

KELLOGG CO
Form 10-Q
August 09, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 3, 2010

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 1-4171

KELLOGG COMPANY

State of Incorporation Delaware IRS Employer Identification No.38-0710690
One Kellogg Square, P.O. Box 3599, Battle Creek, MI 49016-3599

Registrant's telephone number: 269-961-2000

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by 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.

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Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or shorter period that the registrant was required to submit and post such files).

Yes No

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 Accelerated filer Non-accelerated filer 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 No

Common Stock outstanding as of July 31, 2010 377,760,342 shares

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KELLOGG COMPANY

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Table of Contents**Part I FINANCIAL INFORMATION****Item 1. Financial Statements.****Kellogg Company and Subsidiaries****CONSOLIDATED BALANCE SHEET**

(millions, except per share data)

	July 3, 2010 (unaudited)	January 2, 2010 *
Current assets		
Cash and cash equivalents	\$471	\$334
Accounts receivable, net	1,144	1,093
Inventories:		
Raw materials and supplies	224	214
Finished goods and materials in process	661	696
Deferred income taxes	141	128
Other prepaid assets	151	93
Total current assets	2,792	2,558
Property, net of accumulated depreciation of \$4,491 and \$4,520	2,916	3,010
Goodwill	3,639	3,643
Other intangibles, net of accumulated amortization of \$46 and \$45	1,457	1,458
Pension	185	160
Other assets	396	371
Total assets	\$11,385	\$11,200
Current liabilities		
Current maturities of long-term debt	\$954	\$1
Notes payable	158	44
Accounts payable	1,075	1,077
Accrued advertising and promotion	408	409
Accrued income taxes	12	33
Accrued salaries and wages	187	322
Other current liabilities	470	402
Total current liabilities	3,264	2,288
Long-term debt	3,915	4,835
Deferred income taxes	428	425
Pension liability	440	430
Other liabilities	954	947

Commitments and contingencies

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Equity		
Common stock, \$.25 par value	105	105
Capital in excess of par value	481	472
Retained earnings	5,903	5,481
Treasury stock, at cost	(2,010)	(1,820)
Accumulated other comprehensive income (loss)	(2,096)	(1,966)
Total Kellogg Company equity	2,383	2,272
Noncontrolling interests	1	3
Total equity	2,384	2,275
Total liabilities and equity	\$11,385	\$11,200

* Condensed from audited financial statements.
Refer to Notes to Consolidated Financial Statements.

Table of Contents**Kellogg Company and Subsidiaries****CONSOLIDATED STATEMENT OF INCOME**

(millions, except per share data)

(Results are unaudited)	Quarter ended		Year-to-date period ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Net sales	\$3,062	\$3,229	\$6,380	\$6,398
Cost of goods sold	1,757	1,825	3,650	3,692
Selling, general and administrative expense	822	851	1,610	1,624
Operating profit	483	553	1,120	1,082
Interest expense	61	67	126	134
Other income (expense), net	7	9	8	9
Income before income taxes	429	495	1,002	957
Income taxes	128	141	284	284
Earnings (loss) from joint ventures	0	(1)	0	(1)
Net income	\$301	\$353	\$718	\$672
Net income (loss) attributable to noncontrolling interests	(1)	(1)	(2)	(3)
Net income attributable to Kellogg Company	\$302	\$354	\$720	\$675
Per share amounts:				
Basic	\$.80	\$.93	\$ 1.89	\$ 1.77
Diluted	\$.79	\$.92	\$ 1.88	\$ 1.76
Dividends per share	\$.3750	\$.3400	\$.7500	\$.6800
Average shares outstanding:				
Basic	381	383	380	382
Diluted	384	383	384	383
Actual shares outstanding at period end			378	383

Refer to Notes to Consolidated Financial Statements.

Table of Contents**Kellogg Company and Subsidiaries****CONSOLIDATED STATEMENT OF EQUITY**

(millions)

(unaudited)	Common stock		Capital in excess of	Retained earnings	Treasury stock		Accumulated other comprehensive income (loss)	Total Kellogg Company equity	Non- controlling interests	Total equity	Total comprehensive income (loss)
	shares	amount	par value		shares	amount					
Balance, January 3, 2009	419	\$105	\$438	\$4,836	37	(\$1,790)	(\$2,141)	\$ 1,448	\$ 7	\$ 1,455	
Common stock repurchases					4	(187)		(187)		(187)	
Net income (loss)				1,212				1,212	(4)	1,208	\$1,208
Dividends				(546)				(546)		(546)	
Other comprehensive income (loss)							175	175		175	175
Stock compensation			37					37		37	
Stock options exercised and other			(3)	(21)	(3)	157		133		133	
Balance, January 2, 2010	419	\$105	\$472	\$5,481	38	(\$1,820)	(\$1,966)	\$ 2,272	\$ 3	\$ 2,275	\$1,383
Common stock repurchases					7	(356)		(356)		(356)	
Net income (loss)				720				720	(2)	718	718
Dividends				(286)				(286)		(286)	
Other comprehensive income (loss)							(130)	(130)		(130)	(130)
Stock compensation			17					17		17	
Stock options exercised and other			(8)	(12)	(4)	166		146		146	
Balance, July 3, 2010	419	\$105	\$481	\$5,903	41	(\$2,010)	(\$2,096)	\$ 2,383	\$ 1	\$ 2,384	\$588

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	
	July 3, 2010	July 4, 2009
Operating activities		
Net income	\$718	\$672
Adjustments to reconcile net income to operating cash flows:		
Depreciation and amortization	178	189
Deferred income taxes	(52)	30
Other	73	(8)
Postretirement benefit plan contributions	(36)	(84)
Changes in operating assets and liabilities:		
Trade receivables	(84)	(192)
Inventories	25	64
Accounts payable	(1)	(84)
Accrued income taxes	(22)	62
Accrued interest expense	(1)	(2)
Accrued and prepaid advertising, promotion and trade allowances	(31)	60
Accrued salaries and wages	(135)	(49)
All other current assets and liabilities	(39)	38
Net cash provided by operating activities	593	696
Investing activities		
Additions to properties	(147)	(161)
Other	2	1
Net cash used in investing activities	(145)	(160)
Financing activities		
Net issuances (reductions) of notes payable	110	(882)
Issuances of long-term debt	0	745
Reductions of long-term debt	(1)	0
Net issuances of common stock	148	18
Common stock repurchases	(266)	0
Cash dividends	(286)	(260)
Other	6	2
Net cash used in financing activities	(289)	(377)
Effect of exchange rate changes on cash and cash equivalents	(22)	10
Increase in cash and cash equivalents	137	169
Cash and cash equivalents at beginning of period	334	255
Cash and cash equivalents at end of period	\$471	\$424

Refer to Notes to Consolidated Financial Statements.

Table of Contents**Notes to Consolidated Financial Statements****for the quarter ended July 3, 2010 (unaudited)****Note 1 Accounting policies*****Basis of presentation***

The unaudited interim financial information of Kellogg Company (the Company) included in this report reflects normal recurring adjustments that management believes are necessary for a fair statement of the results of operations, financial position, equity and cash flows for the periods presented. This interim information should be read in conjunction with the financial statements and accompanying notes contained on pages 27 to 56 of the Company's 2009 Annual Report on Form 10-K.

The condensed balance sheet data at January 2, 2010 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 period ended July 3, 2010 are not necessarily indicative of the results to be expected for other interim periods or the full year.

New accounting standard

In December 2009, the FASB amended the Accounting Standards Codification related to the consolidation provisions that apply to variable interest entities. This guidance is effective for fiscal years that begin after November 15, 2009 and was adopted by the Company on a prospective basis as of January 3, 2010 without material impact to its consolidated financial statements.

