KELLOGG CO
Form 10-Q
August 05, 2008

Table of Contents

**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 28, 2008**

**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**

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 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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

| Large accelerated filer þ | Accelerated filer o | Non-accelerated filer o | Smaller reporting company o |
|---|---|---|---|

(Do not check if a smaller reporting company)

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 25, 2008 379,404,960 shares

KELLOGG COMPANY
INDEX


| | Page |
|---|---|
| PART I Financial Information | |
| Item 1: Financial Statements | |
| Consolidated Balance Sheet June 28, 2008 and December 29, 2007 | 2 |
| Consolidated Statement of Earnings quarters and year-to-date periods ended June 28, 2008 and June 30, 2007 | 3 |
| Consolidated Statement of Cash Flows year-to-date periods ended June 28, 2008 and June 30, 2007 | 4 |
| Notes to Consolidated Financial Statements | 5-19 |
| Item 2: Management s Discussion and Analysis of Financial Condition and Results of Operations | 20-27 |
| Item 3: Quantitative and Qualitative Disclosures about Market Risk | 28 |
| Item 4: Controls and Procedures | 28 |
| PART II Other Information | |
| Item 1A: Risk Factors | 29 |
| Item 2: Unregistered Sales of Equity Securities and Use of Proceeds | 29 |
| Item 6: Exhibits | 29 |
| Signatures | 30 |
| Exhibit Index | 31 |

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

Table of Contents

## Part I FINANCIAL INFORMATION

**Item 1. Financial Statements.**

**Kellogg Company and Subsidiaries**

**CONSOLIDATED BALANCE SHEET**

(millions, except per share data)

| | **June 28, 2008** (unaudited) | December 29, 2007 * |
|---|---|---|
| **Current assets** | | |
| Cash and cash equivalents | **$ 556** | $ 524 |
| Accounts receivable, net | **1,285** | 1,011 |
| Inventories: | | |
| Raw materials and supplies | **248** | 234 |
| Finished goods and materials in process | **694** | 690 |
| Deferred income taxes | **85** | 103 |
| Other prepaid assets | **169** | 140 |
| **Total current assets** | **3,037** | 2,702 |
| Property, net of accumulated depreciation of $4,502 and $4,313 | **3,071** | 2,990 |
| Goodwill | **3,597** | 3,515 |
| Other intangibles, net of accumulated amortization of $42 and $41 | **1,449** | 1,450 |
| Pension | **518** | 481 |
| Other assets | **321** | 259 |
| **Total assets** | **$11,993** | $11,397 |
| **Current liabilities** | | |
| Current maturities of long-term debt | **$ 2** | $ 466 |
| Notes payable | **1,643** | 1,489 |
| Accounts payable | **1,206** | 1,081 |
| Accrued advertising and promotion | **417** | 378 |
| Accrued income taxes | **28** | |
| Accrued salaries and wages | **222** | 316 |
| Other current liabilities | **365** | 314 |
| **Total current liabilities** | **3,883** | 4,044 |
| Long-term debt | **4,008** | 3,270 |
| Deferred income taxes | **662** | 647 |
| Other liabilities | **936** | 910 |
| **Shareholders equity** | | |

| | | |
|---|---|---|
| Common stock, $.25 par value | **105** | 105 |
| Capital in excess of par value | **407** | 388 |
| Retained earnings | **4,590** | 4,217 |
| Treasury stock, at cost | **(1,915)** | (1,357) |
| Accumulated other comprehensive income (loss) | **(683)** | (827) |
| **Total shareholders equity** | **2,504** | 2,526 |
| **Total liabilities and shareholders equity** | **$11,993** | $11,397 |

* Condensed from audited financial statements.

Refer to Notes to Consolidated Financial Statements.

Table of Contents

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

| *(Results are unaudited)* | Quarter ended **June 28, 2008** | Quarter ended June 30, 2007 | Year-to-date period ended **June 28, 2008** | Year-to-date period ended June 30, 2007 |
|---|---|---|---|---|
| **Net sales** | **$3,343** | $3,015 | **$6,601** | $5,978 |
| **Cost of goods sold** | **1,899** | 1,638 | **3,793** | 3,337 |
| **Selling, general and administrative expense** | **914** | 859 | **1,733** | 1,624 |
| **Operating profit** | **530** | 518 | **1,075** | 1,017 |
| **Interest expense** | **77** | 76 | **159** | 154 |
| **Other income (expense), net** | **(8)** | | **(19)** | 2 |
| **Earnings before income taxes** | **445** | 442 | **897** | 865 |
| **Income taxes** | **133** | 141 | **270** | 243 |
| **Net earnings** | **$ 312** | $ 301 | **$ 627** | $ 622 |
| **Net earnings per share:** | | | | |
| **Basic** | **$ .82** | $ .76 | **$ 1.64** | $ 1.56 |
| **Diluted** | **$ .82** | $ .75 | **$ 1.63** | $ 1.55 |
| **Dividends per share** | **$.3100** | $.2910 | **$.6200** | $.5820 |
| **Average shares outstanding:** | | | | |
| **Basic** | **379** | 397 | **382** | 397 |
| **Diluted** | **382** | 401 | **386** | 401 |
| **Actual shares outstanding at period end** | | | **379** | 396 |

Refer to Notes to Consolidated Financial Statements.

Table of Contents

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

| (unaudited) | Year-to-date period ended June 28, 2008 | June 30, 2007 |
|---|---|---|
| **Operating activities** | | |
| Net earnings | **$ 627** | $ 622 |
| Adjustments to reconcile net earnings to operating cash flows: | | |
| Depreciation and amortization | **182** | 185 |
| Deferred income taxes | **(3)** | (92) |
| Other (a) | **71** | 79 |
| Postretirement benefit plan contributions | **(48)** | (34) |
| Changes in operating assets and liabilities: | | |
| Trade receivables | **(207)** | (189) |
| Inventories | **(10)** | 9 |
| Accounts payable | **106** | 61 |
| Accrued income taxes | | 45 |
| Accrued interest expense | **2** | 1 |
| Accrued and prepaid advertising, promotion and trade allowances | **3** | 66 |
| Accrued salaries and wages | **(95)** | (86) |
| Exit plan-related reserves | | 29 |
| All other current assets and liabilities | **61** | 54 |
| **Net cash provided by operating activities** | **689** | 750 |
| **Investing activities** | | |
| Additions to properties | **(179)** | (181) |
| Acquisitions of business, net of cash acquired | **(133)** | |
| Investments in joint ventures and other (b) | **10** | (4) |
| **Net cash used in investing activities** | **(302)** | (185) |
| **Financing activities** | | |
| Net issuances of notes payable | **152** | 699 |
| Issuances of long-term debt | **756** | |
| Reductions of long-term debt | **(465)** | (729) |
| Issuances of common stock | **61** | 100 |
| Common stock repurchases | **(650)** | (264) |
| Cash dividends | **(236)** | (232) |
| Other | **9** | 10 |

| | | |
|---|---|---|
| **Net cash used in financing activities** | **(373)** | (416) |
| Effect of exchange rate changes on cash | **18** | 14 |
| Increase in cash and cash equivalents | **32** | 163 |
| Cash and cash equivalents at beginning of period | **524** | 411 |
| **Cash and cash equivalents at end of period** | **$ 556** | $ 574 |

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

(b) Includes proceeds from the disposition of assets.

Refer to Notes to Consolidated Financial Statements.

Table of Contents

**Notes to Consolidated Financial Statements**
**for the quarter and year-to-date periods ended June 28, 2008 (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 34 to 57 of the Company s 2007 Annual Report on Form 10-K.

The condensed balance sheet data at December 29, 2007 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 28, 2008 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. The Company s 2008 fiscal year will end on January 3, 2009, and include a 53rd week. Quarters normally consist of 13-week periods, with the fourth quarter of fiscal 2008 including a 14th week.

