ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Kellogg Company and Subsidiaries

RESULTS OF OPERATIONS

Overview

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to help the reader understand Kellogg Company, our operations and our present business environment. MD&A is provided as a supplement to, and should be read in conjunction with, our Consolidated Financial Statements and the accompanying notes thereto contained in Item 8 of this report.

Kellogg Company is the world's leading producer of cereal and a leading producer of convenience foods, including cookies, crackers, toaster pastries, cereal bars, fruit snacks, frozen waffles, and veggie foods. Kellogg products are manufactured and marketed globally. We currently manage our operations in four geographic operating segments, comprised of North America and the three International operating segments of Europe, Latin America, and Asia Pacific. Beginning in 2007, the Asia Pacific segment includes South Africa, which was formerly a part of Europe. Prior years were restated for comparison purposes.

We manage our Company for sustainable performance defined by our long-term annual growth targets. These targets are low single-digit (1 to 3%) for internal net sales, mid single-digit (4 to 6%) for internal operating profit, and high single-digit (7 to 9%) for net earnings per share on a currency neutral basis. See "Foreign currency translation" section on page 15 for an explanation of the Company's definition of currency neutral.

For our full year 2008, we exceeded our net sales target with reported net sales growth of 9%, and internal growth of 5.4%. Consolidated operating profit increased 4.5%, on internal growth of 4.2%, in line with our target. Reported diluted earnings per share grew 8%, within our target, to $2.99 per share, while currency neutral EPS grew 10%.

Consolidated results (dollars in millions except per share data)		**2008**	**2007**	**2006**
Net sales		$12,822	$11,776	$10,907
Net sales growth:	As reported	8.9%	8.0%	7.2%
	Internal (a)	**5.4%**	**5.4%**	**6.8%**
Operating profit		$ 1,953	$ 1,868	$ 1,766
Operating profit growth:	As reported (b)	4.5%	5.8%	.9%
	Internal (a)	**4.2%**	**3.1%**	**4.3%**
Diluted net earnings per share (EPS)		$ 2.99	$ 2.76	$ 2.51
EPS growth (b)		**8%**	**10%**	**6%**
Currency neutral diluted EPS growth (c)		**10%**	**7%**	**11%**

(a) Internal net sales and operating profit growth for 2008 exclude the impact of currency, a 53rd shipping week and acquisitions. Internal net sales and operating profit for 2007 and 2006 excludes the impact of currency. Additionally, internal operating profit growth for 2006 excludes the impact of adopting SFAS No. 123(R) "Share-Based Payment". Accordingly, internal net sales operating profit growth is a non-GAAP financial measure, which is further discussed and reconciled to GAAP-basis growth on page 13.

(b) At the beginning of 2006, we adopted SFAS No. 123(R) "Share-Based Payment," which reduced our fiscal 2006 operating profit by $65 million ($42 million after tax or $.11 per share), due primarily to recognition of compensation expense associated with employee and director stock option grants. Correspondingly, our reported operating profit and net earnings growth for 2006 was reduced by approximately 4% and diluted net earnings per share growth was reduced by approximately 5%.

(c) See section entitled "Foreign currency translation" for discussion and reconciliation of this non-GAAP financial measure.

In combination with an attractive dividend yield, we believe this profitable growth has and will continue to provide a strong total return to our shareholders. We believe we can achieve this sustainable growth through a strategy focused on growing our cereal business, expanding our snacks business, and pursuing selected growth opportunities. We support our business strategy with operating principles that emphasize profit-rich, sustainable sales growth, as well as cash flow and return on invested capital. We believe our steady earnings growth, strong cash flow, and continued investment during a multi-year period of significant commodity and energy-driven cost inflation demonstrates the strength and flexibility of our business model.

Net sales and operating profit

2008 compared to 2007

The following tables provide an analysis of net sales and operating profit performance for 2008 versus 2007:

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consolidated
2008 net sales	**$8,457**	**$2,619**	**$1,030**	**$716**	**$ —**	**$12,822**
2007 net sales	**$7,786**	**$2,357**	**$984**	**$649**	**$ —**	**$11,776**
% change — 2008 vs. 2007:						
Volume (tonnage) (b)	1.3%	−.2%	−2.6%	6.3%	—	.9%
Pricing/mix	4.5%	3.9%	6.9%	1.8%	—	4.5%
Subtotal — internal business	**5.8%**	**3.7%**	**4.3%**	**8.1%**	—	**5.4%**
Acquisitions (c)	.9%	5.5%	—	3.4%	—	1.8%
Shipping day differences (d)	1.9%	1.2%	.5%	1.0%	—	1.7%
Foreign currency impact	—	.7%	−.1%	−2.2%	—	—
Total change	**8.6%**	**11.1%**	**4.7%**	**10.3%**	**—**	**8.9%**

