482**	440
Asia Pacific (a)	**159**	151	**317**	308
Consolidated	**$ 3,015**	$ 2,773	**$ 5,978**	$ 5,500

Segment operating profit

North America	**$ 365**	$ 327	**$ 726**	$ 679
Europe	**127**	97	**235**	181
Latin America	**55**	58	**102**	113
Asia Pacific (a)	**20**	24	**47**	49
Corporate	**(49)**	(45)	**(93)**	(88)
Consolidated	**$ 518**	$ 461	**$ 1,017**	$ 934

(a) Includes Australia, Asia and South Africa.

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Note 12 Supplemental cash flow data
(millions)

	Year-to-date period ended	
Changes in operating assets and liabilities	**June 30, 2007**	July 1, 2006
Trade receivables	**$ (189)**	$ (170)
Inventories	**9**	(3)
Accounts payable	**61**	(5)
Accrued income taxes	**45**	(14)
Accrued interest expense	**1**	1
Accrued and prepaid advertising, promotion and trade allowances	**66**	12
Accrued salaries and wages	**(86)**	(74)
Exit plan-related reserves (a)	**43**	3
All other current assets and liabilities	**40**	(4)
	$ (10)	$ (254)

(a) Refer to Note 3 for further information.

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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, including cookies, crackers, toaster pastries, cereal bars, fruit snacks, frozen waffles, and veggie foods. Kellogg products are manufactured and marketed globally. Principal markets for these products include the United States and United Kingdom. We currently manage our operations in four geographic operating segments, comprised of North America and the three International operating segments of Europe, Latin America, and Asia Pacific. Prior to 2007, the Asia Pacific operating segment included Australia and Asian markets. Beginning in 2007, this segment also includes South Africa, which was formerly a part of Europe. Prior-year periods have been restated.

Our long-term annual growth targets are low single-digit for internal net sales, mid single-digit for internal operating profit and high single-digit for diluted net earnings per share. *(Our measure of internal growth rates excludes the impact of currency, and if applicable, acquisitions, dispositions, and shipping day differences.)* We believe our strong financial performance for the first half of the year provides momentum for achieving or exceeding these annual growth targets for the full year of 2007. For the year-to-date period ended June 30, 2007, we reported consolidated net sales growth of 9% with internal growth of 6%. Consolidated operating profit also increased 9% on internal growth of 6%. Diluted net earnings per share grew 15%, from $1.35 in the first half of 2006 to $1.55 in the current year-to-date period. Similarly, for the second quarter of 2007, we reported consolidated net sales growth of 9% with internal growth of 6%. Consolidated operating profit increased 12% on internal growth of 9%. Diluted net earnings per share grew 12%, from $.67 in the second quarter of 2006 to $.75 in the current period.

Net sales and operating profit

The following table provides an analysis of net sales and operating profit performance for the second quarter of 2007 versus 2006:

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(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consoli-dated
2007 net sales	**$ 1,980**	**$ 623**	**$ 253**	**$ 159**	**$**	**$ 3,015**
2006 net sales	**$ 1,859**	**$ 538**	**$ 225**	**$ 151**	**$**	**$ 2,773**
% change - 2007 vs. 2006:						
Volume (tonnage) (b)	1.4%	3.1%	6.3%	-1.5%		2.0%
Pricing/mix	4.9%	3.9%	1.6%	1.0%		4.2%
Subtotal internal business	**6.3%**	**7.0%**	**7.9%**	**-.5%**		**6.2%**
Foreign currency impact	.2%	8.6%	4.6%	5.8%		2.5%
Total change	**6.5%**	**15.6%**	**12.5%**	**5.3%**		**8.7%**

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consoli-dated
2007 operating profit	**$ 365**	**$ 127**	**$ 55**	**$ 20**	**$ (49)**	**$ 518**
2006 operating profit	**$ 327**	**$ 97**	**$ 58**	**$ 24**	**$ (45)**	**$ 461**
% change - 2007 vs. 2006:						
Internal business	**11.3%**	**19.4%**	**-7.6%**	**-25.8%**	**-6.6%**	**9.1%**
Foreign currency impact	.3%	10.4%	3.9%	5.4%		3.3%
Total change	**11.6%**	**29.8%**	**-3.7%**	**-20.4%**	**-6.6%**	**12.4%**

(a) Includes Australia, Asia and South Africa

(b) We measure the volume impact (tonnage) on revenues based on the stated weight of our product shipments.

