

KELLOGG CO
Form 10-Q
August 05, 2011
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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 2, 2011

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 30, 2011 362,003,351 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 2, 2011	January 1, 2011
	(unaudited)	*
Current assets		
Cash and cash equivalents	\$ 457	\$ 444
Accounts receivable, net	1,364	1,190
Inventories:		
Raw materials and supplies	239	224
Finished goods and materials in process	778	832
Deferred income taxes	161	110
Other prepaid assets	137	115
Total current assets	3,136	2,915
Property, net of accumulated depreciation of \$4,908 and \$4,690	3,246	3,128
Goodwill	3,632	3,628
Other intangibles, net of accumulated amortization of \$48 and \$47	1,455	1,456
Pension	474	333
Other assets	413	387
Total assets	\$ 12,356	\$ 11,847
Current liabilities		
Current maturities of long-term debt	\$	\$ 952
Notes payable	734	44
Accounts payable	1,208	1,149
Accrued advertising and promotion	436	405
Accrued income taxes	31	60
Accrued salaries and wages	205	153
Other current liabilities	412	421
Total current liabilities	3,026	3,184
Long-term debt	5,308	4,908
Deferred income taxes	768	697
Pension liability	171	265
Nonpension postretirement benefits	199	214
Other liabilities	416	425
Commitments and contingencies		

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Equity

Common stock, \$.25 par value	105	105
Capital in excess of par value	513	495
Retained earnings	6,511	6,122
Treasury stock, at cost	(2,890)	(2,650)
Accumulated other comprehensive income (loss)	(1,765)	(1,914)

Total Kellogg Company equity	2,474	2,158
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Noncontrolling interests	(6)	(4)
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Total equity	2,468	2,154
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Total liabilities and equity	\$ 12,356	\$ 11,847
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* 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 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
Net sales	\$ 3,386	\$ 3,062	\$6,871	\$6,380
Cost of goods sold	1,943	1,757	4,007	3,650
Selling, general and administrative expense	900	822	1,749	1,610
Operating profit	543	483	1,115	1,120
Interest expense	53	61	120	126
Other income (expense), net	(1)	7	(1)	8
Income before income taxes	489	429	994	1,002
Income taxes	147	128	287	284
Net income	\$ 342	\$ 301	\$ 707	\$ 718
Net income (loss) attributable to noncontrolling interests	(1)	(1)	(2)	(2)
Net income attributable to Kellogg Company	\$ 343	\$ 302	\$ 709	\$ 720
Per share amounts:				
Basic	\$ 0.94	\$ 0.80	\$ 1.95	\$ 1.89
Diluted	\$ 0.94	\$ 0.79	\$ 1.93	\$ 1.88
Dividends per share	\$ 0.405	\$ 0.375	\$0.810	\$0.750
Average shares outstanding:				
Basic	363	381	364	380
Diluted	366	384	367	384
Actual shares outstanding at period end			362	378

Refer to Notes to Consolidated Financial Statements.

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

(millions)

	Capital in				Treasury stock		Accumulated	Total Kellogg		Non-	Total
	Common stock		excess of	Retained	shares	amount	other comprehensive income (loss)	Company equity	controlling interests	equity	comprehensive income (loss)
(unaudited)	shares	amount	par value	earnings	shares	amount	(loss)				
Balance, January 2, 2010	419	\$105	\$ 472	\$5,481	38	\$(1,820)	\$ (1,966)	\$ 2,272	\$ 3	\$ 2,275	
Common stock repurchases					21	(1,057)		(1,057)		(1,057)	
Net income (loss)				1,247				1,247	(7)	1,240	\$ 1,240
Dividends				(584)				(584)		(584)	
Other comprehensive income							52	52		52	52
Stock compensation			19					19		19	
Stock options exercised and other			4	(22)	(5)	227		209		209	
Balance, January 1, 2011	419	\$105	\$ 495	\$6,122	54	\$(2,650)	\$ (1,914)	\$ 2,158	\$ (4)	\$ 2,154	\$ 1,292
Common stock repurchases					9	(513)		(513)		(513)	
Net income (loss)				709				709	(2)	707	707
Dividends				(296)				(296)		(296)	
Other comprehensive income							149	149		149	149
Stock compensation			11					11		11	
Stock options exercised and other			7	(24)	(5)	273		256		256	
Balance, July 2, 2011	419	\$105	\$ 513	\$6,511	58	\$(2,890)	\$ (1,765)	\$ 2,474	\$ (6)	\$ 2,468	\$ 856

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 2, 2011	July 3, 2010
Operating activities		
Net income	\$ 707	\$ 718
Adjustments to reconcile net income to operating cash flows:		
Depreciation and amortization	175	178
Deferred income taxes	(1)	(52)
Other	25	73
Postretirement benefit plan contributions	(183)	(36)
Changes in operating assets and liabilities:		
Trade receivables	(285)	(84)
Inventories	39	25
Accounts payable	59	(1)
Accrued income taxes	122	(22)
Accrued interest expense	(18)	(1)
Accrued and prepaid advertising, promotion and trade allowances	6	(31)
Accrued salaries and wages	51	(135)
All other current assets and liabilities	(51)	(39)
Net cash provided by operating activities	646	593
Investing activities		
Additions to properties	(243)	(147)
Other	5	2
Net cash used in investing activities	(238)	(145)
Financing activities		
Net issuances of notes payable	687	110
Issuances of long-term debt	397	
Reductions of long-term debt	(946)	(1)
Net issuances of common stock	249	148
Common stock repurchases	(518)	(266)
Cash dividends	(296)	(286)
Other	10	6
Net cash used in financing activities	(417)	(289)
Effect of exchange rate changes on cash and cash equivalents	22	(22)
Increase in cash and cash equivalents	13	137
Cash and cash equivalents at beginning of period	444	334
Cash and cash equivalents at end of period	\$ 457	\$ 471

Refer to Notes to Consolidated Financial Statements.

Table of Contents**Notes to Consolidated Financial Statements****for the quarter ended July 2, 2011 (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 57 of the Company's 2010 Annual Report on Form 10-K.

The condensed balance sheet data at January 1, 2011 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 2, 2011 are not necessarily indicative of the results to be expected for other interim periods or the full year.