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consolidated
2008 operating profit	**$1,447**	**$390**	**$209**	**$92**	**$(185)**	**$1,953**
2007 operating profit	**$1,345**	**$397**	**$213**	**$88**	**$(175)**	**$1,868**
% change — 2008 vs. 2007:						
Internal business	**5.9%**	**−.6%**	**−1.5%**	**11.0%**	**−2.8%**	**4.2%**
Acquisitions (c)	−.8%	−.6%	—	−6.2%	—	−1.0%
Shipping day differences (d)	2.5%	1.2%	−.9%	.8%	−1.9%	1.8%
Foreign currency impact	−.1%	−1.9%	.4%	−1.8%	—	−.5%
Total change	**7.5%**	**−1.9%**	**−2.0%**	**3.8%**	**−4.7%**	**4.5%**

(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) Impact of results for the year-to-date period ended January 3, 2009 from the acquisitions of United Bakers, Bear Naked, Navigable Foods, Specialty Cereals and certain assets and liabilities of the Wholesome & Hearty Foods Company and IndyBake.

(d) Impact of 53rd shipping week in 2008.

During 2008, our consolidated net sales increased almost 9% driven by our North America business with increases in both volume and price/mix for the year. Internal net sales grew over 5%, building on a 5% rate of internal growth during 2007. We had a fifty-third week in our 2008 fiscal year which contributed almost 2% to our reported growth over the prior year as did our acquisitions. For further information on our acquisitions refer to Note 2 within Notes to Consolidated Financial Statements beginning on page 35. Management has estimated the pro forma effect on the Company's results of operations as though these business combinations had been completed at the beginning of either 2008 or 2007 would have been immaterial. Successful innovation, brand-building (advertising and consumer promotion) investment as well as our recent price increases continued to drive growth. Declines in volume in both Europe and Latin America were more than offset by growth in pricing/mix due to our price increases. Asia Pacific had a particularly strong year experiencing growth of 8% driven by cereal sales across the operating segment.

For 2008, our North America operating segment reported a net sales increase of almost 9% with internal net sales growth of 6%. The growth was broad based and driven by our price realization and strong innovation. The major product brands grew as follows: retail cereal +3%; retail snacks (cookies, crackers, toaster pastries, cereal bars, and fruit snacks) +6%; frozen and specialty channels (frozen foods, food service and vending) +9%. While retail cereal grew 3% for the year, we had a relatively soft share performance in the fourth quarter facing aggressive price-based incentives from our competitors. In addition, while we estimate our consumption was up 2% across all channels, reductions in trade inventory also adversely affected shipments. As a result, our fourth quarter internal net sales declined by 3% which was up against a tough comparable of 8% growth in the prior year. Our snacks business grew 6% in 2008 on top of 7% growth last year. Our growth came from volume, price increases, and successful innovations such as *Townhouse Flipsides* and *Cheez-It Duoz*. We saw net sales growth in all product categories — toaster pastries, crackers, cookies and wholesome snacks. Our "Right Bites" 100 calorie cookie and cracker packs performed well as we saw an increase in demand for portion controlled portable food. Our specialty and frozen channels grew over 9%. Our food service business performed well, achieving mid single-digit growth for the year. Frozen realized strong sales driven by innovations such as *Bake Shop Swirlz*, *Mini Muffin Tops* and *French Toast Waffles*.

Our International operating segments collectively achieved net sales growth of 9%, or 5% on an internal basis. Europe's internal net sales grew by almost 4% attributable to price/mix, as volume was down slightly. The UK and continental Europe have been impacted by the economic crisis which has consumers searching for value and retailers reducing inventory. Snacks products are performing well across the region, especially in the UK driven by *Rice Krispies Squares*. Latin America's internal net sales growth was 4% attributable to our price increases and driven by cereal sales in Mexico and Venezuela. This year's growth is on top of last year's 9% growth. Volume was down for the year due to the economic environment which is impacting consumer confidence. Asia Pacific had a very strong year with 8% internal net sales growth. The growth was volume driven and broad based in both retail cereal and retail snacks.