The accounting policies used in preparing these financial statements are the same as those applied in the prior year, except that the Company adopted a portion of the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 157 Fair Value Measurements as of the beginning of its 2008 fiscal year. Adoption of the SFAS No. 157 provisions as of the beginning of the 2008 fiscal year did not have an impact on the measurement of the Company s financial assets and liabilities but resulted in additional disclosures contained in Note 11 herein.

***New accounting pronouncements***

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of SFAS No. 133. SFAS No. 161 will require companies to disclose their objectives and strategies for using derivative instruments, whether or not their derivatives are designated as hedging instruments. The new pronouncement requires disclosure of the fair value of derivative instruments by primary underlying risk exposures (e.g. interest rate, credit, foreign exchange rate, combination of interest rate and foreign exchange rate, or overall price). It also requires detailed disclosures about the income statement impact of derivative instruments by designation as fair-value hedges, cash-flow hedges, or hedges of the foreign-currency exposure of a net investment in a foreign operation. SFAS No. 161 will also require disclosure of information that will enable financial statement users to understand the level of derivative activity entered into by the company (e.g., total number of interest-rate swaps or total notional or quantity or percentage of forecasted commodity purchases that are being hedged). The principles of SFAS No. 161 may be applied on a prospective basis and are effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged. For the Company, SFAS No. 161 will be effective at the beginning of its 2009 fiscal year. Management is currently evaluating the impact of adopting SFAS No. 161 on the Company s financial statements.

In February 2008, the FASB issued Staff Position (FSP) FAS-157-2, which delays by one year, the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities. We plan to adopt SFAS No. 157 for non-financial assets and non-financial liabilities as of the beginning of our 2009 fiscal year.

The Company is continuing to evaluate the impact of SFAS No. 141(R), Business Combinations and SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, which are required to be adopted by the Company at the beginning of its 2009 fiscal year. Further information on these accounting pronouncements is located on page 37 of the Company s 2007 Annual Report on Form 10-K.

Table of Contents

**Note 2 Acquisitions and goodwill and other intangible assets**

***Acquisitions***

To expand the Company s presence in Russia, on January 16, 2008, subsidiaries of the Company acquired substantially all of the equity interests in OJSC Kreker (doing business as United Bakers ) and consolidated subsidiaries. The Company is in the process of acquiring the remaining minority interests through tender offers. United Bakers is a leading producer of cereal, cookie, and cracker products in Russia, with approximately 4,000 employees, six manufacturing facilities, and a broad distribution network.

The Company paid $110 million cash (net of $5 million cash acquired), including approximately $67 million to settle debt and other assumed obligations of the acquired entities. Of the total cash paid, $5 million was spent in 2007 for transaction fees and advances. The remaining amount of $105 million has been classified as an investing activity cash outflow in the Company s Consolidated Statement of Cash Flows for the period ended June 28, 2008. The Company expects to incur approximately $3 million in additional purchase price payments during the remainder of 2008.

In addition, the purchase agreement between the Company and the seller provides for the payment of a currently undeterminable amount of contingent consideration at the end of three years, which will be calculated based on the growth of sales and earnings before income taxes, depreciation and amortization. Such payment would be recognized as additional purchase price when the contingency is resolved.

Assets, liabilities, and results of the acquired business have been included in the Company s consolidated financial statements since the date of acquisition; such results were insignificant for the Company s first half of 2008. Similarly, management has estimated that the pro forma effect on the Company s results of operations, as though this business combination had been completed at the beginning of either 2008 or 2007, would have been immaterial.

As of June 28, 2008 the purchase price allocation was as follows:

| (millions) | Asset/(liability) |
|---|---|
| Cash | $ 5 |
| Property, net | 60 |
| Goodwill (a) | 77 |
| Working capital, net (b) | (11) |
| Long-term debt | (3) |
| Deferred income taxes | (8) |
| Other | (5) |
| Total | $ 115 |

(a) Goodwill is not expected to be tax deductible.

(b) Inventory, receivables and other current assets less current liabilities.

***Subsequent event***

On June 30, 2008, the Company acquired a majority interest of the business of Zhenghang Food Company Ltd. ( Navigable Foods ) for $29 million in cash (net of cash received), including transaction fees. The purchase price is subject to certain post-closing adjustments. Navigable Foods is a manufacturer of cookies and crackers in the northern

and northeastern regions of China, with approximately 1,800 employees, two manufacturing facilities and a sales and distribution network.

During the quarter ended June 28, 2008, the Company paid a total of $27 million in connection with the acquisition, largely consisting of advances to the seller and the seller s lenders to satisfy various debt and other obligations of the seller. The cash outflows associated with the transaction have been classified as investing cash outflows in the Company s Consolidated Statement of Cash Flows for the year-to-date period ended June 28, 2008. These amounts have also been classified as Other assets on the Company s Consolidated Balance Sheet at June 28, 2008.

Table of Contents

In connection with the acquisition, the Company obtained the option to purchase the minority interest in the entity beginning June 30, 2011, and the minority interest holder obtained the option to cause the Company to purchase its remaining interest. The options, which have similar terms, include an exercise price that is expected to approximate fair value on the date of exercise.

***Goodwill and other intangible assets***

**Intangible assets subject to amortization**

| (millions) | Gross carrying amount | | Accumulated amortization | |
|---|---|---|---|---|
| | **June 28, 2008** | December 29, 2007 | **June 28, 2008** | December 29, 2007 |
| Trademarks | **$19** | $ 19 | **$14** | $ 13 |
| Other | **29** | 29 | **28** | 28 |
| Total | **$48** | $ 48 | **$42** | $ 41 |

For intangible assets in the preceding table, amortization was less than $1 million for each of the current and prior year-to-date periods. The currently estimated aggregate amortization expense for full-year 2008 and each of the four succeeding fiscal years is approximately $1 million per year and less than $1 million for the fifth succeeding fiscal year.

**Intangible assets not subject to amortization**

| (millions) | Total carrying amount | |
|---|---|---|
| | **June 28, 2008** | December 29, 2007 |
| Trademarks | **$1,443** | $ 1,443 |

Changes in the carrying amount of goodwill for the year-to-date period ended June 28, 2008 are presented in the following table.

The purchase accounting amounts in the table below were related to minor opening balance sheet adjustments for our November 2007 acquisitions of Bear Naked and certain assets and liabilities of Wholesome & Hearty Food Company. As discussed herein, the Company acquired United Bakers, a cookie and cracker company in Russia and recorded $77 million of goodwill. Certain of the Company s goodwill balances are subject to foreign currency translation adjustments. Fluctuations in exchange rates contributed to the increase in goodwill balance for the period.

**Carrying amount of goodwill**

| (millions) | United States | Europe | Latin America | Asia Pacific (a) | Consolidated |
|---|---|---|---|---|---|
| December 29, 2007 | $ 3,513 | $ | $ | $ 2 | $ 3,515 |
| Purchase accounting adjustments | 1 | | | | 1 |
| Acquisitions | | 77 | | | 77 |
| Currency translation adjustment | | 3 | | 1 | 4 |

| | | | | |
|---|---|---|---|---|
| **June 28, 2008** | **$3,514** | **$80** | **$ 3** | **$3,597** |

(a) Includes Australia, Asia and South Africa.

Table of Contents

**Note 3 Exit or disposal plans**

The Company views its continued spending on cost-reduction initiatives as part of its ongoing operating principles to provide greater visibility in achieving our long-term profit 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 up 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.

***Ongoing initiatives***

The Company currently has two ongoing initiatives: the European manufacturing optimization plan (Manchester, England) and the reorganization of production processes to reflect changing market dynamics (Valls, Spain and Bremen, German). Total costs associated with these ongoing initiatives were $2 million and $7 million during the quarterly periods ended June 28, 2008 and June 30, 2007, respectively; on a year-to-date basis the costs were $11 million and $12 million, respectively. These costs were recorded in cost of goods sold and were attributable to the Europe operating segment.

The Company commenced the multi-year European manufacturing optimization plan in 2006 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 $55 million in total project costs. Of the $55 million in total project costs, $49 million has been incurred to date, of which $21 million represented costs related to employee severance. Refer to page 39 of the Company s 2007 Annual Report on Form 10-K for further information on this initiative.