Accounting standards to be adopted in future periods

In June 2011, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2011-05, Presentation of Comprehensive Income, requiring most entities to present items of net income and other comprehensive income either in one continuous statement referred to as the statement of comprehensive income or in two separate, but consecutive, statements of net income and other comprehensive income. The update does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU No. 2011-05 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. Early adoption is permitted. The Company will be adopting ASU 2011-05 at the beginning of its 2012 fiscal year.

Note 2 Goodwill and other intangible assets

Changes in the carrying amount of goodwill for the quarter ended July 2, 2011 are presented in the following table.

Carrying amount of goodwill

(millions)	North America	Europe	Latin America	Asia Pacific (a)	Consolidated
January 1, 2011	\$3,539	\$62	\$	\$27	\$3,628
Currency translation adjustment		3		1	4
July 2, 2011	\$3,539	\$65	\$	\$28	\$3,632

(a) Includes Australia, Asia and South Africa.

Intangible assets subject to amortization

(millions)	Gross carrying amount		Accumulated amortization	
	July 2, 2011	January 1, 2011	July 2, 2011	January 1, 2011
Trademarks	\$19	\$19	\$17	\$16
Other	41	41	31	31
Total	\$60	\$60	\$48	\$47

For intangible assets in the preceding table, amortization was less than \$1 million for each of the current and prior year comparable quarters. The currently estimated aggregate annual amortization expense for full-year 2011 and each of the four succeeding fiscal years is approximately \$2

million.

Intangible assets not subject to amortization

(millions)	Total carrying amount	
	July 2, 2011	January 1, 2011
Trademarks	\$ 1,443	\$ 1,443

Table of Contents**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.

2011 activities

During 2011, 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 relates to 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 2, 2011 and July 3, 2010 were as follows:

(millions)	Quarter ended, July 2, 2011			Quarter ended, July 3, 2010		
	COGS program	SGA programs	Total	COGS program	SGA programs	Total
Other cash costs (a)	\$	\$	\$	\$	\$1	\$1
Retirement benefits (b)		6	6	1		1
Total	\$	\$ 6	\$ 6	\$ 1	\$1	\$2

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

(millions)	Year-to-date period ended, July 2, 2011			Year-to-date period ended, July 3, 2010		
	COGS program	SGA programs	Total	COGS program	SGA programs	Total
Employee severance	\$4	\$	\$ 4	\$ 2	\$ 1	\$ 3
Other cash costs (a)					5	5
Asset write-offs	1		1			
Retirement benefits (b)		6	6	1		1
Total	\$5	\$ 6	\$11	\$ 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 2, 2011 were as follows:

(millions)	Total program costs through July 2, 2011		
	COGS program	SGA programs	Total
Employee severance	\$22	\$20	\$42
Other cash costs (a)	6	15	21
Asset write-offs	2		2

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Retirement benefits (b)	3	11	14
Total	\$33	\$46	\$79

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

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

In 2009, the Company commenced K LEAN. Refer to page 36 of the Company's 2010 Annual Report on Form 10-K for further information on this initiative. Costs for this program impacted the following operating segments during the quarter and year-to-date periods ended July 2, 2011 and July 3, 2010.

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(millions)	COGS program			
	Quarter ended		Year-to-date period ended	
	July 2, 2011	July 3, 2010	July 2, 2011	July 03, 2010
North America	\$	\$	\$	\$1
Europe		1	5	2
Total	\$	\$ 1	\$ 5	\$3

These costs represent employee severance and other cash costs associated with the elimination of hourly and salaried positions, as well as non-cash asset write offs at various global manufacturing facilities. To date, we have incurred \$33 million in total exit costs for this program. The costs have impacted our operating segments, as follows (in millions): North America-\$14; Europe-\$18; and Asia Pacific-\$1. Based on forecasted exchange rates, the Company currently expects to incur an additional \$10 million in exit costs for this program during 2011.

In 2009, the Company commenced various SGA programs which resulted in an improvement in the efficiency and effectiveness of various support functions. Refer to page 37 of the Company's 2010 Annual Report on Form 10-K for further information on these initiatives. Costs for these programs impacted the following operating segments during the quarter and year-to-date periods ended July 2, 2011 and July 3, 2010 as follows:

(millions)	SGA programs			
	Quarter ended		Year-to-date period ended	
	July 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
North America	\$6	\$1	\$6	\$4
Europe		(1)		
Asia Pacific (a)		1		2
Total	\$6	\$1	\$6	\$6

(a) Includes Australia, Asia and South Africa.

These costs represent severance and other cash costs associated with the elimination of positions. To date, we have incurred \$46 million in exit costs for these programs. The costs have impacted our operating segments as follows (in millions): North America-\$27; Europe-\$15; Asia Pacific-\$3; and Latin America-\$1. Based on forecasted exchange rates, the Company currently expects to incur an additional \$10 million in exit costs for these programs during 2011.

Reserves for the COGS and SGA programs are primarily for employee severance and will be paid out by the end of 2011. The detail is as follows:

(millions)	Balance			Balance
	January 1, 2011	Accruals	Payments	July 2, 2011
COGS program	\$2	\$4	\$(5)	\$1
SGA programs	3		(2)	1
Total	\$5	\$4	\$(7)	\$2

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 5 million and 8 million for the quarter and year-to-date periods

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ended July 2, 2011, respectively, and 4 million for both the quarter and year-to-date periods ended July 3, 2010.

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Quarters ended July 2, 2011 and July 3, 2010:

(millions, except per share data)	Net income attributable to Kellogg Company	Average shares outstanding	Earnings per share
2011			
Basic	\$343	363	\$0.94
Dilutive potential common shares		3	
Diluted	\$343	366	\$0.94
2010			
Basic	\$302	381	\$0.80
Dilutive potential common shares		3	(0.01)
Diluted	\$302	384	\$0.79

Year-to-date period ended July 2, 2011 and July 3, 2010:

(millions, except per share data)	Net income attributable to Kellogg Company	Average shares outstanding	Earnings per share
2011			
Basic	\$709	364	\$1.95
Dilutive potential common shares		3	(0.02)
Diluted	\$709	367	\$1.93
2010			
Basic	\$720	380	\$1.89
Dilutive potential common shares		4	(0.01)
Diluted	\$720	384	\$1.88

During the year-to-date period ended July 2, 2011, the Company issued 0.4 million shares to employees and directors under various benefit plans and stock purchase programs. Equity-based compensation is discussed further in Note 6.