Consolidated operating profit grew by almost 5% on an as reported basis and 4% on an internal basis. Operating profit in all areas was impacted by significant cost pressures as discussed in more detail in the "Margin performance" section beginning on page 14. North America grew by 6% driven by growth in net sales and lower exit costs which offset higher

commodity costs. Costs associated with the peanut-related recall of Kellogg products adversely impacted North America's operating profit by $34 million or 2% of the full year operating profit. See the "Subsequent event" section on page 18 for more details. Operating profit declined slightly in both Europe and Latin America due to increased commodity costs and cost reduction initiatives. Asia Pacific's operating profit increased 11% on an internal basis due to strong top line growth. On a consolidated basis, operating profit from acquisitions decreased internal operating profit by 1%, in line with our expectations, with Europe and Asia Pacific being particularly impacted by our Russian and Chinese acquisitions, respectively.

2007 compared to 2006

The following tables provide an analysis of net sales and operating profit performance for 2007 versus 2006:

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consolidated
2007 net sales	**$7,786**	**$2,357**	**$984**	**$649**	**$ —**	**$11,776**
2006 net sales	**$7,349**	**$2,057**	**$891**	**$610**	**$ —**	**$10,907**
% change — 2007 vs. 2006:						
Volume (tonnage) (b)	1.7%	2.2%	6.5%	−.9%	—	2.1%
Pricing/mix	3.8%	3.1%	2.3%	.6%	—	3.3%
Subtotal — internal business	**5.5%**	**5.3%**	**8.8%**	**−.3%**	**—**	**5.4%**
Foreign currency impact	.5%	9.3%	1.6%	6.7%	—	2.6%
Total change	**6.0%**	**14.6%**	**10.4%**	**6.4%**	—	**8.0%**

(dollars in millions)	North America	Europe	Latin America	Asia Pacific (a)	Corporate	Consolidated
2007 operating profit	**$1,345**	**$397**	**$213**	**$88**	**$(175)**	**$1,868**
2006 operating profit	**$1,341**	**$321**	**$220**	**$90**	**$(206)**	**$1,766**
% change — 2007 vs. 2006:						
Internal business	**−.1%**	**14.2%**	**−4.7%**	**−9.5%**	**14.4%**	**3.1%**
Foreign currency impact	.5%	9.7%	1.5%	7.2%	—	2.7%
Total change	**.4%**	**23.9%**	**−3.2%**	**−2.3%**	**14.4%**	**5.8%**

(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.

During 2007, our consolidated net sales increased 8% on strong results from broad based growth across our operating segments. Internal net sales grew over 5%, building on a 7% rate of internal growth during 2006. Successful innovation, brand-building (advertising and consumer promotion) investment and in-store execution continued to drive broad based sales growth across each of our enterprise-wide product groups. In fact, we achieved growth in retail cereal sales within each of our operating segments.

For 2007, our North America operating segment reported a net sales increase of 6%. Internal net sales grew over 5%, with each major product group contributing as follows: retail cereal +3%; retail snacks (cookies, crackers, toaster pastries, cereal bars, fruit snacks) +7%; frozen and specialty (food service, club stores, vending, convenience, drug and value stores) channels +6%. The significant growth achieved by our North America snacks business built on internal growth of +11% in 2006.

Our International operating segments collectively achieved net sales growth of approximately 12% or 5% on an internal basis, with leading dollar contributions from our businesses in the UK, France, Mexico, and Venezuela. Internal sales of our Asia Pacific operating segment (which represents approximately 5% of our consolidated results) were approximately even with the prior year, as solid growth in Asian markets was offset by weak performance in our Australian business.

Consolidated operating profit for 2007 grew 6%, with internal operating profit up 3% versus 2006. For 2007, Europe contributed a strong 14% internal growth rate, driven by increased sales and stronger gross margins, as well as lower up-front costs. Despite a strong sales performance, operating profit in our North American segment was dampened by continued commodity cost pressures and significantly higher up-front costs associated with cost reduction initiatives as more fully discussed on page 16. Our Latin America and Asia Pacific operating segments suffered operating profit declines, primarily driven by lower gross margins due to increased commodity costs, as well as the previously mentioned weak performance in our Australian business.

Margin performance

Margin performance is presented in the following table.