The following tables present quarter and year-to-date project costs for the European manufacturing optimization plan. There were no exit cost reserves for this project at June 28, 2008 and December 29, 2007.

| | Project costs | | | |
|---|---|---|---|---|
| | Quarter ended | | Year-to-date period ended | |
| (millions) | **June 28, 2008** | June 30, 2007 | **June 28, 2008** | June 30, 2007 |
| Employee severance | **$ 1** | $ 4 | **$ 3** | $ 7 |
| Other cash costs (a) | | 1 | **1** | 2 |
| Asset write-offs (b) | **(5)** | 2 | **(4)** | 3 |
| Retirement benefits (c) | | | **2** | |
| Total | **$(4)** | $ 7 | **$ 2** | $ 12 |

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

(b) Net of gain on the sale of assets previously written down to fair market value less cost to sell.

(c) 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.

The Company commenced the reorganization of certain production processes at the Company s plants in Valls, Spain and Bremen, Germany in October 2007. Based on forecasted foreign exchange rates, the Company expects to incur approximately $25 million of total project costs, comprised of asset write-offs, employee separation benefits and other cash costs. Of the $25 million in total project costs, $12 million has been incurred to date, of which $6 million represented costs related to employee severance. This initiative is expected to be completed in the second half of 2008. Refer to page 40 of the Company s 2007 Annual Report on Form 10-K for further information on this initiative. The following tables present quarter and year-to-date project costs for the reorganization of production processes at the Company s plants in Valls, Spain and Bremen, Germany, along with a reconciliation of employee severance reserves for this initiative.

Table of Contents

| (millions) | Project costs Quarter ended **June 28, 2008** | Year-to-date period ended June 28, 2008 |
|---|---|---|
| Employee severance | **$2** | $ 4 |
| Asset write-offs | **3** | 4 |
| Other cash costs (a) | **1** | 1 |
| Total | **$6** | $ 9 |

(a) Primarily includes expenditures for equipment removal and relocation, and legal and consulting fees to facilitate employee transitions.

| (millions) | Employee severance reserves |
|---|---|
| December 29, 2007 | $ 2 |
| Accruals | 4 |
| Payments | (3) |
| **June 28, 2008** | **$ 3** |

***2007 initiative***

Selling, general, and administrative expense for the quarter and year-to-date periods ended June 30, 2007, included total exit plan-related charges of $38 million. These costs were recorded in the Company s North America operating segment and related to the reorganization of the Company s direct store-door delivery (DSD) operations in the southeastern United States. This initiative has been completed.

**Note 4 Other income (expense), net**

Other income (expense), net includes non-operating items such as interest income, charitable donations, foreign exchange gains and losses and costs related to commodity options. Net foreign exchange losses recognized were $7 million and $13 million, respectively, for the quarter and year-to-date periods ended June 28, 2008, as compared to $7 million, for both the quarter and year-to-date periods ended June 30, 2007. Net expense recognized for premiums paid for commodity options was $8 million and $10 million, respectively, for the quarter and year-to-date periods ended June 28, 2008, as compared to $1 million for both the quarter and year-to-date periods ended June 30, 2007. Interest income for the quarter and year-to-date periods ended June 28, 2008 was $5 million and $10 million,

respectively. Interest income for the quarter and year-to-date periods ended June 30, 2007 was consistent with the current periods.

**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 totaled 5 million for the quarter and year-to-date periods ended June 28, 2008, as compared to 5 million and 4 million shares for the quarter and year-to-date periods ended June 30, 2007.

Table of Contents

| **Quarter** (millions, except per share data) | Net earnings | Average shares outstanding | Net earnings per share |
|---|---|---|---|
| **2008** | | | |
| Basic | **$312** | **379** | **$ .82** |
| Dilutive potential common shares | | **3** | |
| Diluted | **$312** | **382** | **$ .82** |
| **2007** | | | |
| Basic | $301 | 397 | $ .76 |
| Dilutive potential common shares | | 4 | (.01) |
| Diluted | $301 | 401 | $ .75 |

| **Year-to-date** (millions, except per share data) | Net earnings | Average shares outstanding | Net earnings per share |
|---|---|---|---|
| **2008** | | | |
| Basic | **$627** | **382** | **$1.64** |
| Dilutive potential common shares | | **4** | **(.01)** |
| Diluted | **$627** | **386** | **$1.63** |
| **2007** | | | |
| Basic | $622 | 397 | $1.56 |
| Dilutive potential common shares | | 4 | (.01) |
| Diluted | $622 | 401 | $1.55 |

During the year-to-date period ended June 28, 2008, the Company issued 1 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 authorized management to repurchase up to $650 million of the Company s common stock during 2008. In connection with this authorization, during the year-to-date period ended June 28, 2008, the Company spent $650 million to repurchase approximately 13 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 , fair value adjustments associated with cash flow hedges pursuant to SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities , and adjustments for net experience losses and prior service cost pursuant to SFAS No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans.

Pursuant to SFAS No. 158, during the second quarter of 2008, the Company recorded a net increase to its defined benefit pension and postretirement plan obligations of $28 million, comprised of $31 million increase for a

census-related valuation update and $3 million decrease for foreign currency remeasurement. As presented in the following schedule, this resulted in a corresponding net-of-tax increase in net experience loss of $18 million within other comprehensive income. The year-to-date impact on other comprehensive income was similar.

Table of Contents

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.

**Quarter**

| (millions) | Pre-tax amount | Tax (expense) or benefit | After-tax amount |
|---|---|---|---|
| **2008** | | | |
| Net earnings | | | **$312** |
| Other comprehensive income: | | | |
| Foreign currency translation adjustments | **14** | | **14** |
| Cash flow hedges: | | | |
| Unrealized gain (loss) on cash flow hedges | **61** | **(21)** | **40** |
| Reclassification to net earnings | **(6)** | **2** | **(4)** |
| Postretirement and postemployment benefits: | | | |
| Amounts arising during the period: | | | |
| Net experience loss | **(28)** | **10** | **(18)** |
| Prior service cost | | | |
| Reclassification to net earnings: | | | |
| Net experience loss | **12** | **(4)** | **8** |
| Prior service cost | **3** | **(1)** | **2** |
| | **56** | **(14)** | **42** |
| Total comprehensive income | | | **$354** |

| (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 |

Table of Contents

**Year-to-date**

| (millions) | Pre-tax amount | Tax (expense) or benefit | After-tax amount |
|---|---|---|---|
| **2008** | | | |
| Net earnings | | | **$627** |
| Other comprehensive income: | | | |
| Foreign currency translation adjustments | **83** | | **83** |
| Cash flow hedges: | | | |
| Unrealized gain (loss) on cash flow hedges | **90** | **(32)** | **58** |
| Reclassification to net earnings | **(3)** | **1** | **(2)** |
| Postretirement and postemployment benefits: | | | |
| Amounts arising during the period: | | | |
| Net experience loss | **(26)** | **9** | **(17)** |
| Prior service cost | **3** | **(1)** | **2** |
| Reclassification to net earnings: | | | |
| Net experience loss | **24** | **(8)** | **16** |
| Prior service cost | **6** | **(2)** | **4** |
| | **177** | **(33)** | **144** |
| Total comprehensive income | | | **$771** |

| (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 |

12

Table of Contents

Accumulated other comprehensive income (loss) as of June 28, 2008 and December 29, 2007 consisted of the following:

| (millions) | **June 28, 2008** | December 29, 2007 |
|---|---|---|
| Foreign currency translation adjustments | **$(322)** | $ (405) |
| Cash flow hedges unrealized net gain (loss) | **50** | (6) |
| Postretirement and postemployment benefits: | | |
| Net experience loss | **(363)** | (362) |
| Prior service cost | **(48)** | (54) |
| Total accumulated other comprehensive income (loss) | **$(683)** | $ (827) |

**Note 6 Leases and other commitments**

Refer to disclosures contained on page 43 of our 2007 Annual Report on Form 10-K. There have been no material changes in our leases and other commitments since December 29, 2007.