Our strong consolidated net sales performance for the second quarter of 2007 reflects the continuation of broad-based successful innovation, brand-building (advertising and consumer promotion) investment, and in-store execution.

For the quarter, our North America operating segment reported internal net sales growth of 6%, with each major product group contributing as follows: retail cereal +3%; retail snacks (*wholesome snacks, cookies, crackers, toaster pastries, fruit snacks*) +9%; frozen and specialty (*food service, vending, convenience, drug stores, custom manufacturing*) channels +8%. Notably, this quarter s performance represents five consecutive years of quarter-over-quarter internal net sales growth for each of the three product groups within North America.

Our International operating segments collectively reported internal net sales growth of approximately 6% with leading dollar contributions from our UK, France, Mexico, and Venezuela business units. The internal sales decline in our Asia Pacific operating segment (which represents only about 5% of our consolidated results) was attributable to continuing weak performance in our Australian business due to competitive pressures, which offset strong sales growth in our Asian and S. Africa markets.

For the quarter, our consolidated operating profit increased 12% on a reported basis and 9% on an internal basis. This high single-digit internal operating profit growth primarily reflects strong top-line performance coupled with gross margin improvement, as further discussed in the next section entitled *Margin performance.* For the quarter, our consolidated operating profit continued to reflect double-digit growth in advertising investment and good cost containment on promotional expenditures.

As discussed in the section herein entitled *Exit or disposal plans*, this quarter s operating profit included $25 million of incremental exit plan-related charges as compared to the second quarter of 2006. The total incremental amount was allocated to our operating segments as follows (in millions): North America-$18; Europe-$7. The allocation of the net incremental amount within operating profit resulted in a favorable year-over-year impact on cost of goods sold of $13 million and an unfavorable impact on selling, general, and administrative expense of $38 million. Our current-period corporate operating profit also included intangible impairment losses of $7 million. Refer to Note 2 within Notes to Consolidated Financial Statements for further information.

Taking into account the aforementioned year-over-year segment impact of exit plan-related charges, our North American and European operating segments performed very strongly at the operating profit line, with the pace of profit growth exceeding sales growth. This was primarily due to gross margin expansion in both regions and to a lesser extent, timing of brand-building expenditures in North America. As previously predicted, our Latin America operating segment continued to be impacted by corn price inflation and other cost factors, resulting in a reported

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operating profit decline of approximately $3 million for the quarter. Our reported Asia Pacific operating profit also declined by approximately $4 million, largely related to the sales decline in that segment, significant investment in brand-building, and costs associated with an overhead streamlining initiative in Australia. Nevertheless, the combined operating profit decline for our Latin America and Asia Pacific segments reduced our internal operating profit growth for the quarter by only two percentage points. Although we do expect some stabilization and recovery for these regions in the second half of the year, we do not currently believe our Latin America and Asia Pacific segments full-year 2007 operating profit will exceed the 2006 level.

The following table provides an analysis of net sales and operating profit performance for the year-to-date periods of 2007 versus 2006. On a year-to-date basis, incremental exit-plan-related charges were $23 million and were allocated to segments as follows (in millions): North America-$11; Europe-$12. The allocation of the net incremental amount within operating profit resulted in a favorable year-over-year impact on cost of goods sold of $15 million and an unfavorable impact on selling, general, and administrative expense of $38 million. Our year-to-date North America operating profit also included a charge of $5 million related to a lease residual value guarantee. Refer to Note 6 within Notes to Consolidated Financial Statements for further information.

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consoli-dated
2007 net sales	**$3,982**	**$1,197**	**$ 482**	**$ 317**	**$**	**$5,978**
2006 net sales	**$3,724**	**$1,028**	**$ 440**	**$ 308**	**$**	**$5,500**
% change - 2007 vs. 2006:						
Volume (tonnage) (b)	2.2%	3.2%	7.4%	-2.9%		2.6%
Pricing/mix	4.6%	3.6%	.7%	1.7%		3.9%
Subtotal internal business	**6.8%**	**6.8%**	**8.1%**	**-1.2%**		**6.5%**
Foreign currency impact	.1%	9.6%	1.6%	4.1%		2.2%
Total change	**6.9%**	**16.4%**	**9.7%**	**2.9%**		**8.7%**