				Change vs. prior year (pts.)	
	2008	2007	2006	**2008**	2007
Gross margin (a)	**41.9%**	44.0%	44.2%	**(2.1)**	(.2)
SGA% (b)	**−26.7%**	−28.1%	−28.0%	**1.4**	(.1)
Operating margin	**15.2%**	15.9%	16.2%	**(.7)**	(.3)

(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 (SGA) expense as a percentage of net sales.

We strive for gross profit dollar growth to reinvest in brand-building and innovation. Our strategy for increasing our gross profit is to manage external cost pressures through product pricing and mix improvements, productivity savings, and technological initiatives to reduce the cost of product ingredients and packaging. For 2008, our gross profit was up $188 million over 2007, an increase of 4%. Our gross profit would have increased by an additional $5 million excluding the impact of foreign currency.

Our decline in gross margin for 2007 and 2008 reflects the impact of significant cost pressure with higher costs for commodities, energy, and fuel being partially offset by the impact of cost reduction initiatives and increased

pricing. For 2008, these cost pressures represented 10% of 2007's cost of goods sold, primarily associated with our ingredient purchases. In 2007, these cost pressures represented 6% of the prior year's cost of goods sold. In 2008, acquisitions negatively impacted margin by 50 basis points.

For 2009, we expect inflationary trends to continue although we plan to offset the expected 4% to 5% of cost pressures by savings from cost reduction initiatives of up to 4% to keep the gross margin percentage approximately flat year over year.

For 2008, our SGA% decreased over the prior year due to our strong net sales growth, lower expense related to cost reduction initiatives recorded in SGA, continued discipline in overhead spending and efficiencies in advertising and promotion. For 2007, our SGA% was negatively impacted by the reorganization of our direct store-door delivery (DSD) operations. Total program costs of $77 million were recorded in SGA expense, as discussed further in the "Exit or disposal activities" section.

Foreign currency translation

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

The recent volatility in the foreign exchange markets has limited our ability to forecast future U.S. 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 better measurement of comparability given the volatility in foreign exchange markets.

Below is a reconciliation of reported diluted EPS to currency neutral EPS for the fiscal years 2008, 2007 and 2006:

Consolidated results	2008	2007	2006
Diluted net earnings per share (EPS)	$ 2.99	$ 2.76	$ 2.51
Translational impact (a)	0.04	(0.07)	—
Currency neutral diluted EPS	**$ 3.03**	**$ 2.69**	**$ 2.51**
Currency neutral diluted EPS growth (b)	**10%**	**7%**	**11%**

(a) Translational impact is the difference between reported EPS and the translation of current year net profits at prior year exchange rates, adjusted for any gains (losses) on translational hedges.

(b) The growth percentage for 2006 has been adjusted for the impact of our adoption of SFAS No. 123(R) "Share-Based Payment," which reduced our fiscal 2006 operating profit by $65 million ($42 million after tax or $.11 per share), due primarily to recognition of compensation expense associated with employee and director stock option grants. Correspondingly, our reported operating profit and net earnings growth for 2006 was reduced by approximately 4% and diluted net earnings per share growth was reduced by approximately 5%.

Exit or disposal activities

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 activities for which material charges have been incurred. We include these charges in our measure of operating segment profitability.

Cost summary

For 2008 we recorded $27 million of costs associated with exit or disposal activities comprised of $7 million of asset write offs, $17 million of severance and other cash costs and $3 million related to pension costs. $23 million of the 2008 charges were recorded in cost of goods sold within the Europe operating segment, with the balance recorded in SGA expense in the Latin America operating segment.

For 2007, we recorded charges of $100 million, comprised of $7 million of asset write-offs, $72 million for severance and other exit costs including route franchise settlements, $15 million for other cash expenditures, and $6 million for a multiemployer pension plan withdrawal liability. $23 million of the total 2007 charges were recorded in cost of goods sold within the Europe operating segment results, with $77 million recorded in SGA expense within the North America operating results.

For 2006, we recorded charges of $82 million, comprised of $20 million of asset write-offs, $30 million for severance and other exit costs, $9 million for other cash expenditures, $4 million for a multiemployer pension plan withdrawal liability, and

$19 million for pension and other postretirement plan curtailment losses and special termination benefits. $74 million was recorded in cost of goods sold within operating segment results and $8 million in SGA expense within corporate results. The Company's operating segments were impacted as follows (in millions): North America-$46; Europe–$28.

Exit cost reserves at January 3, 2009 were $2 million related to severance payments. Exit cost reserves were $5 million at December 29, 2007, consisting of $2 million for severance and $3 million for lease termination payments.