Note 2 Goodwill and other intangible assets

Changes in the carrying amount of goodwill for the year-to-date period ended July 3, 2010 are presented in the following table. Certain of the Company's goodwill balances are subject to foreign currency translation adjustments. Fluctuations in exchange rates contributed to the change in goodwill balance for the period.

Carrying amount of goodwill

(millions)	North America	Europe	Latin America	Asia Pacific (a)	Consolidated
January 2, 2010	\$3,539	\$62	\$0	\$42	\$3,643
Currency translation adjustment	0	(2)	0	(2)	(4)
July 3, 2010	\$3,539	\$60	\$0	\$40	\$3,639

(a) Includes Australia, Asia and South Africa.

Intangible assets subject to amortization

(millions)	Gross carrying amount		Accumulated amortization	
	July 3, 2010	January 2, 2010	July 3, 2010	January 2, 2010
Trademarks	\$19	\$19	\$16	\$15
Other	41	41	30	30
Total	\$60	\$60	\$46	\$45

For intangible assets in the preceding table, amortization was \$1 million in the current and prior year comparable quarters. The currently estimated aggregate annual amortization expense for full-year 2010 and each of the four succeeding fiscal years is approximately \$2 million.

Table of Contents**Intangible assets not subject to amortization**

	Total carrying amount	
	July 3,	January 2,
(millions)	2010	2010
Trademarks	\$1,443	\$1,443

Note 3 Exit or disposal activities

The Company views its continued spending on cost-reduction activities as part of its ongoing operating principles to provide greater visibility in achieving its long-term profit growth targets. Initiatives undertaken are currently expected to recover cash implementation costs within a five-year period of completion. 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.

2010 activities

During the second quarter of 2010, the Company incurred exit costs related to two ongoing programs which will result in cost of goods sold (COGS) and selling, general and administrative (SGA) expense savings. The COGS program is Kellogg's lean, efficient, and agile network (K LEAN). The SGA programs focus on the efficiency and effectiveness of various support functions.

Total charges incurred during the quarter and year-to-date periods ended July 3, 2010 were as follows:

(millions)	Quarter ended July 3, 2010			Year-to-date period ended July 3, 2010		
	COGS program	SGA programs	Total	COGS program	SGA programs	Total
Employee severance	\$0	\$0	\$0	\$2	\$1	\$3
Other cash costs (a)	0	1	1	0	5	5
Retirement benefits (b)	1	0	1	1	0	1
Total	\$1	\$1	\$2	\$3	\$6	\$9

(a) Includes cash costs for equipment removal and relocation.

(b) Pension plan curtailment losses and special termination benefits.

Total program costs incurred through July 3, 2010 were as follows:

(millions)	Total program costs through July 3, 2010		
	COGS program	SGA programs	Total
Employee severance	\$17	\$18	\$35
Other cash costs (a)	6	13	19
Retirement benefits (b)	4	0	4
Total	\$27	\$31	\$58

- (a) Includes cash costs for equipment removal and relocation.
- (b) Pension plan curtailment losses and special termination benefits.

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In 2009, the Company commenced K LEAN. Refer to page 35 of the Company's 2009 Annual Report on Form 10-K for further information on this initiative. Based on forecasted foreign exchange rates, the Company currently expects to incur \$40 million in total exit costs; \$27 million has been incurred to date which represents employee severance and other cash costs associated with the elimination of hourly and salaried positions at various global manufacturing facilities. Costs for this program impacted the following operating segments for the quarter and year-to-date periods ended July 3, 2010 and July 4, 2009 as follows:

(millions)	COGS program			
	Quarter ended July 3, 2010	Year-to-date period ended July 3, 2010	Quarter ended July 4, 2009	Year-to-date period ended July 4, 2009
North America	\$0	\$1	\$6	\$10
Europe	1	2	1	1
Asia Pacific (a)	0	0	0	0
Total	\$1	\$3	\$7	\$11

(a) Includes Australia, Asia and South Africa.

In 2009, the Company commenced various SGA programs which will result in an improvement in the efficiency and effectiveness of various support functions. Refer to page 35 of the Company's 2009 Annual Report on Form 10-K for further information on this initiative. Based on forecasted foreign exchange rates, the Company currently expects to incur \$35 million in total exit costs; \$31 million has been incurred to date which represents severance and other cash costs associated with the elimination of salaried positions. These programs are expected to be substantially complete by the end of 2010. Costs for these programs impacted the following operating segments for the quarter and year-to-date periods ended July 3, 2010 and July 4, 2009 as follows:

(millions)	SGA programs			
	Quarter ended July 3, 2010	Year-to-date period ended July 3, 2010	Quarter ended July 4, 2009	Year-to-date period ended July 4, 2009
North America	\$1	\$4	\$5	\$5
Europe	(1)	0	0	0
Asia Pacific (a)	1	2	0	0
Total	\$1	\$6	\$5	\$5

(a) Includes Australia, Asia and South Africa.

Reserves for the COGS and SGA programs are primarily for employee severance and will be paid out by the end of 2010. The detail is as follows:

(millions)	Balance			Balance
	January 2, 2010	Accruals	Payments	July 3, 2010
COGS program	\$6	\$2	(\$4)	\$4
SGA programs	12	1	(11)	2
Manufacturing optimization	7		(6)	1
Total	\$25	\$3	(\$21)	\$7

Prior year activities

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During the quarter ended July 4, 2009, the Company incurred \$6 million of severance costs in connection with a European manufacturing optimization plan in Bremen, Germany which was complete as of the end of 2009. Refer to page 36 of the Company's 2009 Annual Report on Form 10-K for further information on this initiative.

Note 4 Equity

Earnings per share

Basic earnings per share is determined by dividing net income attributable to Kellogg Company by the weighted average number of common shares outstanding during the period. Diluted 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 consist principally of employee stock options issued by the Company, and to a lesser extent, certain contingently issuable performance shares. Basic earnings per share is reconciled to diluted earnings per share in the following table. The total number of anti-dilutive potential common shares excluded from the reconciliation were 4 million for both the quarter and year-to-date periods ended July 3, 2010 and 24 million and 20 million for the quarter and year-to-date periods ended July 4, 2009, respectively.

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Quarters ended July 3, 2010 and July 4, 2009:

(millions, except per share data)	Net income attributable to Kellogg Company	Average shares outstanding	Earnings per share
2010			
Basic	\$302	381	\$ 0.80
Dilutive potential common shares		3	(0.01)
Diluted	\$302	384	\$ 0.79
2009			
Basic	\$354	383	\$ 0.93
Dilutive potential common shares		0	(0.01)
Diluted	\$354	383	\$ 0.92

Year-to-date periods ended July 3, 2010 and July 4, 2009:

(millions, except per share data)	Net income attributable to Kellogg Company	Average shares outstanding	Earnings per share
2010			
Basic	\$720	380	\$ 1.89
Dilutive potential common shares		4	(0.01)
Diluted	\$720	384	\$ 1.88
2009			
Basic	\$675	382	\$ 1.77
Dilutive potential common shares		1	(0.01)
Diluted	\$675	383	\$ 1.76

During the year-to-date period ended July 3, 2010, the Company issued 0.2 million shares to employees and directors under various benefit plans and stock purchase programs, as further discussed in Note 5.

On April 23, 2010, the Company's board of directors authorized a \$2.5 billion three-year share repurchase program for 2010 through 2012. This authorization replaced the previous share buyback program which authorized stock repurchases

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of up to \$1,113 million for 2010. During the year-to-date period ended July 3, 2010, the Company repurchased 7 million shares of common stock for a total of \$356 million, of which \$266 million was paid during the six-month period and \$90 million was payable at July 3, 2010 for stock repurchases that did not settle prior to the end of the reporting period. During the year-to-date period ended July 4, 2009, the Company had no stock repurchase activity.

Comprehensive income

Comprehensive income includes net income 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, fair value adjustments associated with cash flow hedges and adjustments for net experience losses and prior service cost related to employee benefit plans.