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consoli-dated
2007 operating profit	**$ 726**	**$ 235**	**$ 102**	**$ 47**	**$ (93)**	**$1,017**
2006 operating profit	**$ 679**	**$ 181**	**$ 113**	**$ 49**	**$ (88)**	**$ 934**
% change - 2007 vs. 2006:						
Internal business	**6.9%**	**18.6%**	**-11.1%**	**-10.4%**	**-5.3%**	**6.2%**
Foreign currency impact	.1%	11.4%	1.4%	4.8%		2.7%
Total change	**7.0%**	**30.0%**	**-9.7%**	**-5.6%**	**-5.3%**	**8.9%**

(a)

Includes Australia, Asia and South Africa

(b) We measure the volume impact (tonnage) on revenues based on the stated weight of our product shipments.

Margin performance

Margin performance for the second quarter and year-to-date periods of 2007 versus 2006 is presented in the following table:

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Quarter	**2007**	2006	*Change vs. prior year (pts.)*
Gross margin	**45.7%**	44.5%	**1.2**
SGA% (a)	**-28.5%**	-27.9%	**(.6)**
Operating margin	**17.2%**	16.6%	**0.6**

Year-to-date	**2007**	2006	*Change*
Gross margin	**44.2%**	44.2%	
SGA% (a)	**-27.2%**	-27.2%	
Operating margin	**17.0%**	17.0%	

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

Our consolidated gross margin increased 120 basis points for the quarter, bringing our year-to-date results in line with the prior-year period. Following a number of periods of quarter-over-quarter decline, we believe this improved gross margin performance largely reflects savings from cost-reduction initiatives, price/mix improvements, and operating leverage, which more than offset continuing commodity, fuel, and energy price inflation. As discussed in the preceding section, a year-over-year shift in earnings caption allocation of exit plan-related charges also favorably impacted gross margin by 40 basis points in the quarter and 30 basis points in the year-to-date period. Lastly, our ongoing focus on package insert and other promotional efficiencies resulted in gross margin improvement of 60 basis points in the quarter and 30 basis points in the year-to-date period. Based on our first-half performance, we currently expect that our full-year 2007 consolidated gross margin will decline by approximately 50 basis points. This forecast incorporates approximately $150-$170 million of year-over-year commodity, fuel, and energy price inflation, net of a modest reduction in employee benefit costs. Approximately one-third of this price inflation was absorbed in the first half of 2007. As compared to our original 2007 price inflation forecast of $110-$130 million (discussed on page 14 of our 2006 Annual Report on Form 10-K), our most recent projection incorporates higher, current market prices for packaging and ingredient purchases, primarily dairy, eggs and wheat. Despite the full-year 2007 forecasted gross margin decline, we use incremental gross profit dollars to fund investment in innovation and brand-building to drive future business growth. For the year-to-date period, we achieved incremental gross profit of $209 million.

Exit or disposal plans

As discussed on pages 14-15 of our 2006 Annual Report on Form 10-K, we view our continued spending on cost-reduction initiatives as part of our ongoing operating principles to reinvest earnings so as to provide greater visibility in meeting long-term growth targets. Initiatives undertaken are currently expected to recover cash implementation costs within a five-year period of completion (expected pay-back target). Upon completion (or as each major stage is completed in the case of multi-year programs), the project begins to deliver cash savings and/or reduced depreciation, which is then used to fund new initiatives. Certain of these

initiatives represent exit or disposal plans for which material charges will be incurred. We include these charges in our measure or operating segment profitability.

We are currently committed to exit plans that are expected to generate up to $102 million of related charges for the full year of 2007 as compared to $82 million in 2006. The 2007 total is approximately allocated as follows (in millions): European manufacturing optimization-$17; U.S. DSD reorganization-$85. (The details of each of these initiatives are discussed in the following paragraphs of this section.) Additionally, we currently expect full-year 2007 cash requirements for these projects to approximate our forecast of exit plan-related charges. We expect these cash requirements to be funded by operating cash flow. These forecasted charges and cash requirements are incorporated in our communicated expectations for 2007 earnings and cash flow performance.