On April 23, 2010, the Company's board of directors authorized a \$2.5 billion three-year share repurchase program for 2010 through 2012. During the year-to-date period ended July 2, 2011, the Company repurchased 9 million shares of common stock for a total of \$513 million. 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.

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.

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 2, 2011:

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2011			
Net income			\$342
Other comprehensive income:			
Foreign currency translation adjustments	\$ 34	\$	34
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	(46)	16	(30)
Reclassification to net earnings	(3)	1	(2)
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience gain (loss)	(1)		(1)
Reclassification to net earnings:			
Net experience loss	32	(11)	21
Prior service cost	3	(1)	2
	\$ 19	\$ 5	24
Total comprehensive income			\$366

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)	\$	(112)
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	(4)		(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		1
Reclassification to net earnings:			
Net experience loss	26	(8)	18
Prior service cost	2	(1)	1
	\$ (72)	\$(13)	(85)
Total comprehensive income			\$ 216

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Year-to-date period ended July 2, 2011:

(millions)	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2011			
Net income			\$707
Other comprehensive income:			
Foreign currency translation adjustments	\$143	\$	143
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	(35)	12	(23)
Reclassification to net earnings	(11)	4	(7)
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience gain (loss)	(13)	4	(9)
Prior service credit (cost)	(1)		(1)
Reclassification to net earnings:			
Net experience loss	64	(22)	42
Prior service cost	6	(2)	4
	\$153	\$ (4)	149
Total comprehensive income			\$856

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)	\$	(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

Accumulated other comprehensive income (loss) as of July 2, 2011 and January 1, 2011 consisted of the following:

(millions)	July 2, 2011	January 1, 2011
Foreign currency translation adjustments	\$ (646)	\$ (789)
Cash flow hedges unrealized net loss	(5)	25
Postretirement and postemployment benefits:		
Net experience loss	(1,042)	(1,075)

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Prior service cost	(72)	(75)
Total accumulated other comprehensive income (loss)	\$(1,765)	\$(1,914)

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The following table presents the components of notes payable at July 2, 2011 and January 1, 2011:

(millions)	July 2, 2011		January 1, 2011	
	Principal amount	Effective interest rate	Principal amount	Effective interest rate
U.S. commercial paper	\$675	0.25%	\$	%
Bank borrowings	59		44	
Total	\$734		\$44	

In May 2011, the Company issued \$400 million of seven-year 3.25% fixed rate U.S. Dollar Notes, using the proceeds from these Notes for general corporate purposes including repayment of commercial paper. 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.

During the first quarter of 2011, the Company repaid its \$946 million, ten-year 6.6% U.S. Dollar Notes at maturity with U.S. commercial paper.

In March 2011, the Company entered into an unsecured Four-Year Credit Agreement to replace its existing unsecured Five-Year Credit Agreement, which would have expired in November 2011. The Four-Year Credit Agreement allows the Company to borrow, on a revolving credit basis, up to \$2.0 billion, to obtain letters of credit in an aggregate amount up to \$75 million, U.S. swingline loans in an aggregate amount up to \$200 million and European swingline loans in an aggregate amount up to \$400 million and to provide a procedure for lenders to bid on short-term debt of the Company. The agreement contains customary covenants and warranties, including specified restrictions on indebtedness, liens, sale and leaseback transactions, and a specified interest coverage ratio. If an event of default occurs, then, to the extent permitted, the administrative agent may terminate the commitments under the credit facility, accelerate any outstanding loans under the agreement, and demand the deposit of cash collateral equal to the lender's letter of credit exposure plus interest.

Table of Contents**Note 6 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 41 to 44 of the Company's 2010 Annual Report on Form 10-K.

The Company classifies pre-tax stock compensation expense in SGA 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 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
Pre-tax compensation expense	\$12	\$10	\$22	\$23
Related income tax benefit	\$ 4	\$ 3	\$ 8	\$ 8

As of July 2, 2011, total stock-based compensation cost related to non-vested awards not yet recognized was \$63 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 2, 2011 and July 3, 2010, 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 42 and 43 of the Company's 2010 Annual Report on Form 10-K.

Year-to-date period ended July 2, 2011:

	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	\$47		
Granted	5	53		
Exercised	(6)	45		
Forfeitures and expirations				
Outstanding, end of period	25	\$48	6.7	\$177
Exercisable, end of period	16	\$46	5.5	\$146

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		

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Granted	4	53		
Exercised	(3)	44		
Forfeitures and expirations				
Outstanding, end of period	27	\$46	6.7	\$132
Exercisable, end of period	21	\$46	5.9	\$107

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The weighted-average fair value of options granted was \$7.59 per share for the year-to-date period ended July 2, 2011 and \$7.90 per share for the year-to-date period ended July 3, 2010. 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 2, 2011:	17%	6.98	3.07%	3.10%
Grants within the year-to-date period ended July 3, 2010:	20%	4.94	2.54%	2.80%

The total intrinsic value of options exercised was \$56 million for the year-to-date period ended July 2, 2011 and \$33 million for the year-to-date period ended July 3, 2010.

Performance shares

In the first quarter of 2011, 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.

The 2011 target grant currently corresponds to approximately 225,000 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 2, 2011, 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 2, 2011
2009 Award	\$19
2010 Award	\$22
2011 Award	\$25

The 2008 performance share award, payable in stock, was settled at 69% of target in February 2011 for a total dollar equivalent of \$6 million.

Note 7 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 44 to 49 of the Company's 2010 Annual Report on Form 10-K. Components of Company plan benefit expense for the periods presented are included in the tables below.