Pre-tax adjustments to the Company's other comprehensive income balances related to pension and post-retirement benefits arising during the periods for net experience gain (loss) and prior service credit (costs) are summarized as follows:

(millions)	Quarter ended		Year-to-date period ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Census-related valuation update	(\$16)	(\$40)	(\$16)	(\$40)
Foreign currency remeasurement	14	(59)	33	(50)
Total	(\$2)	(\$99)	\$17	(\$90)

During the first quarter of 2010, the Company amended its U.S. postretirement healthcare benefit plan, which resulted in a \$17 million decrease of a deferred tax asset.

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Quarter ended July 3, 2010:

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2010			
Net income			\$301
Other comprehensive income:			
Foreign currency translation adjustments	(\$112)	\$0	(112)
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	(4)	0	(4)
Reclassification to net earnings	18	(5)	13
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience gain (loss)	(3)	1	(2)
Prior service credit (cost)	1	0	1
Reclassification to net earnings:			
Net experience loss	26	(8)	18
Prior service cost	2	(1)	1
	(\$72)	(\$13)	(85)
Total comprehensive income			\$216

Quarter ended July 4, 2009:

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2009			
Net income			\$353
Other comprehensive income:			
Foreign currency translation adjustments	\$165	\$0	165
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	0	0	0
Reclassification to net earnings	(9)	3	(6)
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience gain (loss)	(82)	26	(56)
Prior service credit (cost)	(17)	6	(11)
Reclassification to net earnings:			
Net experience loss	16	(5)	11
Prior service cost	2	(1)	1
	\$75	\$29	104
Total comprehensive income			\$457

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Year-to-date period ended July 3, 2010:

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2010			
Net income			\$718
Other comprehensive income:			
Foreign currency translation adjustments	(\$158)	\$0	(158)
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	(39)	11	(28)
Reclassification to net earnings	31	(9)	22
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience gain (loss)	15	(5)	10
Prior service credit (cost)	2	(17)	(15)
Reclassification to net earnings:			
Net experience loss	51	(16)	35
Prior service cost	6	(2)	4
	(\$92)	(\$38)	(130)
Total comprehensive income			\$588

Year-to-date period ended July 4, 2009:

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2009			
Net income			\$672
Other comprehensive income:			
Foreign currency translation adjustments	\$112	\$0	112
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	18	(6)	12
Reclassification to net earnings	(23)	8	(15)
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience gain (loss)	(73)	23	(50)
Prior service credit (cost)	(17)	6	(11)
Reclassification to net earnings:			
Net experience loss	31	(10)	21
Prior service cost	5	(2)	3
	\$53	\$19	72
Total comprehensive income			\$744

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Accumulated other comprehensive income (loss) as of July 3, 2010 and January 2, 2010 consisted of the following:

	July 3,	January 2,
(millions)	2010	2010
Foreign currency translation adjustments	(\$929)	(\$771)
Cash flow hedges unrealized net loss	(36)	(30)
Postretirement and postemployment benefits:		
Net experience loss	(1,059)	(1,104)
Prior service cost	(72)	(61)
Total accumulated other comprehensive income (loss)	(\$2,096)	(\$1,966)

Note 5 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 restricted stock to its non-employee directors. The interim information below should be read in conjunction with the disclosures included on pages 40 to 43 of the Company's 2009 Annual Report in Form 10-K.

The Company classifies pre-tax stock compensation expense in selling, general and administrative expense principally within its corporate operations. For the periods presented, compensation expense for all types of equity-based programs and the related income tax benefit recognized were as follows:

(millions)	Quarter ended		Year-to-date period ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Pre-tax compensation expense	\$10	\$15	\$23	\$28
Related income tax benefit	\$3	\$5	\$8	\$10

As of July 3, 2010, total stock-based compensation cost related to non-vested awards not yet recognized was \$51 million and the weighted-average period over which this amount is expected to be recognized was 2 years.

Stock options

During the year-to-date periods ended July 3, 2010 and July 4, 2009, the Company granted non-qualified stock options to eligible employees 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 pages 41 and 42 of the Company's 2009 Annual Report on Form 10-K.

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Year-to-date period ended July 3, 2010:

	Shares (millions)	Weighted- average exercise price	Weighted- average remaining contractual term (yrs.)	Aggregate intrinsic value (millions)
Employee and director stock options				
Outstanding, beginning of period	26	\$45		
Granted	4	53		
Exercised	(3)	44		
Forfeitures and expirations	0	0		
Outstanding, end of period	27	\$46	6.7	\$132
Exercisable, end of period	21	\$46	5.9	\$107

Year-to-date period ended July 4, 2009:

	Shares (millions)	Weighted- average exercise price	Weighted- average remaining contractual term (yrs.)	Aggregate intrinsic value (millions)
Employee and director stock options				
Outstanding, beginning of period	26	\$45		
Granted	3	40		
Exercised	0	0		
Forfeitures and expirations	0	0		
Outstanding, end of period	29	\$45	6.9	\$106
Exercisable, end of period	24	\$45	6.3	\$81

The weighted-average fair value of options granted was \$7.90 per share for the year-to-date period ended July 3, 2010 and \$6.33 per share for the year-to-date period ended July 4, 2009. 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 July 3, 2010	20.00%	4.94	2.54%	2.80%

The total intrinsic value of options exercised was \$33 million for the year-to-date period ended July 3, 2010 and \$2 million for the year-to-date period ended July 4, 2009.

Performance shares

In the first quarter of 2010, 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 operating profit and internal net sales growth targets are achieved.

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The 2010 target grant currently corresponds to approximately 210,000 shares, with a grant-date fair value of \$48 per share. The actual number of shares issued on the vesting date could range from 0 to 200% of target, depending on actual performance achieved. Based on the market price of the Company's common stock at July 3, 2010, the maximum future value that could be awarded to employees on the vesting date for all outstanding performance share awards was as follows:

(millions)	July 3, 2010
2008 Award	\$16
2009 Award	\$18
2010 Award	\$21

The 2007 performance share award, payable in stock, was settled at 150% of target in February 2010 for a total dollar equivalent of \$14 million.

Note 6 Employee benefits

The Company sponsors a number of U.S. and foreign pension, other nonpension postretirement and postemployment plans to provide various benefits for its employees. These plans are described on pages 43 to 47 of the Company's 2009 Annual Report on Form 10-K. Components of Company plan benefit expense for the periods presented are included in the tables below.

Pension

(millions)	Quarter ended		Year-to-date period ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Service cost	\$21	\$20	\$44	\$40
Interest cost	49	51	99	98
Expected return on plan assets	(77)	(81)	(156)	(157)
Amortization of unrecognized prior service cost	3	3	7	6
Recognized net loss	20	12	40	23
Total pension expense	\$16	\$5	\$34	\$10

Other nonpension postretirement

(millions)	Quarter ended		Year-to-date period ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Service cost	\$5	\$4	\$10	\$9
Interest cost	16	17	32	33
Expected return on plan assets	(16)	(17)	(32)	(34)
Amortization of unrecognized prior service cost	(1)	(1)	(1)	(1)
Recognized net loss	5	3	9	6
Total postretirement benefit expense	\$9	\$6	\$18	\$13

Postemployment

(millions)	Quarter ended		Year-to-date period ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Service cost	\$1	\$2	\$3	\$3
Interest cost	1	1	2	2
Recognized net loss	1	1	2	2
Total postemployment benefit expense	\$3	\$4	\$7	\$7

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Company contributions to employee benefit plans are summarized as follows:

(millions)	Pension	Nonpension postretirement	Total
Quarter ended:			
July 3, 2010	\$10	\$ 4	\$ 14
July 4, 2009	\$ 7	\$ 3	\$ 10
Year-to-date period ended:			
July 3, 2010	\$29	\$ 7	\$ 36
July 4, 2009	\$77	\$ 7	\$ 84
Full year:			
Fiscal year 2010 (projected)	\$35	\$15	\$ 50
Fiscal year 2009 (actual)	\$87	\$13	\$100

Plan funding strategies may be modified in response to management's evaluation of tax deductibility, market conditions, and competing investment alternatives.