In 2006, we commenced a multi-year European manufacturing optimization plan to improve utilization of our facility in Manchester, England and to better align production in Europe. Based on forecasted foreign exchange rates, we currently expect to incur approximately $60 million in total project costs (including those already incurred in 2006), largely comprised of voluntary early retirement and severance benefits to eliminate approximately 220 hourly and salaried employee positions from the Manchester facility by the end of 2008. For 2006, we incurred approximately $28 million of total project costs and expect to incur approximately $17 million in

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2007, with the remainder incurred in 2008. (Refer to page 36 of our 2006 Annual Report on Form 10-K for further information on this initiative.)

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

Project costs to date (in millions)	Employee severance	Other cash costs (a)	Asset write-offs	Retirement benefits(b)	Total
Year ended December 30, 2006	$ 12	$ 2	$ 5	$ 9	$28
Quarter ended March 30, 2007	3	1	1		5
Quarter ended June 30, 2007	4	1	2		7
Total project to date	**$ 19**	**$ 4**	**$ 8**	**$ 9**	**$40**

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

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

Employee severance reserves to date	Beginning of	End of

(in millions)	period	Accruals	Payments	period
Year ended December 30, 2006	$	$12	$	$12
Quarter ended March 30, 2007	12	3	(9)	6
Quarter ended June 30, 2007	6	4	(5)	5
Total project to date		**$19**	**$(14)**	

On June 27, 2007, we began to extend offers to exit approximately 517 distribution route franchise agreements with independent contractors, which were substantially accepted as of July 13, 2007. Based on these acceptances, we then commenced a plan to reorganize our direct store-door delivery (DSD) operations in the southeastern United States by the end of 2007. Certain elements of this plan are conditional, pending the completion of consultations with union representatives at certain facilities. This DSD reorganization plan is intended to integrate our southeastern sales and distribution regions with the rest of our U.S. direct store-door operations, resulting in greater efficiency across the nationwide network. The plan is expected to result in the involuntary termination or relocation of approximately 300 employee positions. To complete this initiative, we currently expect to incur $75-$85 million of total project costs, principally consisting of cash expenditures for route franchise settlements and to a lesser extent, for employee separation, relocation, and reorganization. Based on acceptances received through June 30, 2007, we accrued $38 million of charges for route franchise settlements during the second quarter of 2007, which were in reserve as of quarter end. These charges were recorded in selling, general, and administrative expense within our North America operating segment.

In summary, operating profit for the quarter ended June 30, 2007 included total exit plan-related charges of $45 million, comprised of $7 million recorded in cost of goods sold and $38 million recorded in selling, general, and administrative expense. The operating segment impact of these costs was (in millions): North America-$38; Europe-$7. On a year-to-date basis, operating profit included total exit plan-related charges of $50 million, comprised of $12 million recorded in cost of goods sold and $38 million recorded in selling, general, and administrative expense. The operating segment impact of these costs was (in millions): North America-$38; Europe-$12.

Cost of goods sold for the quarter and year-to-date periods ended July 1, 2006, included total exit plan-related charges of approximately $20 million and $27 million, respectively. The total year-to-date amount for 2006 was comprised of $12 million of asset write-offs, $4 million attributable to a multiemployer pension plan withdrawal liability, and $11 million of cash expenditures, which consisted principally of production relocation and severance costs. These costs were recorded in our North America operating segment and related to a U.S. bakery consolidation initiative, which was completed in 2006. The details of this initiative are provided on page 37 of our 2006 Annual Report on Form 10-K.

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Interest expense

For the first half of 2007, interest expense was $154 million and interest income (which is recorded within other income) was $8 million, as compared to first half 2006 interest expense of $152 million and interest income of $4 million. Accordingly, interest expense, net of interest income, for the year-to-date period of 2007 was within $2 million of the 2006 amount. For the full year of 2007, we currently expect interest expense, net of interest income, to approximate the 2006 level of $296 million.

Income taxes

The consolidated effective income tax rate was 32% for the quarter ended June 30, 2007, as compared to 31% for the quarter ended July 1, 2006. For the year-to-date period ended June 30, 2007, the consolidated effective income tax rate was 28%, as compared to approximately 32% for the comparable prior year-to-date period. During the first quarter of 2007, we implemented an international restructuring initiative, which eliminated a foreign tax liability of approximately $40 million. Accordingly, the first quarter reversal is reflected in our consolidated income tax provision for the year-to-date period ended June 30, 2007.