Table of Contents**Pension**

(millions)	Quarter ended		Year-to-date period ended	
	July 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
Service cost	\$ 23	\$ 21	\$ 49	\$ 44
Interest cost	53	49	105	99
Expected return on plan assets	(94)	(77)	(186)	(156)
Amortization of unrecognized prior service cost	3	3	7	7
Recognized net loss	26	20	52	40
Settlement cost	3		4	
Total pension expense	\$ 14	\$ 16	\$ 31	\$ 34

Other nonpension postretirement

(millions)	Quarter ended		Year-to-date period ended	
	July 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
Service cost	\$ 5	\$ 5	\$ 11	\$ 10
Interest cost	15	16	31	32
Expected return on plan assets	(22)	(16)	(44)	(32)
Amortization of unrecognized prior service cost		(1)	(1)	(1)
Recognized net loss	5	5	10	9
Total postretirement benefit expense	\$ 3	\$ 9	\$ 7	\$ 18

Postemployment

(millions)	Quarter ended		Year-to-date period ended	
	July 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
Service cost	\$1	\$1	\$3	\$3
Interest cost	1	1	2	2
Recognized net loss	1	1	2	2
Total postemployment benefit expense	\$3	\$3	\$7	\$7

Company contributions to employee benefit plans are summarized as follows:

(millions)	Pension	Nonpension postretirement	Total
Quarter ended:			
July 2, 2011	\$ 1	\$ 4	\$ 5
July 3, 2010	\$ 10	\$ 4	\$ 14
Year-to-date period ended:			
July 2, 2011	\$175	\$ 8	\$183
July 3, 2010	\$ 29	\$ 7	\$ 36
Full year:			
Fiscal year 2011 (projected)	\$180	\$ 20	\$200
Fiscal year 2010 (actual)	\$350	\$293	\$643

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

Note 8 Income taxes

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The consolidated effective tax rate for the quarter ended July 2, 2011, of 30% was comparable to prior year's rate of 30%. The consolidated effective tax rate for the year-to-date period ended July 2, 2011 was 29%, compared to the prior year-to-date period ended July 3, 2010 rate of 28%. Both year-to-date periods were positively impacted by discrete items. The effective rate for 2011 benefited from a first quarter international legal restructuring as well as the closing of various audits, while the effective rate for 2010 benefited from an immaterial correction of an item related to prior years.

As of July 2, 2011, the Company classified \$12 million of unrecognized tax positions as a net current liability, representing several 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 \$9 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.

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Following is a reconciliation of the Company's total gross unrecognized tax benefits for the year-to-date period ended July 2, 2011; \$50 million of this total represents the amount that, if recognized, would affect the Company's effective income tax rate in future periods.

(millions)	
January 1, 2011	\$ 104
Tax positions related to current year:	
Additions	5
Tax positions related to prior years:	
Additions	4
Reductions	(14)
Settlements	(29)
July 2, 2011	\$ 70

The Company had the following amounts of income tax related interest accrued as of January 1, 2011 and July 2, 2011.

(millions)	
Interest accrued at January 1, 2011	\$ 26
Reduction of interest expense recognized for the year-to-date period ended July 2, 2011	\$ (4)
Interest accrued at July 2, 2011	\$ 16

Note 9 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, and uses other contracts to reduce volatility in interest rates, foreign currency and commodities. 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 as of July 2, 2011 and January 1, 2011 were as follows:

(millions)	July 2, 2011	January 1, 2011
Foreign currency exchange contracts	\$1,278	\$1,075
Interest rate contracts	2,700	1,900
Commodity contracts	291	379
Total	\$4,269	\$3,354

Following is a description of each category in the fair value hierarchy and the financial assets and liabilities of the Company that were included in each category at July 2, 2011 and January 1, 2011, measured on a recurring basis.

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.

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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. Over-the-counter commodity derivatives are valued using an income approach based on the commodity index prices less the contract rate multiplied by the notional amount. Foreign

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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 2, 2011 or January 1, 2011.

The following table presents assets and liabilities that were measured at fair value in the Consolidated Balance Sheet on a recurring basis as of July 2, 2011 and January 1, 2011:

(millions)	Level 1		Level 2		Total	
	July 2, 2011	January 1, 2011	July 2, 2011	January 1, 2011	July 2, 2011	January 1, 2011
Derivatives designated as hedging instruments:						
Assets:						
Foreign currency exchange contracts:						
Other prepaid assets	\$	\$	\$14	\$ 7	\$14	\$ 7
Interest rate contracts:						
Other prepaid assets				5		5
Other assets			54	69	54	69
Commodity contracts:						
Other prepaid assets	5	23	1		6	23
Total assets	\$ 5	\$ 23	\$ 69	\$ 81	\$ 74	\$ 104
Liabilities:						
Foreign currency exchange contracts:						
Other current liabilities	\$	\$	\$(18)	\$(27)	\$(18)	\$(27)
Interest rate contracts:						
Other liabilities			(13)		(13)	
Commodity contracts:						
Other current liabilities	(12)		(9)	(10)	(21)	(10)
Other liabilities			(25)	(29)	(25)	(29)
Total liabilities	\$(12)	\$	\$(65)	\$(66)	\$(77)	\$ (66)

Derivatives not designated as hedging instruments:**Assets:**

Interest rate contracts:

Other assets	\$	\$	\$26	\$	\$26	\$
Total assets	\$	\$	\$26	\$	\$26	\$

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The effect of derivative instruments on the Consolidated Statement of Income for the quarters ended July 2, 2011 and July 3, 2010 was as follows:

Derivatives in fair value hedging relationships (millions)	Location of gain (loss) recognized in income	Gain (loss) recognized in income July 2, 2011	Gain (loss) recognized in income July 3, 2010
Foreign currency exchange contracts	Other income (expense), net	\$ 3	\$ (22)
Interest rate contracts	Interest expense	12	10
Total		\$ 15	\$ (12)

Derivatives in cash flow hedging relationships (millions)	Gain (loss) recognized in		Location of gain (loss) reclassified from AOCI	Gain (loss) reclassified from		Location of gain (loss) recognized in income (a)	Gain (loss) recognized in income(a)	
	AOCI			AOCI into income			recognized in income(a)	
	July 2, 2011	July 3, 2010		July 2, 2011	July 3, 2010		July 2, 2011	July 3, 2010
Foreign currency exchange contracts	\$ (1)	\$	COGS	\$ (1)	\$ (6)	Other income (expense), net	\$	\$
Foreign currency exchange contracts	(1)	1	SGA expense			Other income (expense), net		
Interest rate contracts	(12)		Interest expense	1	(1)	N/A		
Commodity contracts	(32)	(5)	COGS	3	(11)	Other income (expense), net		
Total	\$ (46)	\$ (4)		\$ 3	\$ (18)		\$	\$