**Note 7 Debt**

On March 6, 2008, the Company issued $750 million of five-year 4.25% fixed rate U.S. Dollar Notes, using the proceeds from these Notes to retire a portion of its U.S. commercial paper. These Notes were issued under an existing shelf registration statement. The Notes contain customary covenants that limit the ability of the Company and its restricted subsidiaries (as defined) to incur certain liens or enter into certain sale and lease-back transactions, as well as a change of control provision.

In conjunction with the March 2008 debt issuance, the Company entered into interest rate swaps with notional amounts totaling $750 million, which effectively converted this debt from a fixed rate to a floating rate obligation for the duration of the five-year term. These derivative instruments, which were designated as fair value hedges of the debt obligation, resulted in an effective interest rate of 3.568% as of June 28, 2008. At June 28, 2008, Other Liabilities of $20 million have been recorded to reflect the fair value of interest rate swaps, offset by a decrease in the fair value of the related Long Term Debt on the Company s Consolidated Balance Sheet.

In June 2003, the Company issued $500 million of five-year 2.875% fixed rate U.S. Dollar Notes, using the proceeds from these Notes to replace maturing long-term debt. These Notes were issued under an existing shelf registration statement. The effective interest rate on these Notes, reflecting issuance discount and swap settlement, was 3.35%. The Notes contained customary covenants that limited the ability of the Company and its restricted subsidiaries (as defined) to incur certain liens or enter into certain sale and lease-back transactions. In December 2005, the Company redeemed $35 million of these Notes, and in June 2008 the Company repaid the remainder of the Notes.

As of June 28, 2008, commercial paper outstanding was $1,586 million.

Refer to pages 43-44 of the Company s 2007 Annual Report on Form 10-K for comparable information as of December 29, 2007.

Table of Contents

**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 non-employee directors. These awards are administered through several plans, as described on pages 44 to 47 of the Company s 2007 Annual Report on Form 10-K.

The Company classifies 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 page 35 of the Company s 2007 Annual Report on Form 10-K.

For the periods presented, compensation expense for all types of equity-based programs and the related income tax benefit recognized are as follows:

| | Quarter ended | | Year-to-date period ended | |
|---|---|---|---|---|
| (millions) | **June 28, 2008** | June 30, 2007 | **June 28, 2008** | June 30, 2007 |
| Pre-tax compensation expense | **$32** | $ 22 | **$53** | $ 47 |
| Related income tax benefit | **$12** | $ 8 | **$19** | $ 17 |

Pre-tax compensation expense for the quarter and year-to-date periods ended June 28, 2008 included $4 million of expense related to modification of certain stock options to eliminate the accelerated ownership feature ( AOF ) and $13 million representing accrued cash compensation payable at June 28, 2008 to holders of modified stock options to replace the value of the AOF, which is discussed in the following section, *Stock options* .

As of June 28, 2008, total stock-based compensation cost related to non-vested awards not yet recognized was approximately $46 million and the weighted-average period over which this amount is expected to be recognized was approximately 1.4 years.

***Stock options***

Effective April 25, 2008, the Company eliminated the AOF from all outstanding stock options. Stock options that contained the AOF feature included the vested pre-2004 option awards and all reload options. Reload options are the stock options awarded to eligible employees and directors to replace previously owned Company stock used by those individuals to pay the exercise price, including related employment taxes, of vested pre-2004 options awards containing the AOF. The reload options were immediately vested with an expiration date which was the same as the original option grant. Apart from removing the AOF, the stock options were not otherwise affected. Subsequent to June 28, 2008, holders of the stock options received cash compensation to replace the value of the AOF.

The Company accounted for the elimination of the AOF as a modification in accordance with SFAS No. 123(R), Share-Based Payment, which required the Company to record a modification charge equal to the difference between the value of the modified stock options on the date of modification and their values immediately prior to modification. Since the modified stock options were 100% vested and had relatively short remaining contractual terms of one to five years, the Company used a Black-Scholes model to value the awards for the purpose of calculating the modification charge. The total fair value of the modified stock options increased by $4 million because of an increase in the expected term.

As a result of this action, pre-tax compensation expense for the quarter and year-to-date periods ended June 28, 2008 included $4 million of expense related to the modification of stock options and $13 million representing accrued cash compensation payable at June 28, 2008 to holders of the stock options to replace the value of the AOF. Approximately 900 employees were holders of the modified stock options.

During the year-to-date periods ended June 28, 2008 and June 30, 2007, 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 46 of the Company s 2007 Annual Report on Form 10-K.

Table of Contents

Year-to-date period ended June 28, 2008:

| 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 | **26** | **$ 44** | | |
| Granted | **4** | **51** | | |
| Exercised | **(2)** | **42** | | |
| Forfeitures and expirations | | | | |
| Outstanding, end of period | **28** | **$ 45** | **6.2** | **$137** |
| Exercisable, end of period | **23** | **$ 44** | **5.4** | **$118** |

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 |

The weighted-average fair value of options granted was $7.90 per share for the year-to-date period ended June 28, 2008 and $7.52 per share for the year-to-date period ended June 30, 2007. The fair value was estimated using the following assumptions:

| | Weighted-average expected volatility | Weighted-average expected term (years) | Weighted-average risk-free interest rate | Dividend yield |
|---|---|---|---|---|
| Grants within the year-to-date period ended June 28, 2008 | 20.74% | 4.08 | 2.66% | 2.40% |

The total intrinsic value of options exercised was $22 million for the year-to-date period ended June 28, 2008 and $56 million for the year-to-date period ended June 30, 2007.

***Performance shares***

In the first quarter of 2008, 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 internal operating profit growth targets are achieved.

Table of Contents

The 2008 target grant currently corresponds to approximately 205 thousand shares, with a grant-date fair value of $47 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 2006 and 2007, refer to page 47 of the Company s 2007 Annual Report on Form 10-K. Based on the market price of the Company s common stock at June 28, 2008, the maximum future value that could be awarded to employees on the vesting date is (in millions): 2006 award-$24; 2007 award-$20; and 2008 award-$20. In addition to these awards, a 2005 performance share award, payable in stock, was settled at 200% of target in February 2008 for a total dollar equivalent of $28 million.

**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 47 to 51 of the Company s 2007 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 28, 2008** | June 30, 2007 | **June 28, 2008** | June 30, 2007 |
| Service cost | **$ 21** | $ 24 | **$ 44** | $ 48 |
| Interest cost | **51** | 46 | **101** | 92 |
| Expected return on plan assets | **(77)** | (69) | **(154)** | (138) |
| Amortization of unrecognized prior service cost | **3** | 3 | **6** | 5 |
| Recognized net loss | **9** | 16 | **18** | 32 |
| Curtailment and special termination benefits | | | **7** | |
| Total pension expense Company plans | **$ 7** | $ 20 | **$ 22** | $ 39 |

***Other nonpension postretirement***

| | Quarter ended | | Year-to-date period ended | |
|---|---|---|---|---|
| (millions) | **June 28, 2008** | June 30, 2007 | **June 28, 2008** | June 30, 2007 |
| Service cost | **$ 5** | $ 4 | **$ 9** | $ 8 |
| Interest cost | **16** | 17 | **33** | 34 |
| Expected return on plan assets | **(16)** | (15) | **(32)** | (30) |
| Recognized net loss | **2** | 6 | **4** | 12 |
| Postretirement benefit expense | **$ 7** | $ 12 | **$ 14** | $ 24 |

***Postemployment***

| | Quarter ended | | Year-to-date period ended | |
|---|---|---|---|---|
| (millions) | **June 28, 2008** | June 30, 2007 | **June 28, 2008** | June 30, 2007 |
| Service cost | **$1** | $ 1 | **$ 2** | $ 2 |
| Interest cost | **1** | 1 | **2** | 2 |

| | | | | |
|---|---|---|---|---|
| Recognized net loss | **1** | 1 | **2** | 1 |
| Postemployment benefit expense | **$3** | $ 3 | **$ 6** | $ 5 |

Management currently plans to contribute approximately $50 million to its defined benefit pension plans and $15 million to its retiree health and welfare benefit plans during 2008, for a total of $65 million. During 2007, the Company contributed approximately $84 million to defined benefit pension plans and $12 million to retiree health and welfare benefit plans, for a total of $96 million. Plan funding strategies are periodically modified to reflect management s current evaluation of tax deductibility, market conditions, and competing investment alternatives.

