

KELLOGG CO
Form 10-Q
August 03, 2007

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

(Mark One)

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

For the quarterly period ended June 30, 2007

OR

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

For the transition period from _____ to _____

**Commission file number 1-4171
KELLOGG COMPANY**

Delaware
State of Incorporation

38-0710690
IRS Employer Identification No.

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

Registrant's telephone number: 269-961-2000

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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 27, 2007 395,733,185 shares

KELLOGG COMPANY
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CONSOLIDATED BALANCE SHEET***(millions, except per share data)*

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

Treasury stock, at cost	(1,044)	(912)
Accumulated other comprehensive income (loss)	(1,000)	(1,046)
Total shareholders equity	2,401	2,069
Total liabilities and shareholders equity	\$11,123	\$10,714

* *Condensed from
audited
financial
statements.*

Refer to Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENT OF EARNINGS***(millions, except per share data)*

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

Refer to Notes to Consolidated Financial Statements.

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

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

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

Refer to Notes to Consolidated Financial Statements.

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

Note 1 Accounting policies

Basis of presentation

The unaudited interim financial information included in this report reflects normal recurring adjustments that management believes are necessary for a fair statement of the results of operations, financial position, and cash flows for the periods presented. This interim information should be read in conjunction with the financial statements and accompanying notes contained on pages 27 to 56 of the Company's 2006 Annual Report on Form 10-K.

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

The Company's fiscal year normally ends on the Saturday closest to December 31 and as a result, a 5th week is added approximately every sixth year. Under this convention, the Company's 2006 fiscal year ended on December 30 and its 2007 fiscal year will end on December 29, 2007. Each quarterly period in 2006 and 2007 includes thirteen weeks.

The accounting policies used in preparing these financial statements are the same as those applied in the prior year, except that the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48 Accounting for Uncertainty in Income Taxes, as of the beginning of its 2007 fiscal year, which is discussed in Note 10.

Additionally, the Company adopted FASB Statement of Financial Accounting Standard (SFAS) No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, as of the end of its 2006 fiscal year, which affected only the year-end balance sheet presentation of postretirement and postemployment benefit obligations.

Accordingly, the Company's 2007 fiscal year (and interim periods within that year) is the first reporting period for which total comprehensive income will be affected by the adoption of this standard. Refer to page 33 of the Company's 2006 Annual Report on Form 10-K for further information on SFAS No. 158. Lastly, the Company is continuing to evaluate the impact of adopting SFAS No. 157 Fair Value Measurements in the first quarter of its 2008 fiscal year. Refer to page 34 of the Company's 2006 Annual Report on Form 10-K for further information on SFAS No. 157.

Note 2 Acquisitions, other investments, and intangibles

Joint venture arrangement

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

Goodwill and other intangible assets

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

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

Intangible assets subject to amortization

(millions)	Gross carrying amount		Accumulated amortization	
	June 30, 2007	December 30, 2006	June 30, 2007	December 30, 2006
Trademarks	\$14	\$ 30	\$13	\$ 22
Other	29	29	28	27
Total	\$43	\$ 59	\$41	\$ 49
Amortization expense			June 30, 2007	July 1, 2006
Year-to-date			\$ 8	\$ 1

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

Intangible assets not subject to amortization

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

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

Carrying amount of goodwill

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

(a) Includes
Australia, Asia
and South

Africa.

Note 3 Exit or disposal plans

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

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

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

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

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

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

Employee severance reserves to date (in millions)	Beginning of period	Accruals	Payments	End of period
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Year ended December 30, 2006	\$	\$12	\$	\$12
Quarter ended March 30, 2007	12	3	(9)	6
Quarter ended June 30, 2007	6	4	(5)	5
Total project to date		\$19	\$(14)	

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

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

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

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

Note 5 Equity**Earnings per share**

Basic net earnings per share is determined by dividing net earnings by the weighted average number of common shares outstanding during the period. Diluted net earnings per share is similarly determined, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all dilutive potential common shares had been issued. Dilutive potential common shares are comprised principally of employee stock options issued by the Company, and to a lesser extent, certain contingently issuable performance shares. Basic net earnings per share is reconciled to diluted net earnings per share in the following table. The total number of anti-dilutive potential common shares excluded from the reconciliation was 5 million and 4 million, respectively, for the quarter and year-to-date periods ended June 30, 2007, as compared to 10 million for both the quarter and year-to-date periods ended July 1, 2006.

Quarter (millions, except per share data)	Net earnings	Average shares outstanding	Net earnings per share
2007			
Basic	\$301	397	\$.76
Dilutive potential common shares		4	(.01)
Diluted	\$301	401	\$.75
2006			
Basic	\$267	394	\$.68
Dilutive potential common shares		3	(.01)
Diluted	\$267	397	\$.67
Year-to-date (millions, except per share data)			
	Net earnings	Average shares outstanding	Net earnings per share
2007			
Basic	\$622	397	\$1.56
Dilutive potential common shares		4	(.01)
Diluted	\$622	401	\$1.55
2006			
Basic	\$541	396	\$1.36
Dilutive potential common shares		3	(.01)
Diluted	\$541	399	\$1.35

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

Comprehensive Income

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

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

Table of Contents**Quarter**

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

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

Table of Contents**Year-to-date**

<i>(millions)</i>	Pre-tax amount	Tax (expense) or benefit	After-tax amount
2007			
Net earnings			\$ 622
Other comprehensive income:			
Foreign currency translation adjustments	27		27
Cash flow hedges:			
Unrealized gain (loss) on cash flow hedges	17	(6)	11
Reclassification to net earnings	1		1
Postretirement and postemployment benefits:			
Amounts arising during the period:			
Net experience loss	(38)	13	