During the first quarter of 2010, the Company amended its U.S. postretirement healthcare benefit plan, which resulted in a decrease of a deferred tax asset of \$17 million. This impact was recorded in other comprehensive income.

Note 7 Income taxes

The consolidated effective income tax rate for 2010 as compared to 2009 is as follows:

	Effective income tax rate
Quarter ended:	
July 3, 2010	30%
July 4, 2009	29%
Year-to-date period ended:	
July 3, 2010	28%
July 4, 2009	30%

The consolidated effective tax rate for the year-to-date period ended July 3, 2010 was slightly less than the prior year due to a correction of an immaterial item in the first quarter of 2010.

As of July 3, 2010, the Company classified \$25 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 consists of the current liability balance, expected to be settled within one year, offset by \$10 million of projected additions. 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 July 3, 2010; \$107 million of this total represents the amount that, if recognized, would affect the Company's effective income tax rate in future periods.

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(millions)	
January 2, 2010	\$ 130
Tax positions related to current year:	
Additions	6
Reductions	0
Tax positions related to prior years:	
Additions	1
Reductions	(7)
Settlements	(1)
July 3, 2010	\$ 129

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 liabilities.

The Company classifies income tax-related interest and penalties as interest expense and SGA expense, respectively.

(millions)	
Interest expense recognized for the year-to-date period ending July 3, 2010	\$ 5
Interest accrued at July 3, 2010	\$ 30

Note 8 Derivative instruments and fair value measurements

The Company is exposed to certain market risks such as changes in interest rates, foreign currency exchange rates, and commodity prices, which exist as a part of its ongoing business operations. Management uses derivative financial and commodity instruments, including futures, options, and swaps, where appropriate, to manage these risks. Instruments used as hedges must be effective at reducing the risk associated with the exposure being hedged and must be designated as a hedge at the inception of the contract.

The Company designates derivatives as cash flow hedges, fair value hedges, net investment hedges, or other contracts used to reduce volatility in the translation of foreign currency earnings to U.S. dollars. The fair value of derivative instruments is recorded in other prepaid assets, other assets, other current liabilities or other liabilities. Gains and losses representing either hedge ineffectiveness, hedge components excluded from the assessment of effectiveness, or hedges of translational exposure are recorded in the Consolidated Statement of Income in other income (expense), net. Within the Consolidated Statement of Cash Flows, settlements of cash flow and fair value hedges are classified as an operating activity; settlements of all other derivatives are classified as a financing activity. As a matter of policy, the Company does not engage in trading or speculative hedging transactions.

Total notional amounts of the Company's derivative instruments at July 3, 2010 and January 2, 2010 were as follows:

(millions)	July 3,	January 2,
	2010	2010
Foreign currency exchange contracts	\$ 1,170	\$1,588
Interest rate contracts	1,900	1,900
Commodity contracts	206	213
Total	\$ 3,276	\$3,701

Cash flow hedges

Qualifying derivatives are accounted for as cash flow hedges when the hedged item is a forecasted transaction. Gains and losses on these instruments are recorded in other comprehensive income until the underlying transaction is recorded in earnings. When the hedged item is realized, gains or losses are reclassified from accumulated other comprehensive income (loss) (AOCI) to the Consolidated Statement of Income on the same line item as the underlying transaction.

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Fair value hedges

Qualifying derivatives are accounted for as fair value hedges when the hedged item is a recognized asset, liability, or firm commitment. Gains and losses on these instruments are recorded in earnings, offsetting gains and losses on the hedged item.

Net investment hedges

Qualifying derivative and nonderivative financial instruments are accounted for as net investment hedges when the hedged item is a nonfunctional currency investment in a subsidiary. Gains and losses on these instruments are included in foreign currency translation adjustments in AOCI.

Other contracts

The Company also periodically enters into foreign currency forward contracts and options to reduce volatility in the translation of foreign currency earnings to U.S. dollars. Gains and losses on these instruments are recorded in other income (expense), net, generally reducing the exposure to translation volatility during a full-year period.

Foreign currency exchange risk

The Company is exposed to fluctuations in foreign currency cash flows related primarily to third-party purchases, intercompany transactions and nonfunctional currency denominated third-party debt. The Company is also exposed to fluctuations in the value of foreign currency investments in subsidiaries and cash flows related to repatriation of these investments. Additionally, the Company is exposed to volatility in the translation of foreign currency denominated earnings to U.S. dollars. Management assesses foreign currency risk based on transactional cash flows and translational volatility and enters into forward contracts, options, and currency swaps to reduce fluctuations in net long or short currency positions. Forward contracts and options are generally less than 18 months duration. Currency swap agreements are established in conjunction with the term of underlying debt issues.

For foreign currency cash flow and fair value hedges, the assessment of effectiveness is generally based on changes in spot rates. Changes in time value are reported in other income (expense), net.

Interest rate risk

The Company is exposed to interest rate volatility with regard to future issuances of fixed rate debt. The Company periodically uses interest rate swaps, including forward-starting swaps, to reduce interest rate volatility and funding costs associated with certain debt issues, and to achieve a desired proportion of variable versus fixed rate debt, based on current and projected market conditions.

Fixed-to-variable interest rate swaps are accounted for as fair value hedges and the assessment of effectiveness is based on changes in the fair value of the underlying debt, using incremental borrowing rates currently available on loans with similar terms and maturities.

Price risk

The Company is exposed to price fluctuations primarily as a result of anticipated purchases of raw and packaging materials, fuel, and energy. The Company has historically used the combination of long-term contracts with suppliers, and exchange-traded futures and option contracts to reduce price fluctuations in a desired percentage of forecasted raw material purchases over a duration of generally less than 18 months.

Commodity contracts are accounted for as cash flow hedges. The assessment of effectiveness for exchange-traded instruments is based on changes in futures prices. The assessment of effectiveness for over-the-counter transactions is based on changes in designated indexes.

Credit-risk-related contingent features

Certain of the Company's derivative instruments contain provisions requiring the Company to post collateral on those derivative instruments that are in a liability position if the Company's credit rating falls below BB+ (S&P), or Baa1 (Moody's). The fair value of all derivative instruments with credit-risk-related contingent features in a liability position on July 3, 2010 was \$29 million. If the credit-risk-related contingent features were triggered as of July 3, 2010, the Company would be required to post collateral of \$29 million. In addition, certain derivative instruments contain provisions that would be triggered in the event the Company defaults on its debt agreements. There were no collateral posting

requirements as of July 3, 2010 triggered by credit-risk-related contingent features.

Fair value measurements

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 July 3, 2010 and January 2, 2010.

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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.

For the Company, level 2 financial assets and liabilities 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. The Company's calculation of the fair value of level 2 financial assets and liabilities takes into consideration the risk of nonperformance, including counterparty credit risk.

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 did not have any level 3 financial assets or liabilities as of July 3, 2010 or January 2, 2010.