Table of Contents

**Note 10 Income taxes**

***Effective income tax rate***

The consolidated effective income tax rate was approximately 30% for the quarter ended June 28, 2008, as compared to 32% for the comparable quarter of 2007. The second quarter 2008 provision for income taxes included two significant, but partially-offsetting adjustments. In conjunction with a planned international legal restructuring, management has decided to repatriate approximately $700 million of prior and current year earnings and capital, for a gross U.S. tax cost recorded in the second quarter of $33 million. This cost was offset by foreign tax credit related items of $18 million, reducing the net cost of repatriation to $15 million. In addition, the Company reduced its reserves for uncertain tax positions by $18 million, related to the settlement of audits in various tax jurisdictions.

For the year-to-date period ended June 28, 2008, the consolidated effective income tax rate was 30%, as compared to 28% 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.

***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. See page 53 in the Company s 2007 Annual Report on Form 10-K for further information regarding FIN No. 48.

The Company files income taxes in the U.S. federal jurisdiction, and in various state, local and foreign jurisdictions. With limited exceptions, the Company is no longer subject to U.S. federal examinations by the Internal Revenue Service 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. During the second quarter of 2008, the Company entered into the IRS Compliance Assurance Program ( CAP ) for the 2008 tax year. The IRS will also be performing a focused review of the 2006 and 2007 tax years which is anticipated to be completed in 2009.

As of June 28, 2008, the Company has classified approximately $20 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 $22 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.

Following is a reconciliation of the Company s total gross unrecognized tax benefits for the year-to-date period ended June 28, 2008. Approximately $115 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) | |
|---|---|
| December 29, 2007 | $ 169 |
| Tax positions related to current year: | |
| Additions | 14 |
| Reductions | |
| Tax positions related to prior years: | |

| | |
|---|---|
| Additions | 1 |
| Reductions | (44) |
| Settlements | (3) |
| **June 28, 2008** | **$ 137** |

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.

Table of Contents

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 28, 2008, the Company recognized expense of $6 million for tax related interest and had approximately $36 million accrued at June 28, 2008.

**Note 11 Fair value measurements**

In September 2006, the FASB issued SFAS No. 157 Fair Value Measurements in order to establish a single definition of fair value and a framework for measuring fair value that is intended to result in increased consistency and comparability in fair value measurements. Certain provisions of the standard were effective for the Company at the beginning of its 2008 fiscal year. Adoption of SFAS No. 157 provisions as of the beginning of the 2008 fiscal year did not have an impact on the measurement of the Company s financial assets and liabilities but resulted in additional disclosures contained herein.

In February 2008, the FASB issued Staff Position (FSP) FAS-157-2, which delayed by one year the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay pertains to items including, but not limited to, non-financial assets and non-financial liabilities initially measured at fair value in a business combination, reporting units measured at fair value in the first step of evaluating goodwill for impairment under SFAS No. 142 Goodwill and Other Intangible Assets , indefinite-lived intangible assets measured at fair value for impairment assessment under SFAS No. 142, and long-lived assets measured at fair value for impairment assessment under SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets . The Company plans to adopt the remaining provisions of SFAS No. 157 as of the beginning of its 2009 fiscal year. Balance sheet items carried at fair value on a non-recurring basis (to which SFAS No. 157 will apply in 2009) consist of assets held for sale and exit liabilities.

As required by SFAS No. 157, the Company has categorized its financial assets and liabilities into a three-level fair value hierarchy, based on the nature of the inputs used in determining fair value. The hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). Following is a description of each category in the fair value hierarchy and the financial assets and liabilities of the Company that are included in each category at June 28, 2008.

*Level 1* Financial assets and liabilities whose values are based on unadjusted quoted prices for identical assets or liabilities in an active market. For the Company, level 1 financial assets and liabilities consist primarily of commodity derivative contracts.

*Level 2* Financial assets and liabilities whose values are based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the asset or liability. Level 2 financial assets and liabilities for the Company consist of interest rate swaps and over-the-counter commodity and currency contracts.

The Company s calculation of the fair value of interest rate swaps is derived from a discounted cash flow analysis based on the terms of the contract and the interest rate curve. Commodity derivatives are valued using an income approach based on the commodity index prices less the contract rate multiplied by the notional amount. Foreign currency contracts are valued using an income approach based on forward rates less the contract rate multiplied by the notional amount.

*Level 3* Financial assets and liabilities whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management s own assumptions about the assumptions a market participant would use in pricing the asset or liability. The Company does not have any level 3 financial assets or liabilities.

The following table presents the Company s fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis as of June 28, 2008:

Table of Contents

| (millions) | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| **Assets:** | | | | |
| Derivatives (recorded in Other Receivables) | $15 | $ 3 | $ | $ 18 |
| Derivatives (recorded in Other Assets) | | 59 | | 59 |
| Total Assets | $15 | $ 62 | $ | $ 77 |
| **Liabilities:** | | | | |
| Derivatives (recorded in Other Current Liabilities) | $ | $(42)(a) | $ | $(42) |

(a) Shown net of $30 million of cash collateral received in connection with reciprocal collateralization agreements between the Company and certain counterparties. These agreements call for the posting of collateral in the form of cash, treasury securities or letters of credit if the fair value of the hedge exceeds a certain threshold.

**Note 12 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.

| | Quarter ended | | Year-to-date period ended | |
|---|---|---|---|---|
| *(millions)* | **June 28,** | June 30, | **June 28,** | June 30, |
| *(Results are unaudited)* | **2008** | 2007 | **2008** | 2007 |

| | | | | |
|---|---|---|---|---|
| **Net sales** | | | | |
| North America | **$2,127** | $1,980 | **$4,275** | $3,982 |
| Europe | **746** | 623 | **1,423** | 1,197 |
| Latin America | **283** | 253 | **536** | 482 |
| Asia Pacific (a) | **187** | 159 | **367** | 317 |
| Consolidated | **$3,343** | $3,015 | **$6,601** | $5,978 |
| **Operating profit** | | | | |
| North America | **$ 380** | $ 365 | **$ 783** | $ 726 |
| Europe | **122** | 127 | **234** | 235 |
| Latin America | **60** | 55 | **105** | 102 |
| Asia Pacific (a) | **22** | 20 | **53** | 47 |
| Corporate | **(54)** | (49) | **(100)** | (93) |
| Consolidated | **$ 530** | $ 518 | **$1,075** | $1,017 |

(a) Includes Australia, Asia and South Africa.

Table of Contents

**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.

Our long-term annual growth targets are low single-digit (1 to 3%) for internal net sales, mid single-digit (4 to 6%) for internal operating profit and high single-digit (7 to 9%) for diluted net earnings per share. *(Our measure of internal growth rates excludes the impact of changes in foreign currency exchange rates, and if applicable, acquisitions, dispositions, and shipping day differences.)* For 2008, we expect to exceed our internal net sales growth target and achieve mid single-digit (4 to 6%) growth. We expect the higher-than-targeted net sales growth to come principally from previously announced pricing initiatives, improved product mix and continued innovation. We expect to meet our operating profit and net earnings per share growth targets. We believe our strong financial performance in the first half provides momentum for achieving these growth targets for the full year.