Derivatives not designated as hedging instruments (millions)	Location of gain (loss) recognized in income	Gain (loss) recognized in income July 2, 2011	Gain (loss) recognized in income July 3, 2010
Foreign currency exchange contracts	Other income (expense), net	\$ 1	\$
Interest rate contracts	Interest expense		
Total		\$ 1	\$

(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 2, 2011 and July 3, 2010 were as follows:

Derivatives in fair value hedging relationships (millions)	Location of gain (loss) recognized in income	Gain (loss) recognized in income	
		July 2, 2011	July 3, 2010
Foreign currency exchange contracts	Other income (expense), net	\$ 25	\$ (51)
Interest rate contracts	Interest expense	27	20
Total		\$ 52	\$ (31)

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 2, 2011	July 3, 2010		July 2, 2011	July 3, 2010		July 2, 2011	July 3, 2010
Foreign currency exchange contracts	\$ (3)	\$ (12)	COGS	\$ (3)	\$ (13)	Other income (expense), net	\$ (1)	\$
Foreign currency exchange contracts	(2)	2	SGA expense			Other income (expense), net		
Interest rate contracts	(13)		Interest expense	2	(2)	N/A		
Commodity contracts	(17)	(29)	COGS	12	(16)	Other income (expense), net		(1)
Total	\$ (35)	\$ (39)		\$ 11	\$ (31)		\$ (1)	\$ (1)

Derivatives not designated as hedging

instruments (millions)	Location of gain (loss) recognized in income	Gain (loss) recognized in income	
		July 2, 2011	July 3, 2010
Foreign currency exchange contracts	Other income (expense), net	\$ 1	\$
Interest rate contracts	Interest expense	(3)	
Total		\$ (2)	\$

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

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 2, 2011 was \$33 million. If the credit-risk-related contingent features were triggered as of July 2, 2011, the Company would be required to post collateral of \$33 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 2, 2011 triggered by credit-risk-related contingent features.

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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 2, 2011:

(millions)	Fair Value	Carrying Value
Long-term debt	\$ 5,767	\$ 5,308

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.

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 \$48 million as of July 2, 2011.

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 2, 2011.

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 28% of consolidated trade receivables at July 2, 2011.

Note 10 Product recall

On June 25, 2010, the Company announced a recall of select packages of Kellogg's cereal in the U.S. due to an odor from waxy resins found in the package liner. 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; and other recall costs were recorded as SGA expenses. In addition to the costs of the recall, the Company also lost sales of the impacted products in the second quarter of 2010.

	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

Note 11 Operating segments

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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.

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(millions)	Quarter ended		Year-to-date period ended	
	July 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
Net sales				
North America	\$ 2,231	\$ 2,064	\$ 4,595	\$ 4,339
Europe	634	560	1,255	1,166
Latin America	281	240	542	462
Asia Pacific (a)	240	198	479	413
Consolidated	\$ 3,386	\$ 3,062	\$ 6,871	\$ 6,380
Segment operating profit				
North America (b)	\$ 406	\$ 364	\$ 846	\$ 862
Europe	102	100	203	205
Latin America	61	47	109	92
Asia Pacific (a)	25	20	56	57
Corporate (b)	(51)	(48)	(99)	(96)
Consolidated	\$ 543	\$ 483	\$ 1,115	\$ 1,120

(a) Includes Australia, Asia and South Africa.

(b) Research and Development expense totaling \$2 million for the quarter ended July 3, 2010 and \$5 million for the year-to-date period ended July 3, 2010 was reallocated to Corporate from North America.

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***

For more than 100 years, consumers have counted on Kellogg for great-tasting, high-quality and nutritious foods. Kellogg Company is the world's leading producer of cereal and a leading producer of convenience foods, including cookies, crackers, toaster pastries, cereal bars, 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 3 to 4% 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 2, 2011, our reported net sales increased 11% and internal net sales increased 6%. Consolidated operating profit increased 12%, while internal operating profit increased 8%. Diluted earnings per share (EPS) increased 19% to \$0.94, compared to \$0.79 in the comparable prior year quarter. EPS on a currency-neutral basis was up 13%. Our performance was in-line with our expectations for the quarter. We had strong top-line growth, driven by price execution, and invested in brand building and in our supply chain. We lapped a soft 2010 second quarter.

For the full year 2011, we expect our internal net sales to increase by approximately 4-5%. We are on track to meet our internal operating profit guidance of flat to down 2%, and our currency-neutral earnings per diluted share growth of low single-digits (1 to 3%).

Net sales and operating profit

The following table provides an analysis of net sales and operating profit performance for the second quarter of 2011 versus 2010:

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consoli- dated
2011 net sales	\$ 2,231	\$ 634	\$ 281	\$ 240	\$	\$ 3,386
2010 net sales	\$ 2,064	\$ 560	\$ 240	\$ 198	\$	\$ 3,062
% change 2011 vs. 2010:						
Volume (tonnage) (b)	1.9%	(3.1)%	(.6)%	.2%		.6%
Pricing/mix	5.6%	3.7%	7.7%	3.6%		5.4%
Subtotal internal business	7.5%	.6%	7.1%	3.8%		6.0%
Foreign currency impact	.6%	12.7%	10.3%	16.6%		4.6%
Total change	8.1%	13.3%	17.4%	20.4%		10.6%
(dollars in millions)	North America	Europe	Latin America	Asia Pacific	Corporate	Consoli- dated
2011 operating profit	\$ 406	\$ 102	\$ 61	\$ 25	\$ (51)	\$ 543
2010 operating profit	\$ 364	\$ 100	\$ 47	\$ 20	\$ (48)	\$ 483

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% change 2011 vs. 2010:						
Internal business	10.9%	(8.9)%	18.9%	3.1%	(5.3)%	7.8%
Foreign currency impact	.7%	10.2%	11.3%	20.6%	%	4.6%
Total change	11.6%	1.3%	30.2%	23.7%	(5.3)%	12.4%

- (a) Includes Australia, Asia, and South Africa.
- (b) We measure the volume impact (tonnage) on revenues based on the stated weight of our product shipments.
- (c) Research and Development expense totaling \$2 million for the quarter ended July 3, 2010 was reallocated to Corporate from North America.