Fair values of these assets and liabilities in the Consolidated Balance Sheet measured at fair value on a recurring basis consists of derivatives designated as hedging instruments, and as of July 3, 2010 and January 2, 2010 were as follows:

(millions)	Level 1		Level 2		Total	
	July 3, 2010	January 2, 2010	July 3, 2010	January 2, 2010	July 3, 2010	January 2, 2010
Assets:						
Foreign currency exchange contracts:						
Other prepaid assets	\$0	\$0	\$25	\$7	\$25	\$7
Interest rate contracts:						
Other prepaid assets	0	0	8	0	8	0
Other assets	0	0	68	44	68	44
Commodity contracts:						
Other prepaid assets	3	4	0	0	3	4
Other assets	0	0	0	0	0	0
Total assets	\$3	\$4	\$101	\$51	\$104	\$55
Liabilities:						
Foreign currency exchange contracts:						
Other current liabilities	\$0	\$0	(\$27)	(\$31)	(\$27)	(\$31)
Interest rate contracts:						
Other current liabilities	0	0	0	0	0	0
Other liabilities	0	0	0	(1)	0	(1)
Commodity contracts:						
Other current liabilities	(2)	0	(9)	(6)	(11)	(6)
Other liabilities	0	0	(23)	(14)	(23)	(14)
Total liabilities	(\$2)	\$0	(\$59)	(\$52)	(\$61)	(\$52)

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The effect of derivative instruments on the Consolidated Statement of Income for the quarters ended July 3, 2010 and July 4, 2009 was as follows:

Derivatives in fair value hedging relationships (millions)	Location of gain (loss) recognized in income	Gain (loss) recognized in income	
		July 3, 2010	July 4, 2009
Foreign currency exchange contracts	Other income (expense), net	(\$22)	(\$12)
Interest rate contracts	Interest expense	10	6
Total		(\$12)	(\$6)

Derivatives in cash flow hedging relationships (millions)	Gain (loss) recognized in AOCI		Location of gain (loss) reclassified From AOCI	Gain (loss) reclassified from AOCI into income		Location of gain (loss) recognized in income (a)	Gain (loss) recognized in income(a)	
	July 3,			July 3,			July 3,	July 4,
	2010	July 4, 2009		2010	July 4, 2009		2010	2009
Foreign currency exchange contracts	\$0	(\$9)	COGS	(\$6)	\$9	Other income (expense), net	\$0	\$0
Foreign currency exchange contracts	1	1	SGA expense	0	(1)	Other income (expense), net	0	0
Interest rate contracts	0	2	Interest expense	(1)	(1)	N/A	0	0
Commodity contracts	(5)	6	COGS	(11)	2	Other income (expense), net	0	0
Total	(\$4)	\$0		(\$18)	\$9		\$0	\$0

Derivatives not designated as hedging instruments (millions)	Location of gain (loss) recognized in income	Gain (loss) recognized in income	
		July 3, 2010	July 4, 2009
Foreign currency exchange contracts	Other income (expense), net	\$0	\$0

(a) Includes the ineffective portion and amount excluded from effectiveness testing

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The effect of derivative instruments on the Consolidated Statement of Income for the year-to-date periods ended July 3, 2010 and July 4, 2009 was as follows:

Derivatives in fair value hedging relationships (millions)	Location of gain (loss) recognized in income	Gain (loss) recognized in income	
		July 3, 2010	July 4, 2009
Foreign currency exchange contracts	Other income (expense), net	(\$51)	(\$8)
Interest rate contracts	Interest expense	20	9
Total		(\$31)	\$1

Derivatives in cash flow hedging relationships (millions)	Gain (loss) recognized in AOCI		Location of gain (loss) reclassified From AOCI	Gain (loss) reclassified from AOCI into income		Location of gain (loss) recognized in income (a)	Gain (loss) recognized in income (a)	
	July 3, 2010	July 4, 2009		July 3, 2010	July 4, 2009		July 3, 2010	July 4, 2009
Foreign currency exchange contracts	(\$12)	(\$3)	COGS	(\$13)	\$18	Other income (expense), net	\$0	(\$1)
Foreign currency exchange contracts	2	2	SGA expense	0	(2)	Other income (expense), net	0	0
Interest rate contracts	0	2	Interest expense	(2)	(3)	N/A	0	0
Commodity contracts	(29)	17	COGS	(16)	10	Other income (expense), net	(1)	0
Total	(\$39)	\$18		(\$31)	\$23		(\$1)	(\$1)

Derivatives not designated as hedging instruments (millions)	Location of gain (loss) recognized in income	Gain (loss) recognized in income	
		July 3, 2010	July 4, 2009
Foreign currency exchange contracts	Other income (expense), net	\$0	\$1

(a) Includes the ineffective portion and amount excluded from effectiveness testing

Financial instruments

The carrying values of the Company's short-term items, including cash, cash equivalents, accounts receivable, accounts payable and notes payable approximate fair value. The fair value of the Company's long-term debt is calculated based on broker quotes and was as follows at July 3, 2010:

(millions)	Fair Value	Carrying Value
Current maturities of long-term debt	\$ 988	\$ 954
Long-term debt	4,371	3,915
Total	\$ 5,359	\$ 4,869

Credit risk concentration

The Company is exposed to credit loss in the event of nonperformance by counterparties on derivative financial and commodity contracts. Management believes a concentration of credit risk with respect to derivative counterparties is limited due to the credit ratings of the

counterparties and the use of master netting and reciprocal collateralization agreements.

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Master netting agreements apply in situations where the Company executes multiple contracts with the same counterparty. Certain counterparties represent a concentration of credit risk to the Company. If those counterparties fail to perform according to the terms of derivative contracts, this would result in a loss to the Company of \$57 million as of July 3, 2010.

For certain derivative contracts, reciprocal collateralization agreements with counterparties call for the posting of collateral in the form of cash, treasury securities or letters of credit if a fair value loss position to the Company or our counterparties exceeds a certain amount. There were no collateral balance requirements at July 3, 2010.

Management believes concentrations of credit risk with respect to accounts receivable is limited due to the generally high credit quality of the Company's major customers, as well as the large number and geographic dispersion of smaller customers. However, the Company conducts a disproportionate amount of business with a small number of large multinational grocery retailers, with the five largest accounts encompassing approximately 29% of consolidated accounts receivable at July 3, 2010.

Note 9 Voluntary product recall

On June 25, 2010, the Company announced a voluntary recall of select packages of Kellogg's cereal in the U.S. due to an odor from waxy resins found in the package liner. In addition to the costs of the voluntary recall detailed below, the Company also lost sales of the impacted products in the second quarter of 2010. Estimated customer returns and consumer rebates were recorded as a reduction of net sales; costs associated with returned product and the disposal and write-off of inventory were recorded as COGS.

	Quarter ended July 3, 2010
(millions, except per share amount)	
Reduction of net sales	\$30
Cost of goods sold	18
Total	\$48
Earnings per diluted share impact	\$0.09

Note 10 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, consisting of North America and the three International operating segments of Europe, Latin America, and Asia Pacific.

	Quarter ended July 3, 2010	July 4, 2009	Year-to-date period ended July 3, 2010	July 4, 2009
(millions)				
Net sales				
North America	\$2,064	\$2,176	\$4,339	\$4,387
Europe	560	617	1,166	1,174
Latin America	240	258	462	488
Asia Pacific (a)	198	178	413	349
Consolidated	\$3,062	\$3,229	\$6,380	\$6,398
Segment operating profit				
North America	\$362	\$426	\$857	\$829
Europe	100	104	205	199
Latin America	47	57	92	106
Asia Pacific (a)	20	21	57	46
Corporate	(46)	(55)	(91)	(98)
Consolidated	\$483	\$553	\$1,120	\$1,082

(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. We currently manage our operations in four geographic operating segments, consisting of North America and the three International operating segments of Europe, Latin America and Asia Pacific.

We manage our Company for sustainable performance defined by our long-term annual growth targets. These 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 net earnings per share on a currency neutral basis. Internal net sales and internal operating profit exclude the impact of foreign currency translation, acquisitions, dispositions and shipping day differences. See the Foreign currency translation section for an explanation of management's definition of currency neutral.

For the quarter ended July 3, 2010, our reported net sales declined 5% compared to the same period last year; internal net sales declined 4%. Consolidated operating profit was down 13%, while internal operating profit declined 11%. Diluted earnings per share (EPS) declined 14% to \$.79, compared to \$.92 in the comparable prior period. EPS on a currency neutral basis was down 11%.