For the year-to-date period ended June 28, 2008, we reported consolidated net sales growth of 10% with internal growth of 6%. Consolidated operating profit increased 6% on internal growth of 4%. Diluted net earnings per share were $1.63 for the first half of 2008, as compared to $1.55 in the comparable prior year period. Similarly for the second quarter of 2008, we reported consolidated net sales growth of 11% with internal growth of 6%. Consolidated operating profit increased 2% both on an as reported and internal basis. Diluted net earnings per share grew 9% from $.75 in the second quarter of 2007 to $.82 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 2008 versus 2007:

| (dollars in millions) | North America | Europe | Latin America | Asia Pacific (a) | Corporate | Consoli-dated |
|---|---|---|---|---|---|---|
| **2008 net sales** | **$2,127** | **$ 746** | **$ 283** | **$ 187** | **$** | **$3,343** |
| **2007 net sales** | **$1,980** | **$ 623** | **$ 253** | **$ 159** | **$** | **$3,015** |
| % change - 2008 vs. 2007: | | | | | | |
| Volume (tonnage) (b) | .9% | 1.1% | .8% | 8.7% | | 1.3% |
| Pricing/mix | 5.2% | 3.6% | 5.8% | .4% | | 4.7% |
| **Subtotal internal business** | **6.1%** | **4.7%** | **6.6%** | **9.1%** | | **6.0%** |
| Acquisitions (c) | .7% | 6.4% | | | | 1.8% |
| Foreign currency impact | .6% | 8.8% | 5.2% | 7.6% | | 3.1% |
| **Total change** | **7.4%** | **19.9%** | **11.8%** | **16.7%** | | **10.9%** |

| (dollars in millions) | North America | Europe | Latin America | Asia Pacific (a) | Corporate | Consolidated |
|---|---|---|---|---|---|---|
| **2008 operating profit** | **$ 380** | **$ 122** | **$ 60** | **$ 22** | **$ (54)** | **$ 530** |
| **2007 operating profit** | **$ 365** | **$ 127** | **$ 55** | **$ 20** | **$ (49)** | **$ 518** |
| % change - 2008 vs. 2007: | | | | | | |
| **Internal business** | **5.3%** | **-4.0%** | **2.1%** | **1.4%** | **-11.7%** | **2.0%** |
| Acquisitions (c) | -2.2% | -1.9% | | | | -2.0% |
| Foreign currency impact | 1.0% | 2.8% | 5.0% | 9.2% | | 2.2% |
| **Total change** | **4.1%** | **-3.1%** | **7.1%** | **10.6%** | **-11.7%** | **2.2%** |

(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.

(c) Impact of results for the quarterly period ended June 28, 2008 from the acquisitions of United Bakers, Bear Naked and certain assets and liabilities of the Wholesome & Hearty Foods Company.

Table of Contents

Our strong consolidated net sales performance for the second quarter of 2008 was broad based across all of our operating segments. Successful innovation, brand-building (advertising and consumer promotion) investment, as well as our recent price increases continued to drive the growth. Our reported net sales were favorably impacted by foreign exchange. Also contributing to our growth are our recent acquisitions of Bear Naked and certain assets and liabilities of Wholesome & Hearty Foods Company (marketed under the *Gardenburger®* brand) which were completed in November, 2007 and are included in our North America operating segment, and United Bakers which was completed in January, 2008 and reported in our Europe operating segment. For further information on our acquisitions, refer to Note 2 within Notes to Consolidated Financial Statements, which is included herein under Part I, Item 2. Management has estimated that the pro forma effect on the Company s results of operations, as though these business combinations had been completed at the beginning of 2007, would have been immaterial.

For the quarter, our North America operating segment reported strong, internal net sales growth of 6%, with each major product group contributing as follows: retail cereal +5%; retail snacks *(cookies, crackers, cereal bars, toaster pastries, and fruit snacks)* +6%; frozen and specialty channels *(food service, club stores, and vending)* +10%. The broad based growth was driven by our previously announced price increases, strong innovation as well as growth in our base products. Retail cereal performed well with strong results from our core brands and innovations such as *Special K Cinnamon Pecan, All Bran Strawberry Medley* and *Frosted Flakes Gold*. Our recent snack innovations *Townhouse Flipsides* and *Cheez-It Duoz* are performing very well and contributed to our strong second quarter performance in retail snacks.

Our International operating segments collectively reported internal net sales growth of approximately 6%, with leading dollar contributions from our UK, Italy and Mexico business units. During the period, we achieved strong sales growth in both cereal and snack products in Europe. Asia Pacific s performance was strong in the second quarter led by growth in cereal.

For the quarter, our consolidated operating profit increased 2% both on a reported basis and on an internal basis. We experienced this growth by offsetting higher commodity and fuel costs and double digit increases in advertising and promotion with a combination of pricing and productivity initiatives. Second quarter operating profit also benefited from lower incremental exit-plan related charges as compared to the second quarter of 2007. As discussed in the *Exit or disposal plans* section herein, this quarter s operating profit included $2 million of exit-plan related charges as compared to $45 million recorded in the second quarter of 2007. The net incremental favorable impact on the operating segments is (in millions): North America-$38 (all within selling, general and administrative expense) and Europe-$5 (all within cost of goods sold). In addition to the exit-plan related charges, the Company incurred $17 million of expenses related to other cost reduction initiatives as discussed in the *Other cost reduction initiatives* section herein.

Internal operating profit for our North America operating segment was strong due to lower exit costs; and increased sales, driven by price increases and innovation partially offset by higher commodity costs. Europe s internal operating profit declined despite net sales growth due to increased investment in advertising and promotion and higher commodity costs. Latin America s operating profit increased due to net sales growth partially offset by increased advertising and overhead costs. Internal operating profit growth in Asia Pacific was driven by its strong net sales performance.

The following tables provide analysis of our net sales and operating profit performance for the year-to-date periods of 2008 as compared to 2007. The year-to-date net sales performance was similar to the quarter with growth driven by increased price/mix. Reported operating profit for the year-to-date period was up versus prior year due to sales growth, offset by increased commodity and fuel costs. Latin America s year-to-date operating profit was impacted by a $10 million charge taken in cost of goods sold in the first quarter of 2008 in connection with a payment for the restructuring of our labor force at a manufacturing facility in Mexico.

Table of Contents

| (dollars in millions) | North America | Europe | Latin America | Asia Pacific (a) | Corporate | Consolidated |
|---|---|---|---|---|---|---|
| **2008 net sales** | **$4,275** | **$1,423** | **$ 536** | **$ 367** | **$** | **$6,601** |
| **2007 net sales** | **$3,982** | **$1,197** | **$ 482** | **$ 317** | **$** | **$5,978** |
| % change - 2008 vs. 2007: | | | | | | |
| Volume (tonnage) (b) | .9% | 1.8% | -.6% | 6.7% | | 1.1% |
| Pricing/mix | 4.9% | 3.1% | 7.4% | .3% | | 4.6% |
| **Subtotal internal business** | **5.8%** | **4.9%** | **6.8%** | **7.0%** | | **5.7%** |
| Acquisitions (c) | .8% | 5.2% | | | | 1.6% |
| Foreign currency impact | .8% | 8.9% | 4.4% | 8.5% | | 3.1% |
| **Total change** | **7.4%** | **19.0%** | **11.2%** | **15.5%** | | **10.4%** |

| (dollars in millions) | North America | Europe | Latin America | Asia Pacific (a) | Corporate | Consolidated |
|---|---|---|---|---|---|---|
| **2008 operating profit** | **$ 783** | **$ 234** | **$ 105** | **$ 53** | **$ (100)** | **$1,075** |
| **2007 operating profit** | **$ 726** | **$ 235** | **$ 102** | **$ 47** | **$ (93)** | **$1,017** |
| % change - 2008 vs. 2007: | | | | | | |
| **Internal business** | **7.6%** | **-2.4%** | **-2.0%** | **2.8%** | **-6.8%** | **4.1%** |
| Acquisitions (c) | -1.0% | -2.1% | | | | -1.2% |
| Foreign currency impact | 1.1% | 4.3% | 4.1% | 9.8% | | 2.7% |
| **Total change** | **7.7%** | **-0.2%** | **2.1%** | **12.6%** | **-6.8%** | **5.6%** |

(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.

(c) Impact of results for the year-to-date period ending June 28, 2008 from the acquisitions of United Bakers, Bear Naked and certain assets and liabilities of the Wholesome & Hearty Foods Company.