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Our reported consolidated net sales grew by 11%. Volumes increased slightly in the quarter and pricing/mix increased net sales by 5.4%. We lapped the soft comparisons of the second quarter of 2010 when we were negatively impacted by weakness in cereal, lower waffle sales and a recall of select packages of breakfast cereals. If we exclude the impact of the cereal recall, volume would have been down slightly, but net sales would have been up almost 5%. Overall, we are pleased with the performance as we continued to execute our plan to gain momentum in our business by price realization, innovation and brand building. Foreign exchange provided a favorable impact of almost 5%.

Our North America operating segment had internal net sales growth of 8%. North America has three product groups: retail cereal; retail snacks; and frozen and specialty channels. Internal net sales of retail cereal increased 13%, lapping a soft second quarter 2010 which was negatively impacted by the recall of select breakfast cereals. During the second quarter of 2011, we saw improving trends in the cereal category, which responds well to innovation and brand building. These positive trends were reflected in our second quarter results. Our growth was driven by net price realization, good base performance which was supported by our 2011 first half innovation and increased distribution points.

The retail snack product group (cookies, crackers, toaster pastries, cereal bars and fruit-flavored snacks) grew 3% driven by strength in our cracker business. Our first quarter cracker innovation has been very successful. Our cookie sales saw strong base growth but delivered lower net sales in the quarter. We launched the *Keebler*® master brand initiative in the second quarter which aligned pricing, packaging and scale across the *Keebler*® brand. This caused a reduction in activity during the quarter, which negatively impacted our results.

Internal net sales in the frozen and specialty channels (frozen foods, food service and vending) increased 10%, driven by growth in our frozen food business, particularly in our waffle business. The veggie category remained strong. Our food service business was soft in the quarter due to a continued difficult operating environment.

Internal net sales in our international operating segments increased 3%. Europe's internal net sales grew by 1%, driven by positive performance in France, Italy and Russia. In the U.K., we began to see early signs of improvement in the cereal category, while snacks continued to struggle in the tough consumer and trade environment. Latin America's internal net sales grew by 7% due to price realization and volume recovery in Brazil, as well as strength in Colombia. Net sales in Mexico were flat, where we have been negatively impacted by trade issues which we believe are behind us. In Asia Pacific, internal net sales were up 4% as a result of the strong sales in our India, South Africa and Korea businesses. In Australia, our sales were up slightly over last year in a difficult retail environment.

Consolidated operating profit increased by 12% on a reported basis, and 8% on an internal basis. The increase was driven by strong sales growth and savings from our cost savings initiatives. We lapped a soft second quarter of 2010 where internal operating profit was down 11%.

Internal operating profit in North America increased by 11% in the quarter, lapping last year's decline of 16%. The increase in operating profit reflected strong net sales growth, which more than offset higher input costs and increased brand building investments. Europe's internal operating profit declined by 9%, impacted by the difficult operating environment in the U.K. and input cost inflation across the region. In Latin America, internal operating profit increased by 19%, driven by strong sales growth, partially offset by a double-digit increase in brand-building investment. Latin America's operating profit for the quarter includes a few discrete items, including a gain on the sale of a previously closed facility. Excluding these discrete items, Latin America operating profit grew approximately 10%. Asia Pacific's internal operating profit increased by 3% primarily due to price execution across the region.

The following tables provide analysis of our net sales and operating performance for the year-to-date periods of 2011 as compared to 2010. Our net sales benefited from a slight increase in volume, improved pricing/mix due to price realization and foreign exchange. Internal operating profit was down on a year-to-date basis due to a lag in price execution behind a significant increase in input cost inflation in the first quarter of 2011.

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(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consolidated
2011 net sales	\$ 4,595	\$ 1,255	\$ 542	\$ 479	\$	\$ 6,871
2010 net sales	\$ 4,339	\$ 1,166	\$ 462	\$ 413	\$	\$ 6,380
% change 2011 vs. 2010:						
Volume (tonnage) (b)	1.8%	(1.9)%	1.6%	2.6%		1.2%
Pricing/mix	3.6%	1.9%	7.0%	.3%		3.3%
Subtotal internal business	5.4%	%	8.6%	2.9%		4.5%
Foreign currency impact	.5%	7.7%	8.8%	12.9%		3.2%
Total change	5.9%	7.7%	17.4%	15.8%		7.7%
(dollars in millions)	North America (c)	Europe	Latin America	Asia Pacific (a)	Corporate (c)	Consolidated
2011 operating profit	\$ 846	\$ 203	\$ 109	\$ 56	\$ (99)	\$ 1,115
2010 operating profit	\$ 862	\$ 205	\$ 92	\$ 57	\$ (96)	\$ 1,120
% change 2011 vs. 2010:						
Internal business	(2.4)%	(8.8)%	10.2%	(13.8)%	(3.5)%	(3.6)%
Foreign currency impact	.5%	7.4%	9.3%	12.4%	%	3.1 %
Total change	(1.9)%	(1.4)%	19.5%	(1.4)%	(3.5)%	(.5)%

(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) Research and Development expense totaling \$5 million for the year-to-date period ended July 3, 2010 was reallocated to Corporate from North America.

Margin performance

Margin performance for the second quarter and year-to-date periods of 2011 versus 2010 is as follows:

Quarter	2011	2010	Change vs. prior year (pts.)
Gross margin (a)	42.6 %	42.6 %	
SGA (b)	(26.6)%	(26.8)%	0.2
Operating margin	16.0 %	15.8 %	0.2
Year-to-date	2011	2010	Change
Gross margin (a)	41.7 %	42.8 %	(1.1)
SGA (b)	(25.5)%	(25.2)%	(0.3)
Operating margin	16.2 %	17.6 %	(1.4)

(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.