In July 2007, the government of the United Kingdom enacted a statutory rate reduction of two percentage points, applicable from April 1, 2008. During the third quarter of 2007, we also expect the government of Germany to enact a federal statutory income tax rate reduction of ten percentage points effective in 2008, partially offset by the effect of other German tax law changes. Accordingly, during the third quarter of 2007, we plan to reduce our net deferred income tax liabilities in these jurisdictions to reflect the lower rates; our current estimate of the resulting earnings benefit is approximately $16 million. Taking into account this discrete benefit, we currently believe that our full-year 2007 consolidated effective income tax rate will be approximately 30%. Our projection of effective income tax rate for any period is highly influenced by country mix of earnings, changes in statutory tax rates, timing of implementation of tax planning initiatives, and developments which affect our evaluation of uncertain tax positions. For further information on our uncertain tax positions, refer to Note 10 within Notes to Consolidated Financial Statements.

Liquidity and capital resources

Our principal source of liquidity is operating cash flows, 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. The principal source of our operating cash flow is net earnings, meaning cash receipts from the sale of our products, net of costs to manufacture and market our products. Our cash conversion cycle *(defined as days of inventory and trade receivables outstanding less days of trade payables outstanding)* is relatively short; equating to approximately 29 days for the trailing 365-day period ended June 30, 2007. As a result, our operating cash flow should generally reflect our net earnings performance over time, although, as illustrated in the following schedule, specific results for any particular period may be significantly affected by the level of benefit plan contributions, working capital movements (operating assets and liabilities) and other factors.

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(in millions)	Year-to-date period ended June 30, 2007	Year-to-date period ended July 1, 2006	*Change versus prior year*
Operating activities			
Net earnings	$ 622	$ 541	$ 81
Items in net earnings not requiring (providing) cash:			
Depreciation and amortization	185	173	12
Deferred income taxes	(92)	(2)	(90)
Other (a)	79	74	5
Pension and other postretirement benefit plan contributions	(34)	(30)	(4)
Changes in operating assets and liabilities:			
Core working capital (b)	(119)	(178)	59
Other working capital	109	(76)	185
	(10)	(254)	244
Net cash provided by operating activities	$ 750	$ 502	$ 248

(a) Consists principally of non-cash expense accruals for employee compensation and benefit obligations.

(b) Inventory and trade receivables less trade payables.

Our net cash provided by operating activities for the year-to-date period ended June 30, 2007 was $248 million higher than the comparable period of 2006, due primarily to growth in cash-basis earnings, timing of advertising/promotion expenditures, and favorable working capital performance. As presented in the preceding schedule, these contributing factors are concentrated within the core and other working capital captions:

In relation to the prior period, the favorable year-over-year variance in core working capital movement was principally attributable to higher trade payables, which are due, in part, to increased payment terms in international locations and in comparison to a significant decline in the first half of 2006.

The favorable movement in other working capital primarily represents accrued expenses not paid in the current year-to-date period, including advertising/promotion liabilities and exit-plan related obligations, as discussed herein in the section entitled *Exit or disposal plans*. Additionally, the movement in accrued income taxes favorably impacted other working capital for 2007 versus 2006, but was offset by the unfavorable movement in deferred income taxes, as illustrated in the preceding table.

Refer to Note 12 within Notes to Consolidated Financial Statements for additional information on changes in the components of working capital during the periods presented.

Total 2007 postretirement benefit plan contributions are currently estimated at approximately $48 million, as compared to $99 million in 2006. Actual 2007 contributions could exceed our current projections, as influenced by our decision to undertake discretionary funding of our benefit trusts versus other competing investment priorities, future changes in government requirements, renewals of union contracts, or higher-than-expected health care claims cost experience.