***Margin performance***

Margin performance for the second quarter and year-to-date periods of 2008 versus 2007 are presented in the following table:

| **Quarter** | **2008** | 2007 | *Change vs. prior year (pts.)* |
|---|---|---|---|
| Gross margin (a) | **43.2%** | 45.7% | **-2.5** |
| SGA% (b) | **-27.4%** | -28.5% | **1.1** |
| Operating margin | **15.8%** | 17.2% | **-1.4** |

| **Year-to-date** | **2008** | 2007 | *Change* |
|---|---|---|---|
| Gross margin (a) | **42.5%** | 44.2% | **-1.7** |
| SGA% (b) | **-26.2%** | -27.2% | **1.0** |
| Operating margin | **16.3%** | 17.0% | **-0.7** |

(a) Gross profit as a percentage of net sales. Gross profit is equal to net sales less cost of goods sold.

(b) Selling, general and administrative

expense as a percentage of net sales.

We strive for gross profit dollar growth to reinvest in brand-building and innovation expenditures. Our strategy for increasing our gross profit is to manage external cost pressures through product pricing and mix improvements, productivity savings and technological initiatives to reduce the cost of product ingredients and packaging. For the quarter, our gross profit was up $67 million, a 5% increase over the comparable 2007 period. Year-to-date gross profit was up $167 million, a 6% increase over the first half of 2007.

As illustrated in the preceding table, our consolidated gross margin declined 250 basis points in the quarter and 170 basis points year-to-date versus the prior year periods. Our recent acquisitions lowered gross margin by approximately 70 basis points for the quarter and 60 basis points year-to-date. We also continue to experience inflationary cost pressures for fuel, energy, commodities and benefits. During this period, higher costs were offset by savings from cost reduction initiatives and price increases.

For the full-year 2008, we currently expect incremental costs for fuel, energy, commodities and benefits to be approximately $.90 per share. Accordingly, we believe our full year consolidated gross margin could decline by

Table of Contents

approximately 200 basis points, half of which relates to acquisitions and increased investments in exit plans and other cost reduction initiatives expected in cost of goods sold.

***Exit or disposal plans***

We view our continued spending on cost reduction initiatives as part of our ongoing operating principles to provide greater visibility in achieving our long-term profit 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 up 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. Certain of these initiatives represent exit or disposal plans for which material charges will be incurred. We include these charges in our measure of operating segment profitability.

*Ongoing initiatives*

We currently have two ongoing initiatives: the European manufacturing optimization plan (Manchester, England) and the reorganization of production processes to reflect changing market dynamics (Valls, Spain and Bremen, Germany). Total costs associated with these ongoing initiatives were $2 million and $7 million during the quarterly periods ended June 28, 2008 and June 30, 2007, respectively; on a year-to-date basis the costs were $11 million and $12 million, respectively. These costs were recorded in cost of goods sold and were attributable to the Europe operating segment.

We commenced the multi-year European manufacturing optimization plan in 2006 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 $55 million in total project costs. Of the $55 million in total project costs, $49 million has been incurred to date, of which $21 million represented costs related to employee severance. Refer to page 39 of the Company s 2007 Annual Report on Form 10-K for further information on this initiative.

The following tables present quarter and year-to-date project costs for our European manufacturing optimization plan. There were no exit cost reserves for this project at June 28, 2008 and December 29, 2007.

| | Project costs | | | |
|---|---|---|---|---|
| | Quarter ended | | Year-to-date ended | |
| (millions) | **June 28, 2008** | June 30, 2007 | **June 28, 2008** | June 30, 2007 |
| Employee severance | **$ 1** | $ 4 | **$ 3** | $ 7 |
| Other cash costs (a) | | 1 | **1** | 2 |
| Asset write-offs (b) | **(5)** | 2 | **(4)** | 3 |
| Retirement benefits (c) | | | **2** | |
| Total | **$(4)** | $ 7 | **$ 2** | $ 12 |

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

facilitate employee transitions.

(b) Net of proceeds received for assets sold.

(c) 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.

We commenced the reorganization of certain production processes at our plants in Valls, Spain and Bremen, Germany in October 2007. Based on forecasted foreign exchange rates, we expect to incur approximately $25 million of total project costs, comprised primarily of asset write-offs, employee separation benefits and other cash costs. Of the $25 million in total project costs, $12 million has been incurred to date, of which $6 million represented costs related to employee severance. This initiative is expected to be completed in the second half of 2008. Refer to page 40 of the Company s 2007 Annual Report on Form 10-K for further information on this initiative.

The following tables present quarter and year-to-date project costs for the reorganization of production processes at our plants in Valls, Spain and Bremen, Germany, along with a reconciliation of employee severance reserves for this initiative.

Table of Contents

| (millions) | Project costs Quarter ended **June 28, 2008** | Project costs Year-to-date period ended June 28, 2008 |
|---|---|---|
| Employee severance | **$2** | $ 4 |
| Asset write-offs | **3** | 4 |
| Other cash costs (a) | **1** | 1 |
| Total | **$6** | $ 9 |

(a) Primarily includes expenditures for equipment removal and relocation, and legal and consulting fees to facilitate employee transitions.

| (millions) | Employee severance reserves |
|---|---|
| December 29, 2007 | $ 2 |
| Accruals | 4 |
| Payments | (3) |
| **June 28, 2008** | **$ 3** |

*2007 initiative*

Selling, general, and administrative expense for the quarter and year-to-date periods ended June 30, 2007, included total exit plan-related charges of $38 million. These costs were recorded in our North America operating segment and related to the reorganization of our direct store-door delivery (DSD) operations in the southeastern United States. This initiative has been completed.

***Other cost reduction initiatives***

During the second quarter we incurred $17 million of expense associated with other cost reduction initiatives related to the elimination of the accelerated ownership feature of certain employee stock options. Refer to Note 8 within Notes to Consolidated Financial Statements, which is included herein under Part I, Item 2 for further information. This expense was recorded in selling, general and administrative expense within corporate operating profit.

We incurred $10 million of expense during the first quarter of 2008 in connection with a payment for the restructuring of our labor force at a manufacturing facility in Mexico. This cost, which was recorded in cost of goods sold and was attributable to the Latin America operating segment.

***Interest expense***

For the first half of 2008, interest expense was $159 million and interest income (which is recorded within other income) was $9 million, as compared to first half 2007 interest expense of $154 million and interest income of $8 million. For the full year of 2008, we currently expect interest expense, net of interest income, to approximate the 2007 level.

***Income taxes***

The consolidated effective income tax rate was approximately 30% for the quarter ended June 28, 2008, as compared to 32% for the quarter ended June 30, 2007. The second quarter 2008 provision for income taxes included two significant, put partially-offsetting adjustments. In conjunction with a planned international legal restructuring, management has decided to repatriate approximately $700 million of prior and current year earnings and capital, for a gross U.S. tax cost recorded in the second quarter of $33 million. This cost was offset by foreign tax credit related items of $18 million, reducing the net cost of repatriation to $15 million. In addition, we reduced our reserves for uncertain tax positions by $18 million, related to the settlement of audits in various tax jurisdictions.

For the year-to-date period ended June 28, 2008, the consolidated effective income tax rate was 30%, as compared to 28% 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.

For the full year 2008, we currently expect the consolidated effective income tax rate to be approximately 31%. Our estimate of effective income tax rate for any period is highly influenced by

Table of Contents

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.

**Liquidity and capital resources**

***Overview***

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

***Operating activities***

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 22 days for the trailing 365-day period ended June 28, 2008. This represents a reduction of approximately 3 days when compared with the comparable prior year period, reflecting an increase in 2008 in the days of trade payables outstanding.