On a year-to-date basis, our reported net sales were down slightly, with internal net sales down 1%. Consolidated operating profit was up 4% on a reported basis and 3% on an internal basis. Diluted EPS was up 7%, at \$1.88, compared to \$1.76 in the prior year. EPS on a currency neutral basis was also up 7%.

We have lowered our guidance for the full year to reflect weaker business performance in the second quarter and the voluntary cereal recall in the U.S. which is discussed further in the Voluntary product recall section. For the full year, we now expect our internal net sales to be flat to up 1%. Internal operating profit is expected to be up 4 to 6% and currency neutral earnings per share is expected to grow 8 to 10%.

Net sales and operating profit

The following table provides an analysis of net sales and operating profit performance for the second quarter of 2010 versus 2009:

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consolidated
2010 net sales	\$ 2,064	\$ 560	\$ 240	\$ 198	\$	\$ 3,062
2009 net sales	\$ 2,176	\$ 617	\$ 258	\$ 178	\$	\$ 3,229
% change 2010 vs. 2009:						
Volume (tonnage) (b)	-5.3%	-3.3%	-6.1%	3.9%		-4.5%
Pricing/mix	-.5%	.8%	10.8%	-.5%		.6%
Subtotal internal business	-5.8%	-2.5%	4.7%	3.4%		-3.9%
Foreign currency impact	.7%	-6.8%	-12.0%	8.5%		-1.3%
Total change	-5.1%	-9.3%	-7.3%	11.9%		-5.2%
(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consolidated

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2010 operating profit	\$ 362	\$ 100	\$ 47	\$ 20	\$ (46)	\$ 483
2009 operating profit	\$ 426	\$ 104	\$ 57	\$ 21	\$ (55)	\$ 553
% change 2010 vs. 2009:						
Internal business	-16.2%	6.3%	-9.9%	-10.3%	16.7%	-11.1%
Foreign currency impact	.9%	-9.6%	-7.1%	9.8%		-1.5%
Total change	-15.3%	-3.3%	-17.0%	-.5%	16.7%	-12.6%

(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.

Our consolidated net sales were down 5% reflecting weakness in cereal, lower *Eggo* sales, and a voluntary recall of select packages of breakfast cereals. Reported net sales were negatively impacted by currency, resulting in an internal net sales decline of 4%.

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Internal net sales for our North America operating segment declined 6%. North America has three product groups: retail cereal, retail snacks and frozen and specialty channels. Retail cereal declined by 13% in the quarter. There were three primary drivers of the decline in our retail cereal business. The first driver was consumer consumption of cereal in the second quarter of 2010 versus the second quarter of 2009. Consumer consumption impacts purchases by retailers who, in turn, are our primary customers. We estimate that total consumption in the cereal category declined in the second quarter of 2010 by 2 to 3% in value, while consumption of our products was down approximately 5%. A large part of the decline in the category and in the consumption of our products can be explained by comparisons to the prior year. In the second quarter of 2009, the cereal category grew approximately 4% in value while the consumption of our products increased approximately 6 to 7%. The increase in consumption of our products in 2009 was ahead of the category. In 2010 the consumption of our products decreased. The second factor was the voluntary recall of select packages of breakfast cereals in the U.S. The reversed sales resulting from the recall reduced our North America retail cereal sales by 4% in the second quarter. In addition to the reversed sales, we incurred lost sales of the impacted products. Finally, during the first quarter of 2010, retailers bought ahead of promotions to be executed in the second quarter. As a result, there was a reduction in trade inventory which negatively impacted second quarter 2010 sales.

The retail snack product group (cookies, crackers, toaster pastries, cereal bars, and fruit snacks) grew by 1%. The modest growth was driven by *Pop-Tarts* and strong wholesome snack bar sales including our bar innovations such as *FiberPlus* Chocolate Peanut Butter and *Special K* Fruit Crisps which offset softness in cookies and crackers.

Internal net sales in the frozen and specialty channels (frozen foods, food service and vending) decreased by 9%. Over the past several months we have made significant progress in increasing *Eggo* production levels from the supply disruption that began at the end of the third quarter of 2009. At the end of the first quarter we began rebuilding internal and customer inventory. Additionally, we have resumed demand driving activities including advertising, coupons and price promotions.

Our International operating segments' internal net sales were flat compared to the prior year. Europe's internal net sales declined 3% in the second quarter. Similar to the U.S., we are seeing price deflation in many food categories across Europe, especially in the U.K. The continued migration away from lower margin bulk products to higher margin packaged products in Russia drove lower volumes and contributed to Europe's lower top line results. Latin America's internal net sales growth was up 5%, on top of last year's strong 8% growth. Cereal sales in Mexico continue to be strong, but they were partially offset by a decline in Brazil due to the temporary supply disruption at our plant in the first quarter. An estimated double-digit increase in consumer consumption was not fully reflected in our net sales performance as retailers reduced inventory in the quarter. Cereal sales in Venezuela were up due to price increases. Internal net sales in Asia Pacific grew 3%, on top of last year's 3% growth. Cereal growth in South Korea and India were very strong, but was partially offset by weakness in China and Japan.

Consolidated operating profit declined by 13% on an as reported basis and by 11% on an internal basis, when excluding the impact of foreign currency translation. Operating profit declined primarily due to the voluntary cereal recall in the U.S. as well as the overall weakness in the business. The recall reduced our internal operating profit by 9%.

Internal operating profit in North America decreased by 16%, Europe's grew by 6%, Latin America's declined by 10% and Asia Pacific's declined by 10%. North America's operating profit suffered from the voluntary recall which negatively impacted internal operating profit by 11%. Europe's increase in internal operating profit is attributable to favorability in mix, lower up-front costs, as well as savings from cost savings initiatives. Latin America's decline is due primarily to increased commodity, fuel, benefit, distribution costs and advertising investments. Asia Pacific's decline is due to higher commodity costs and investment in advertising and promotion.

The following tables provide analysis of our net sales to operating performance for the year-to-date periods of 2010 compared to 2009. Our weak top-line growth in the second quarter of 2010 has more than offset our first quarter position, resulting in year-to-date internal net sales to be down 1%. Despite a decline in operating profit in the second quarter, our strong internal operating profit performance in the first quarter resulted in a year-to-date increase of 3%.

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consoli- dated
2010 net sales	\$ 4,339	\$ 1,166	\$ 462	\$ 413	\$	\$ 6,380
2009 net sales	\$ 4,387	\$ 1,174	\$ 488	\$ 349	\$	\$ 6,398

% change 2010 vs. 2009:

Table of Contents**Margin performance**

Margin performance for the second quarter and year-to-date periods of 2010 versus 2009 is as follows:

Quarter	2010	2009	<i>Change vs. prior year (pts.)</i>
Gross margin (a)	42.6%	43.5%	-0.9
SGA% (b)	-26.8%	-26.4%	-0.4
Operating margin	15.8%	17.1%	-1.3
Year-to-date	2010	2009	<i>Change</i>
Gross margin (a)	42.8%	42.3%	0.5
SGA% (b)	-25.2%	-25.4%	0.2
Operating margin	17.6%	16.9%	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. For the second quarter, our gross profit was down \$99 million, \$48 million of which was due to the voluntary cereal recall.

As illustrated in the preceding table, our consolidated gross margin decreased by 90 basis points in the quarter. The voluntary recall negatively impacted our gross margin by 120 basis points. Absent the recall, our gross margin would have been up 30 basis points. While we are achieving savings from our cost reduction initiatives, we continue to experience inflationary cost pressures for fuel, energy, commodities and employee benefits.

Our selling, general and administrative (SGA) expenses were down in the quarter due to a slight decline in promotional spending as well as lower overhead spending.