Our management measure of cash flow is defined as net cash provided by operating activities reduced by expenditures for property additions. We use this non-GAAP financial 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 the most comparable GAAP measure, as follows:

	Year-to-date period ended		*Change*
(dollars in millions)	June 30, 2007	July 1, 2006	*versus prior year*
Net cash provided by operating activities	$ 750	$ 502	
Additions to properties	(181)	(162)	
Cash flow	$ 569	$ 340	67.4%

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As discussed in Note 6 within Notes to Consolidated Financial Statements, our property additions for the year-to-date period of 2007 include approximately $16 million for the purchase of a previously-leased snacks manufacturing facility in Chicago, Illinois. For the full-year of 2007, we currently expect property expenditures to remain at approximately 4% of net sales, which is consistent with our actual spending rate for 2006 and also our long-term target for capital spending. For 2007, we are targeting cash flow of approximately $950-$1,025 million. We expect to achieve our target principally through operating profit, which is forecasted to offset higher levels of capital spending and income tax payments during 2007.

For 2007, our Board of Directors has currently authorized a stock repurchase program of up to $650 million for general corporate purposes and to offset issuances under employee benefit programs. As of June 30, 2007, we had spent $264 million of this authorization to purchase approximately 5 million shares.

In July 2007, our Board of Directors declared a dividend of $.31 per common share, payable September 15, 2007, to shareholders of record at the close of business on September 1, 2007. This represents a 6.5% increase from the quarterly dividends paid during the trailing twelve months of $.2910 per common share. This increase is consistent with our current plan to maintain our dividend pay-out ratio between 40% and 50% of reported net earnings.

To utilize excess cash and reduce financing costs, on February 28, 2007, we redeemed Euro 550 million of floating rate notes otherwise due May 2007 (the Euro Notes), for $728 million. To partially refinance this redemption, we established a program to issue euro-commercial paper notes up to a maximum aggregate amount outstanding at any time of $750 million or its equivalent in alternative currencies. The notes may have maturities ranging up to 364 days and are senior unsecured obligations of the applicable issuer, with subsidiary issuances guaranteed by the Company. On June 13, 2007, we also increased the aggregate principal amount of notes that may be outstanding at any time under our U.S. commercial paper program from $2.0 billion to $2.5 billion.

In connection with these financing activities, we increased our short-term lines of credit from $2.2 billion at December 30, 2006 to approximately $3.3 billion at June 30, 2007. This increase was achieved via a $400 million unsecured 364-Day Credit Agreement effective January 31, 2007 and a $700 million 364-Day Credit Agreement effective June 13, 2007. These 364-Day Agreements contain customary covenants, warranties, and restrictions similar to those described for the Five-Year Credit Agreement on page 41 of our 2006 Annual Report on Form 10-K. Our credit facilities are available for general corporate purposes, including commercial paper back-up, although we do not currently anticipate any draw-down of the facilities.

As compared to our financial position as of December 30, 2006, our total cash at June 30, 2007 has increased $163 million to $574 million, while total debt has remained approximately even at slightly over $5 billion. Additionally, the domicile of approximately $600 million of short-term debt (notes payable and current maturities of long-term debt) has shifted from international locations to the United States. These movements during the first half of 2007 are primarily associated with the settlement of certain intercompany transactions. During the second half of 2007, we expect our total cash balance to decline modestly and our net debt (*debt, net of cash*) level to remain fairly stable.

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, including the pursuit of selected growth opportunities, 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 our 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 aforementioned credit facilities, which represented in excess of 1.5 times our outstanding commercial paper balance of approximately $1.9 billion at June 30, 2007. In addition, assuming continuation of market liquidity, we believe it would be possible to term out certain short-term maturities or obtain additional credit facilities such that the Company could further extend its ability to meet its long-term borrowing obligations through 2008.

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Future outlook & forward-looking statements

Our 2007 forecasted consolidated results are generally based on our long-term annual growth targets discussed on page 18, although we currently expect our internal net sales to increase by mid single-digits, slightly exceeding our low single-digit growth target. Based on first-half results, we currently expect this higher-than-targeted growth to be fairly broad-based, with our North America, European, and Latin American operating segments all delivering strong sales performance this year. Despite a projected decline in gross margin of approximately 50 basis points and significant, incremental charges for exit plans, we believe the higher-than-targeted sales growth will support mid single-digit consolidated operating profit growth. Our net interest expense for 2007 is currently expected to be approximately even with 2006 results and our consolidated effective income tax rate is projected to be approximately two percentage points lower than the 2006 rate of 32%. These two factors are expected to provide leverage for purposes of achieving our target of high single-digit growth in 2007 diluted net earnings per share. In addition, we remain committed to reinvesting in brand building, cost-reduction initiatives, and other growth opportunities. Lastly, we expect our cash flow performance to remain strong and are currently targeting a level of approximately $950-$1,025 million for 2007.