The following table presents the major components of our operating cash flow during the current and prior year-to-date periods:

| | Year-to-date period ended | | |
|---|---|---|---|
| *(millions)* | June 28, 2008 | June 30, 2007 | *Change versus prior year* |
| **Operating activities** | | | |
| Net earnings | $ 627 | $ 622 | $ 5 |
| Items in net earnings not requiring (providing) cash: | | | |
| Depreciation and amortization | 182 | 185 | (3) |
| Deferred income taxes | (3) | (92) | 89 |
| Other (a) | 71 | 79 | (8) |
| Net Earnings after non-cash items | 877 | 794 | 83 |
| Pension and other postretirement benefit plan contributions | (48) | (34) | (14) |
| Changes in operating assets and liabilities: | | | |
| Core working capital (b) | (111) | (119) | 8 |
| Other working capital | (29) | 109 | (138) |
| | (140) | (10) | (130) |
| **Net cash provided by operating activities** | $ 689 | $ 750 | $ (61) |

(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 28, 2008 was $61 million lower than the comparable period of 2007, due primarily to an unfavorable year-over-year variance in other working capital. This unfavorable variance was attributable in large part to an increase in cash paid in 2008 for advertising and promotion and exit plan related reserves. To a lesser extent, this unfavorable year-over-year variance in other working capital reflected cash outflows in connection with United Bakers, the Russian business we acquired in the first quarter of 2008.

We estimate that we will make postretirement benefit plan contributions totaling $65 million in 2008, as compared to $96 million in 2007. Actual 2008 contributions could exceed our current projections, as influenced by our decision to undertake additional 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

Table of Contents

opportunities, and share repurchases. Our cash flow metric is reconciled to the most comparable GAAP measure, as follows:

| (dollars in millions) | Year-to-date period ended **June 28, 2008** | June 30, 2007 | *Change versus prior year* |
|---|---|---|---|
| Net cash provided by operating activities | **$ 689** | $ 750 | **-8.1%** |
| Additions to properties | **(179)** | (181) | |
| Cash flow | **$ 510** | $ 569 | **-10.4%** |

For full year 2008, we are targeting cash flow (as defined) ranging from $1,000 million to $1,075 million.

***Investing activities***

Our net cash used by investing activities for the year-to-date period ending June 28, 2008 amounted to $302 million, an increase of $117 million when compared with $185 million in first half of 2007. The increase was primarily attributable to cash outflows of $133 million associated with the Company s acquisitions during the first half of 2008. Acquisitions are discussed in Note 2 within Notes to Consolidated Financial Statements.

For 2008, we expect total property additions to be approximately 4% of net sales, which is consistent with our actual spending rate for 2007 and our long-term target for capital spending.

***Financing activities***

Our net cash used by financing activities for the first half of 2008 amounted to $373 million, a decrease of $43 million when compared with $416 million in first half of 2007.

During the year-to-date period ended June 28, 2008, we spent $650 million, the entire amount authorized as of that date, to purchase approximately 13 million shares of our common stock, while share repurchases in the first half of 2007 amounted to $264 million. Subsequent to June 28, 2008, our Board of Directors authorized an additional $500 million share repurchase which we expect to commence late this year and to be executed within the next twelve months.

We also had cash outflows of $465 million in connection with the repayment of five-year U.S. Dollar Notes at maturity on June 1, 2008. The debt had an effective interest rate of 3.35%.

As discussed in Note 7 within Notes to Consolidated Financial Statements, we issued $750 million of five-year 4.25% fixed rate U.S. Dollar Notes in March 2008. We used proceeds of $746 million from issuance of this long-term debt to retire a portion of our commercial paper. In conjunction with this March 2008 debt issuance, we entered into interest rate swaps with notional amounts totaling $750 million, which effectively converted this debt from a fixed rate to a floating rate obligation for the duration of the five-year term.

Financing activity in the first half of 2007 involved the redemption of $728 million of Euro denominated long-term debt, offset in large part by a $699 million increase in commercial paper.

In July 2008, our Board of Directors declared a dividend of $0.34 per common share, payable September 16, 2008, to shareholders of record at the close of business on September 2, 2008. The dividend of $0.34 per common share represents a 10% increase in the $0.31 per share quarterly dividend rate paid during the trailing twelve months. Increasing the dividend rate is consistent with our plan to maintain our dividend pay-out ratio in a range of 40% to 50% of reported net earnings.

We continue to 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 bolt-on acquisitions. This will be accomplished through our strong cash flow, our program of issuing short-term debt, and maintaining our credit facilities on a global basis.

Table of Contents

**Critical accounting policies and estimates**

On pages 23-27 of our Annual Report on Form 10-K for the fiscal year ended December 29, 2007, we identified certain policies and estimates that require significant judgments and assumptions likely to have a material impact on our financial statements. As disclosed therein, accounting for stock compensation under SFAS No. 123(R) represents a critical accounting estimate, which requires significant judgments and assumptions likely to have a material impact on our financial statements.

Until April 25, 2008, reload options were awarded to eligible employees and directors to replace previously-owned Company stock used by those individuals to pay the exercise price, including related employment taxes, of vested pre-2004 option awards containing the accelerated ownership feature (AOF). The reload options were immediately vested with an expiration date which was the same as the original option grant. Under SFAS No. 123(R), these reload options resulted in additional compensation expense in the year of grant.

On April 25, 2008, the Company eliminated the AOF from all outstanding stock options. Stock options that contained the AOF included the vested pre-2004 option awards and all reload options. As a result of this action, we will no longer award reload options and will no longer need to determine the grant-date fair value of stock options that are the result of reloads.

The modification of the stock options that contained the AOF is further discussed in Note 8 within Notes to Consolidated Financial Statements.

**Forward-looking statements**

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 in business acquisitions; capital expenditures; 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.

Table of Contents

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Our Company is exposed to certain market risks, which exist as a part of our ongoing business operations. We use derivative financial and commodity instruments, where appropriate, to manage these risks.

Refer to disclosures contained on pages 28-29 of our 2007 Annual Report on Form 10-K. Other than changes noted here, there have been no material changes in the Company s market risk as of June 28, 2008.

The total notional amount of commodity derivative instruments at June 28, 2008, including natural gas swaps, was $341 million, with a fair value of approximately $103 million. The total notional amount of commodity derivative instruments at December 29, 2007, including natural gas swaps, was $229 million, with a fair value of $22 million.

In some instances we have reciprocal collateralization agreements with our counterparties regarding fair value positions in excess of certain thresholds. These agreements call for the posting of collateral in the form of cash, treasury securities or letters of credit if a fair value loss position to our counterparties or us exceeds a certain amount. At June 28, 2008, $30 million collateral in the form of cash was posted by our counterparties and was reflected as a reduction in the fair value of the related derivative on the Company s Consolidated Balance Sheet. The collateral balance at December 29, 2007 was zero.

In connection with the issuance of U.S. Dollar Notes on March 6, 2008, we entered into interest rate swaps. Refer to disclosures contained in Note 7 within Notes to Consolidated Financial Statements herein.

**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 28, 2008, 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.

Table of Contents

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 29, 2007. The risk factors disclosed under this Part II, Item 1A and in Part I, Item 1A to our Annual report on Form 10-K for the fiscal year ended December 29, 2007, 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**

(c) 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 |
|---|---|---|---|---|
| Month #4: 3/30/09-4/26/08 | 0.3 | $ 52.43 | 0.3 | $ 0 |
| Month #5: 04/27/08-05/24/08 | 0.0 | 0.00 | 0.0 | 0 |
| Month #6: 05/25/08-06/28/08 | 0.0 | 0.00 | 0.0 | 0 |
| Total (1) | 0.3 | 52.43 | 0.3 | |

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

a. Approximately .2 million shares were purchased during the second quarter of 2008 under a program authorized by our Board of Directors to repurchase up to $650 million of Kellogg common stock during 2008 for general corporate purposes and to offset issuances for employee benefit programs. This repurchase program was publicly announced in a press release on October 29, 2007.

b. Approximately .1 million shares were purchased during the second quarter of 2008 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.

**Item 6. Exhibits**

(a) Exhibits:

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 Mackay

32.2 Section 1350 Certification from John A. Bryant

Table of Contents

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,
Kellogg Company and President, Kellogg North America

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

Date: August 5, 2008

Table of Contents

KELLOGG COMPANY
EXHIBIT INDEX

| Exhibit No. | Description | Electronic (E) Paper (P) Incorp. By Ref. (IBRF) |
|---|---|---|
| 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 |