On a year-to-date basis, our strong first quarter results have resulted in gross margin and operating margin expansion. We expect our full year gross margin to expand by approximately 50 basis points.

Foreign currency translation

The reporting currency for our financial statements is the U.S. dollar. Certain of our assets, liabilities, expenses and revenues are denominated in currencies other than the U.S. dollar, primarily in the Euro, British pound, Mexican peso, Australian dollar and Canadian dollar. To prepare our consolidated financial statements, we must translate those assets, liabilities, expenses and revenues into U.S. dollars at the applicable exchange rates. As a result, increases and decreases in the value of the U.S. dollar against these other currencies will affect the amount of these items in our consolidated financial statements, even if their value has not changed in their original currency. This could have significant impact on our results if such increase or decrease in the value of the U.S. dollar is substantial.

Volatility in the foreign exchange markets has limited our ability to forecast future U.S. dollar reported earnings. As such, we are measuring diluted earnings per share growth and providing guidance on future earnings on a currency neutral basis, assuming earnings are translated at the prior year's exchange rates. This non-GAAP financial measure is being used to focus management and investors on local currency business results, thereby providing visibility to the underlying trends of the Company. Management believes that excluding the impact of foreign currency from EPS provides a useful measurement of comparability given the volatility in foreign exchange markets.

Below is a reconciliation of reported EPS to currency neutral EPS:

Consolidated results	Quarter ended		Year-to-date ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009

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Diluted net earnings per share (EPS)	\$0.79	\$0.92	\$1.88	\$1.76
Translational impact (a)	0.03	0.09	0.01	0.17
Currency neutral EPS	\$0.82	\$1.01	\$1.89	\$1.93
Currency neutral EPS growth (b)	-11%		7%	

- (a) Translation impact is the difference between reported EPS and the translation of current year net profits at prior year exchange rates, adjusted for gains (losses) on translational hedges.
- (b) Calculated as a percentage of growth from the prior years' reported EPS.

Table of Contents***Voluntary product recall***

On June 25, 2010, we announced a voluntary recall of select packages of Kellogg's cereal in the U.S. due to an odor from waxy resins found in the package liner. In addition to the costs of the voluntary recall detailed below, we also lost sales of the impacted products in the second quarter of 2010. We expect to incur additional lost sales during the third quarter. Estimated customer returns and consumer rebates were recorded as a reduction of net sales; costs associated with returned product and the disposal and write-off of inventory were recorded as cost of goods sold (COGS).

	Quarter ended
(millions, except per share amount)	July 3, 2010
Reduction of net sales	\$ 30
Cost of goods sold	18
Total	\$ 48
Earnings per diluted share impact	\$0.09

Other cost reduction initiatives

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. 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. See further discussion in Note 3. We include these charges in our measure of operating segment profitability. In 2009, we announced our intention to achieve \$1 billion plus of annual cost savings in three years (beginning in 2012). These initiatives are integral to meeting our \$1 billion plus savings challenge.

2010 activities

We incurred costs related to our cost reduction initiatives which do not qualify as exit costs under generally accepted accounting principles in the United States. These represent cash costs for consulting and other charges for our COGS and selling, general and administrative (SGA) programs.

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Costs incurred during the quarter and year-to-date period ended July 3, 2010 are as follows:

(millions)	Quarter ended July 3, 2010			Year-to-date period ended July 3, 2010		
	COGS programs	SGA programs	Total	COGS programs	SGA programs	Total
North America	\$6	\$	\$6	\$12	\$1	\$13
Europe	4		4	6		6
Latin America	1		1	1		1
Asia Pacific				1		1
Corporate		2	2		2	2
Total	\$11	\$2	\$13	\$20	\$3	\$23

Total program costs to date are as follows:

(millions)	Total program costs through July 3, 2010		
	COGS programs	SGA programs	Total
North America	\$62	\$14	\$76
Europe	16	2	18
Latin America	6		6
Asia Pacific	6		6
Corporate		2	2
Total	\$90	\$18	\$108

The additional cost and cash outlay in 2010 for these programs, excluding exit costs, is estimated to be \$25 to \$30 million. The projects are expected to be substantially complete by the end of 2010.

Prior year activities

During the second quarter of 2009, we incurred \$22 million of consulting and other costs in connection with our COGS and SGA programs. Costs were recorded in the following operating segments for the quarter and year-to-date period ended July 4, 2009.

(millions)	Quarter ended July 4, 2009			Year-to-date period ended July 4, 2009		
	COGS programs	SGA programs	Total	COGS programs	SGA programs	Total
North America	\$12	\$6	\$18	\$25	\$6	\$31
Europe	2		2	3		3
Latin America	1		1	2		2
Asia Pacific	1		1	1		1
Total	\$16	\$6	\$22	\$31	\$6	\$37

Interest expense

For the quarter and year-to-date period ended July 3, 2010, interest expense was \$61 million and \$126 million, respectively, as compared to the quarter and year-to-date period ended July 4, 2009 with interest expense of \$67 million and \$134 million, respectively.

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For the full year 2010, we expect gross interest expense to be approximately \$250 to \$260 million, compared to 2009's full year amount of \$295 million. The forecasted decline is driven primarily by costs of the bond tender executed in 2009.

Income taxes

The consolidated effective income tax rate was 30% for the quarter ended July 3, 2010, as compared to 29% for the comparable quarter of 2009. The year-to-date consolidated effective tax rate for 2010 was 28% as compared to 30% in the previous year.

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For the full year 2010, we currently expect the consolidated effective income tax rate to be approximately 29 to 30%. Our estimate of the effective income tax rate for any period is highly influenced by country mix of earnings, changes in statutory tax rates, timing of implementation of tax planning initiatives, and developments which affect our evaluation of uncertain tax positions.

Liquidity and capital resources

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.

We believe that our operating cash flows, together with our credit facilities and other available debt financing, will be adequate to meet our operating, investing and financing needs in the foreseeable future. However, there can be no assurance that volatility and/or disruption in the global capital and credit markets will not impair our ability to access these markets on terms acceptable to us, or at all.

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, based on a trailing 12 month average) was approximately 22 days and 23 days for the 12 month periods ended July 3, 2010 and July 4, 2009, respectively.

The following table presents the major components of our operating cash flow:

(millions)	Year-to-date period ended		<i>Change versus prior year</i>
	July 3, 2010	July 4, 2009	
Operating activities			
Net income	\$718	\$672	\$46
Items in net income not requiring (providing) cash:			
Depreciation and amortization	178	189	(11)
Deferred income taxes	(52)	30	(82)
Other	73	(8)	81
Net Income after non-cash items	917	883	34
Postretirement benefit plan contributions	(36)	(84)	48
Changes in operating assets and liabilities:			
Core working capital (a)	(60)	(212)	152
Other working capital	(228)	109	(337)
	(288)	(103)	(185)
Net cash provided by operating activities	\$593	\$696	\$(103)

(a) Inventory and trade receivables less trade payables.

Lower operating cash flow in 2010 was the result of an unfavorable year-over-year variance in other working capital, which more than offset a favorable variance relating to core working capital.

Cash flows associated with other working capital in 2010 primarily reflected increased payments for advertising, salaries and wages, and income taxes. An increase in cash paid for the settlement of hedge contracts in 2010 versus the prior year period was also a factor.

Cash flows associated with core working capital in 2010 were favorable compared with the same period in 2009, largely the result of lower receivables. We continue to manage core working capital by focusing on the timely collection of trade receivables, extending terms on accounts payable and careful monitoring of inventory.