Gross profit dollars in the quarter were up 11% to \$1.4 billion. Our price realization and cost savings initiatives covered input cost inflation, resulting in a flat gross margin compared to a year ago at 42.6 percent. Our selling, general and administrative (SGA) expense as a percentage of net sales decreased by 20 basis points primarily due to an increase in the net sales base.

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On a year-to-date basis, gross margin is down 110 basis points. This is due to the lag of price execution in the first quarter of 2011 to cover increased input costs. Our SGA expense as a percentage of net sales increased by 30 basis points primarily due to increased investments in advertising and promotion.

For the full year, we expect gross margin to remain under pressure and be down approximately 50 basis points.

Table of Contents**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 a 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.

	Quarter ended		Year-to-date period ended	
	July 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
Consolidated results				
Diluted net earnings per share (EPS)	\$ 0.94	\$ 0.79	\$ 1.93	\$ 1.88
Translation impact (a)	(0.05)	0.03	(0.07)	0.01
Currency neutral EPS	\$ 0.89	\$ 0.82	\$ 1.86	\$ 1.89
Currency neutral EPS growth (b)	13%		(1)%	

- (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 year's reported EPS.

Product recall

On June 25, 2010, we announced a recall of select packages of Kellogg's cereal in the U.S. due to an odor from waxy resins found in the package liner. 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); and other recall costs were recorded as SGA expense. In addition to the costs of the recall, we also lost sales of the impacted products in the second quarter of 2010.

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

Cost reduction initiatives

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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.

2011 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 SGA programs.

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Costs incurred during the quarter and year-to-date periods ended July 2, 2011 were as follows:

(millions)	Quarter ended, July 2, 2011			Year-to-date period ended July 2, 2011		
	COGS programs	SGA programs	Total	COGS programs	SGA programs	Total
North America	\$ 1	\$	\$ 1	\$ 1	\$	\$ 1
Europe	1		1	2		2
Asia Pacific (a)				1		1
Total	\$ 1	\$	\$ 1	\$ 4	\$	\$ 4

(a) Includes Australia, Asia and South Africa.

Total program costs incurred through July 2, 2011 were as follows:

(millions)	Total program costs through July 2, 2011		
	COGS programs	SGA programs	Total
North America	\$ 68	\$ 14	\$ 82
Europe	22	3	25
Latin America	8		8
Asia Pacific (a)	9		9
Corporate		3	3
Total	\$ 107	\$ 20	\$ 127

(a) Includes Australia, Asia and South Africa.

Prior year activities

During the second quarter of 2010, we incurred \$13 million of consulting and other costs in connection with our COGS and SGA programs. Costs were recorded in the following operating segments during the quarter and year-to-date periods ended July 3, 2010.

(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 (a)				1		1
Corporate		2	2		2	2
Total	\$ 11	\$ 2	\$ 13	\$ 20	\$ 3	\$ 23

(a) Includes Australia, Asia and South Africa.

The additional cost and cash outlay in 2011 for these programs, excluding exit costs, is estimated to be \$5 million. The projects are expected to be substantially complete by the end of 2011.

SAP reimplementation

We are reimplementing SAP which will result in process and productivity improvements. The program is expected to require approximately \$70 million of incremental expense, including consulting, in addition to capital investments. The reimplementation will begin in the third quarter of 2011.

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Total costs incurred for this program during the quarter and year-to-date periods ended July 2, 2011 and July 3, 2010 were as follows:

(millions)	Quarter ended		Year-to-date period ended	
	July 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010
North America	\$ 2	\$ 2	\$ 4	\$ 4
Latin America	1		1	
Total	\$ 3	\$ 2	\$ 5	\$ 4

To date, we have incurred \$14 million in program costs. These costs impacted our operating segments as follows (in millions): North America-\$12; and Latin America-\$2. The additional cost and cash outlay for the remainder of 2011 through 2014 for this program is expected to be approximately \$55 million.

Interest expense

For the quarter and year-to-date periods ended July 2, 2011, interest expense was \$ 53 million and \$ 120 million, respectively, as compared to the quarter and year-to-date periods ended July 3, 2010 with interest expense of \$ 61 million and \$ 126 million, respectively. Second quarter 2011 interest expense was lower than prior periods due to the differential in interest rates on debt that matured in March 2011 versus debt that was issued in May 2011.

For the full year 2011, we expect gross interest expense to be approximately \$235 to \$245 million, compared to 2010's full year amount of \$248 million.

Income taxes

The consolidated effective income tax rate was 30% for the quarter ended July 2, 2011, as compared to 30% for the comparable quarter of 2010. Refer to Note 8 of the Consolidated Financial Statements for further discussion.

For the full year 2011, we currently expect the consolidated effective income tax rate to be approximately 29%. Fluctuations in foreign currency exchange rates could impact the expected effective income tax rate as it is dependent upon U.S. dollar earnings of foreign subsidiaries doing business in various countries with differing statutory rates. Additionally, the rate could be impacted if pending uncertain tax matters, including tax positions that could be affected by planning initiatives, are resolved more or less favorably than we currently expect.

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.

The following table sets forth a summary of our cash flows:

(millions)	Year-to-date period ended	
	July 2, 2011	July 3, 2010
Net cash provided by (used in):		
Operating activities	\$ 646	\$ 593
Investing activities	(238)	(145)
Financing activities	(417)	(289)

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Effect of exchange rates on cash and cash equivalents		22	(22)
Net increase in cash and cash equivalents	\$	13	\$ 137

Table of Contents**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.

Net cash provided by our operating activities for the first half of 2011 amounted to \$646 million, an increase of more than \$50 million compared with the first half of 2010, attributable to lower incentive compensation payments during first quarter 2011, partially offset by a negative impact of the timing of working capital.

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) is relatively short, equating to approximately 23 days and 22 days for the 12 month periods ended July 2, 2011 and July 3, 2010, respectively. Compared with the 12 month period ended July 3, 2010, the unfavorable impact on the 2011 cash conversion cycle resulted from higher days of inventory outstanding.

Our pension and other postretirement benefit plan contributions amounted to \$183 million and \$36 million for the year-to-date periods ended July 2, 2011 and July 3, 2010, respectively. For full year 2011, we currently expect that our contributions to pension and other postretirement plans will total approximately \$200 million. Plan funding strategies may be modified in response to our evaluation of tax deductibility, market conditions and competing investment alternatives.