This Management s Discussion and Analysis contains forward-looking statements with projections concerning, among other things, our strategy, financial principles, and plans; initiatives, improvements and growth; sales, gross margins, advertising, promotion, merchandising, brand building, operating profit, and earnings per share; innovation; investments; capital expenditure; asset write-offs and expenditures and costs related to productivity or efficiency initiatives; the impact of accounting changes and significant accounting estimates; our ability to meet interest and debt principal repayment obligations; minimum contractual obligations; future common stock repurchases or debt reduction; effective income tax rate; cash flow and core working capital improvements; interest expense; commodity, fuel, 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. Our future results could be affected by a variety of 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;
- fuel, energy and commodity (ingredient and packaging) prices;
- labor, wage and benefit costs;
- the availability of and interest rates on short-term and long-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, taxes and tariffs, currency conversion and availability;

§ legal and regulatory factors;

§ business disruption or other losses from war, terrorist acts, or political unrest; and,

§ the risks and uncertainties described herein under Part II, Item 1A.

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

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

Refer to disclosures contained on pages 25-26 of our 2006 Annual Report on Form 10-K. There have been no material changes in our exposures, risk management strategies, or hedging positions since December 30, 2006.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our 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 our management, including our Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure under Rules 13a-15(e) and 15d-15(e). Disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable, rather than absolute, assurance of achieving the desired control objectives.

As of June 30, 2007, we carried out an evaluation under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

During the last fiscal quarter, there have been no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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KELLOGG COMPANY
PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in Part I, Item 1A to our Annual Report on Form 10-K for the fiscal year ended December 30, 2006. The risk factors disclosed in Part I, Item 1A to our Annual report on Form 10-K for the fiscal year ended December 30, 2006, in addition to the other information set forth in this Report, could materially affect our business, financial condition, or results. Additional risks and uncertainties not currently known to us or that we deem to be immaterial could also materially adversely affect our business, financial condition, or results.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(e) Issuer Purchases of Equity Securities
(millions, except per share data)

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
Period #1: 4/1/07-4/28/07	0.1	$ 51.85	0.1	$ 536
Period #2: 4/29/07-5/26/07	1.0	53.42	1.0	536
Period #3: 5/27/07-6/30/07	3.4	52.45	3.4	386
Total (1)	4.5	52.67	4.5	

(1) Shares included in the table above were purchased as part of publicly announced plans or programs, as follows:

a. Approximately 2.9 million shares were purchased during the second quarter of 2007 under a program authorized by our Board of Directors to repurchase up to $650 million of Kellogg common stock during 2007 for general corporate purposes and to offset issuances for employee benefit programs. This repurchase program was publicly announced in a press release on December 11, 2006.

b. Approximately 1.6 million shares were purchased during the second quarter of 2007 from employees and directors in stock swap and similar transactions pursuant to various shareholder-approved equity-based compensation plans described in Note 8 within Notes to Consolidated Financial Statements, which is included herein under Part I, Item 1.

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Item 6. Exhibits

(a) Exhibits:

4.01	364-Day Credit Agreement dated as of June 13, 2007 with JPMorgan Chase Bank, N.A.
31.1	Rule 13a-14(e)/15d-14(a) Certification from A.D. David Mackay
31.2	Rule 13a-14(e)/15d-14(a) Certification from John A. Bryant
32.1	Section 1350 Certification from A.D. David Mackey
32.2	Section 1350 Certification from John A. Bryant

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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/ A.R. Andrews
A.R. Andrews
Principal Accounting Officer;
Vice President Corporate Controller

Date: August 3, 2007

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KELLOGG COMPANY
EXHIBIT INDEX

Exhibit No.	Description	Electronic (E) Paper (P) Incorp. By Ref. (IBRF)
4.01	364-Day Credit Agreement dated as of June 13, 2007 with JPMorgan Chase Bank, N.A.	E
31.1	Rule 13a-14(e)/15d-14(a) Certification from A.D. David Mackay	E
31.2	Rule 13a-14(e)/15d-14(a) Certification from John A. Bryant	E
32.1	Section 1350 Certification from A.D. David Mackay	E
32.2	Section 1350 Certification from John A. Bryant	E