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Our pension and postretirement benefit plan contributions amounted to \$36 million and \$84 million for the year to date periods ended July 3, 2010 and July 4, 2009, respectively. During the remainder of 2010, we currently project that we will make additional contributions to pension and postretirement plans totaling \$14 million. Actual 2010 contributions could be different from our current projections, as influenced by our decision to undertake discretionary funding of our benefit trusts versus other competing investment priorities, future changes in government requirements, trust asset performance, renewals of union contracts, or higher-than-expected health care claims cost experience.

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We measure cash flow as net cash provided by operating activities reduced by expenditures for property additions. We use this non-GAAP financial measure of cash flow to focus management and investors on the amount of cash available for debt repayment, dividend distributions, acquisition opportunities, and share repurchases. Our cash flow metric is reconciled to the most comparable GAAP measure, as follows:

(dollars in millions)	Year-to-date period ended		<i>Change versus prior year</i>
	July 3, 2010	July 4, 2009	
Net cash provided by operating activities	\$593	\$696	-14.8%
Additions to properties	(147)	(161)	
Cash flow	\$446	\$535	-16.6%

For 2010, we are projecting cash flow (as defined) within a range of \$1.15 to \$1.2 billion.

Investing activities

Our net cash used in investing activities for 2010 amounted to \$145 million, a decrease of \$15 million compared to cash used of \$160 million in 2009, reflecting a reduction in capital expenditures in 2010.

Our long-term target for capital spending is between 3.0% and 4.0% of net sales. Our 2010 capital plan projects spending of approximately \$500 million, which is at the high end of our 3.0% to 4.0% range. This is driven by a significant investment in our information technology infrastructure as we reinstall and upgrade our SAP platform. We also have plans to increase our manufacturing capacity in 2010.

Financing activities

Our net cash used in financing activities for the year-to-date period ended July 3, 2010 amounted to \$289 million compared with \$377 million for comparable period in 2009.

We had positive cash flows associated with the issuance of commercial paper in 2010, while we reduced commercial paper outstanding during the first half of 2009, primarily through the use of \$745 million proceeds associated with our May 2009 issuance of \$750 million in long-term debt.

Cash inflows from net issuances of common stock amounted to \$148 million in the first half of 2010 compared with \$18 million during the same period in 2009, with the increase attributable to a higher level of stock option exercise activity in 2010.

During the year-to-date period ended July 3, 2010, we repurchased approximately 7 million shares of our common stock for a total of \$356 million. Of the \$356 million, \$266 million was paid during the six-month period and \$90 million was payable at July 3, 2010 for stock repurchases that did not settle prior to the end of the reporting period. Our current EPS guidance for 2010 assumes that we will be repurchasing between \$600 million and \$1 billion of our common stock over the full year 2010. Actual 2010 repurchases could be different from our current projections, as influenced by factors such as the impact of changes in our stock price and other competing priorities. During the year-to-date period ended July 4, 2009, we had no stock repurchase activity. The 2010 repurchase activity falls under the program approved in April 2010. On April 23, 2010, our board of directors authorized a \$2.5 billion three-year share repurchase program for 2010 through 2012. This authorization replaced the previous share buyback program which authorized stock repurchases of up to \$1,113 million for 2010.

We paid cash dividends of \$286 million and \$260 million during the year-to-date periods ended July 3, 2010 and July 4, 2009, respectively. In July 2010, the board of directors declared a dividend of \$0.405 per common share, payable on September 15, 2010 to shareholders of record at close of business on September 1, 2010. The dividend of \$0.405 per share represents an 8% increase in the \$0.375 per share quarterly dividend rate paid during the trailing twelve months. This increase is consistent with our current plan to maintain our dividend pay-out ratio between 40% and 50% of reported net income.

We plan to refinance our \$946 million of debt maturing in March 2011 prior to its maturity, and 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. We expect to meet these obligations while still meeting our operational needs, including the pursuit of selected bolt-on acquisitions. This will be accomplished through our strong cash flow, borrowings, and maintaining our credit facilities on a global basis.

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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; 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, 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, renovation and new product introductions;

the recoverability of the carrying value of goodwill and other intangibles;

the success of productivity improvements and business transitions;

commodity and energy prices;

labor costs;

disruptions or inefficiencies in supply chain;

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, statutory tax rates, currency conversion and availability;

legal and regulatory factors including changes in advertising and labeling laws and regulations;

the ultimate impact of product recalls;

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

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

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

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

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 Note 8 within Notes to Consolidated Financial Statements for further information on our derivative financial and commodity instruments.

Refer to disclosures contained on pages 24-26 of our 2009 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 July 3, 2010.

The total notional amount of foreign currency derivative instruments as July 3, 2010 was \$1,170 million, representing a settlement obligation of \$3 million. The total notional amount of foreign currency derivative instruments at January 2, 2010 was \$1,588 million, representing a settlement obligation of \$24 million. Assuming an unfavorable 10% change in period-end exchange rates, the settlement obligation would have increased by \$117 million and \$159 million as of July 3, 2010 and January 2, 2010, respectively. Those unfavorable changes would generally have been offset by favorable changes in the values of the underlying exposures.

Venezuela was designated as a highly inflationary economy as of the beginning of our 2010 fiscal year. Gains and losses resulting from the translation of the financial statements of subsidiaries operating in highly inflationary economies are recorded in earnings. As of the end of our 2009 fiscal year, we used the parallel rate to translate our Venezuelan subsidiary's financial statements to U.S. dollars. In May 2010, the Venezuelan government effectively eliminated the parallel market. In June, several large Venezuelan commercial banks began operating the Transaction System for Foreign Currency Denominated Securities (SITME). We intend to use SITME to settle non-functional currency denominated assets and liabilities. Accordingly, we are using the SITME rate at July 3, 2010 to translate our Venezuelan subsidiary's financial statements to U.S. dollars. During the second quarter of 2010, we recorded an \$8 million foreign exchange gain in other income (expense), net, associated with the translation of our subsidiary's financials into U.S. dollars. On a year-to-date basis we recorded a \$6 million foreign exchange gain in other income (expense), net. On a consolidated basis, Venezuela represents only 1% to 2% of our business; therefore, any ongoing impact is expected to be immaterial.

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 July 3, 2010, 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 January 2, 2010. 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 January 2, 2010, 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 #1: 4/4/10 - 5/1/10	0	\$ 0.00	0	\$2,352
Month #2: 5/2/10 - 5/29/10	274,800	\$52.87	274,800	\$2,337
Month #3: 5/30/10 - 7/3/10	3,747,931	\$51.90	3,747,931	\$2,142
Total	4,022,731	\$51.97	4,022,731	

On April 23, 2010, our board of directors authorized a \$2.5 billion three-year share repurchase program for 2010 through 2012. This authorization replaced the previous share buyback program which authorized stock repurchases of up to \$1,113 million for 2010. During the year-to-date period ended July 3, 2010, we repurchased 7 million shares of our common stock for a total of \$356 million, of which \$266 million was paid during the six-month period and \$90 million was payable at July 3, 2010 for stock repurchases that did not settle prior to the end of the reporting period. The 2010 repurchase activity falls under the program approved in April 2010.

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 Ronald L. Dissinger

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32.1	Section 1350 Certification from A.D. David Mackay
32.2	Section 1350 Certification from Ronald L. Dissinger
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

* To be filed by amendment.

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KELLOGG COMPANY

SIGNATURES

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

KELLOGG COMPANY

/s/ R. L. Dissinger
R. L. Dissinger
Principal Financial Officer;

Senior Vice President and Chief Financial Officer

/s/ A. R. Andrews
A. R. Andrews
Principal Accounting Officer;

Vice President Corporate Controller

Date: August 9, 2010

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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 Ronald L. Dissinger	E
32.1	Section 1350 Certification from A. D. David Mackay	E
32.2	Section 1350 Certification from Ronald L. Dissinger	E
101.INS*	XBRL Instance Document	
101.SCH*	XBRL Taxonomy Extension Schema Document	
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document	
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document	
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document	
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document	

* To be filed by amendment.