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:

(millions)	Year-to-date period ended		<i>Change versus prior year</i>
	July 2, 2011	July 3, 2010	
Net cash provided by operating activities	\$ 646	\$ 593	8.9%
Additions to properties	(243)	(147)	
Cash flow	\$ 403	\$ 446	(9.6)%

For 2011, we are projecting cash flow (as defined) within a range of \$1.1 billion to \$1.2 billion. This projection reflects the impact of our expected pension and postretirement benefit plan contributions, net of tax.

Investing activities

Our net cash used in investing activities during the year-to-date period ended July 2, 2011 amounted to \$238 million, an increase of almost \$100 million compared with the same period in 2010. The year-over-year increase was primarily attributable to the addition of manufacturing capacity to support growth and innovation as well as investments in our supply chain infrastructure.

For full-year 2011, we project capital spending of approximately 4 to 5% of net sales. We are increasing our investment in manufacturing capacity as well as improving our information technology infrastructure.

Financing activities

Our net cash used in financing activities for the year-to-date period ended July 2, 2011 amounted to \$417 million compared with \$289 million for the comparable period in 2010. The increase was primarily attributable to an increase in repurchases of common stock.

We spent \$518 million and \$356 million to repurchase common stock during the year-to-date periods ended July 2, 2011 and July 3, 2010, respectively. Of the \$518 million spent in 2011, \$5 million was related to shares purchased in 2010 that did not settle prior to the end of the 2010 reporting period. During the first half of 2011 we repurchased approximately 9.5 million shares of our common stock. During the same period of 2010, we repurchased approximately 7 million shares of our common stock, \$266 million of which was paid during the six-month period ending

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July 3, 2010; \$90 million was payable at that date, for stock repurchases that did not settle prior to the end of the reporting period.

On April 23, 2010, our board of directors authorized a \$2.5 billion, three-year share repurchase program for 2010 through 2012. As of July 2, 2011, total purchases under the repurchase authorization amounted to 30 million shares totaling \$1.6 billion. During the remainder of 2011 and 2012, we plan to execute the remaining repurchases under the 2010 authorization. We project total purchases of \$800 million in 2011, which includes the \$518 million executed in the first half of 2011, with the balance in 2012. Actual 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.

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We paid cash dividends of \$296 million in the first half of 2011, compared to \$286 million during the same period in 2010. In July 2011, the board of directors declared a dividend of \$.43 per common share, payable September 15, 2011 to shareholders of record at close of business on September 1, 2011. The dividend of \$.43 per share represents a 6% increase in the \$.405 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 between 40% and 50% of reported net income.

We used commercial paper to refinance \$946 million of long-term debt that matured in the first quarter of 2011. In May 2011, we issued \$400 million of seven-year 3.25% fixed rate U.S. Dollar Notes, and used proceeds of \$397 million to pay down commercial paper.

In March 2011, we entered into an unsecured Four-Year Credit Agreement to replace our existing unsecured Five-Year Credit Agreement, which would have expired in November 2011. The Four-Year Credit Agreement allows us to borrow, on a revolving credit basis, up to \$2.0 billion, although we do not plan to use it. (See Note 5 within Notes to Consolidated Financial Statements for additional information on the Four-Year Credit Agreement.)

We are in compliance with all debt covenants. 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 our access to public debt and commercial paper markets, along with operating cash flows, will be adequate to meet future operating, investing and financing needs, including the pursuit of selected acquisitions.

Accounting standards to be adopted in future periods

In June 2011, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2011-05, Presentation of Comprehensive Income, requiring most entities to present items of net income and other comprehensive income either in one continuous statement referred to as the statement of comprehensive income or in two separate, but consecutive, statements of net income and other comprehensive income. The update does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU No. 2011-05 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. Early adoption is permitted. We will be adopting ASU 2011-05 at the beginning of our 2012 fiscal year.

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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," "can," "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 9 within Notes to Consolidated Financial Statements for further information on our derivative financial and commodity instruments.

Refer to disclosures contained on pages 25-26 of our 2010 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 2, 2011.

During the quarter ended April 2, 2011, we entered into additional interest rate swaps in connection with certain U.S. Dollar Notes. The total notional amount of interest rate swaps at July 2, 2011 was \$2.7 billion, representing a settlement receivable of \$67 million. The total notional amount of interest rate swaps at January 1, 2011 was \$1.9 billion, representing a settlement receivable of \$74 million.

The total notional amount of commodity derivative instruments at July 2, 2011 was \$291 million, representing a settlement obligation of approximately \$40 million. The total notional amount of commodity derivative instruments at January 1, 2011 was \$379 million, representing a settlement obligation of approximately \$16 million. Assuming a 10% decrease in period-end commodity prices, the settlement obligation would have increased by approximately \$25 million at July 2, 2011, and \$36 million at January 1, 2011, generally offset by a reduction in the cost of the underlying commodity purchases.

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 2, 2011, 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 1, 2011. 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 1, 2011, 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:				
4/3/11-4/30/11		\$0.00		\$1,119
Month #2:				
5/1/11-5/28/11	1,078,431	\$57.10	1,078,431	\$1,058
Month #3:				
5/29/11-7/2/11	2,306,266	\$55.50	2,306,266	\$930
Total	3,384,697	\$56.01	3,384,697	

On April 23, 2010, the 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.

Item 6. Exhibits

(a) Exhibits:

31.1	Rule 13a-14(e)/15d-14(a) Certification from John A. Bryant
31.2	Rule 13a-14(e)/15d-14(a) Certification from Ronald L. Dissinger
32.1	Section 1350 Certification from John A. Bryant
32.2	Section 1350 Certification from Ronald L. Dissinger
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document

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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

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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 5, 2011

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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 John A. Bryant	E
31.2	Rule 13a-14(e)/15d-14(a) Certification from Ronald L. Dissinger	E
32.1	Section 1350 Certification from John A. Bryant	E
32.2	Section 1350 Certification from Ronald L. Dissinger	E
101.INS	XBRL Instance Document	E
101.SCH	XBRL Taxonomy Extension Schema Document	E
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	E
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	E
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	E
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	E