Specific initiatives

During the fourth quarter of 2008, we executed a cost-reduction initiative in Latin America that resulted in the elimination of approximately 120 salaried positions. The cost of the program was $4 million and was recorded in Latin America's SGA expense. The charge related primarily to severance benefits which were paid by the end of the year. There were no reserves as of January 3, 2009 related to this program.

We commenced a multi-year European manufacturing optimization plan in 2006 to improve utilization of our facility in Manchester, England and to better align production in Europe. The project resulted in an elimination of approximately 220 hourly and salaried positions from our Manchester facility through voluntary early retirement and severance programs. The pension trust funding requirements of these early retirements exceeded the recognized benefit expense by $5 million which was funded in 2006. During this program certain manufacturing equipment was removed from service.

All of the costs for the European manufacturing optimization plan have been recorded in cost of goods sold within our Europe operating segment. The following tables present total project costs and a reconciliation of employee severance reserves for this initiative. All other cash costs were paid in the period incurred. The project was completed in 2008.

Project costs to date (millions)	Employee severance	Other cash costs (a)	Asset write-offs	Retirement benefits (b)	Total
Year ended December 30, 2006	$12	$ 2	$ 5	$9	$28
Year ended December 29, 2007	7	8	4	—	19
Year ended January 3, 2009	5	3	(3)	3	8
Total project costs	**$24**	**$13**	**$ 6**	**$12**	**$55**

(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 (millions)	Beginning of period	Accruals	Payments	End of period
Year ended December 29, 2007	$12	$7	$(19)	$—
Year ended January 3, 2009	$—	$5	$ (3)	$ 2

In October 2007, we committed to reorganize certain production processes at our plants in Valls, Spain and Bremen, Germany. Commencement of this plan followed consultation with union representatives at the Bremen facility regarding the elimination of approximately 120 employee positions. This reorganization plan improved manufacturing and distribution efficiency across the Company's continental European operations, and has been completed as of the end of the Company's 2008 fiscal year.

All of the costs for European production process realignment have been recorded in cost of goods sold within our Europe operating segment.

The following tables present total project costs and a reconciliation of employee severance reserves for this initiative. All other cash costs were paid in the period incurred.

Project costs to date (millions)	Employee severance	Other cash costs (a)	Asset write-offs	Total
Year ended December 29, 2007	$2	$1	$ 1	$ 4
Year ended January 3, 2009	4	1	10	15
Total project costs	**$6**	**$2**	**$11**	**$19**

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

Employee severance reserves to date (millions)	Beginning of period	Accruals	Payments	End of period
Year ended December 29, 2007	$—	$2	$—	$ 2
Year ended January 3, 2009	$ 2	$4	$ (6)	$—

In July 2007, we began a plan to reorganize our direct store-door delivery (DSD) operations in the southeastern United States. This DSD reorganization plan was intended to integrate our southeastern sales and distribution regions with the rest of our U.S. DSD operations, resulting in greater efficiency across the nationwide network. We exited approximately 517 distribution route franchise agreements with independent contractors. The plan also resulted in the involuntary termination or relocation of approximately 300 employee positions. Total project costs incurred were $77 million, principally consisting of cash expenditures for route franchise settlements and to a lesser extent, for employee separation, relocation, and reorganization. Exit reserves were $3 million at December 29, 2007 and were paid in 2008. All of the costs for the U.S. DSD reorganization plan have been recorded in SGA expense within our North America operating segment. This initiative is complete.

During 2006, we commenced several initiatives to enhance the productivity and efficiency of our

U.S. cereal manufacturing network, primarily through technological and sourcing improvements in warehousing and packaging operations. In conjunction with these initiatives, we offered voluntary separation incentives, which resulted in the retirement of approximately 80 hourly employees by early 2007. During 2006, we incurred approximately $15 million of total up-front costs, comprised of approximately 20% asset write-offs and 80% cash costs, including $10 million of pension and other postretirement plan curtailment losses. These initiatives were complete by the end of 2007.

Also during 2006, we undertook an initiative to improve customer focus and selling efficiency within a particular Latin American market, leading to a shift from a third-party distributor to a direct sales force model. As a result of this initiative, we paid $8 million in cash during 2006 to exit the existing distribution arrangement.

During 2008 we finalized our pension plan withdrawal liability related to our North America snacks bakery consolidation which was executed in 2005 and 2006. The final liability was $20 million, $16 million of which was recognized in 2005 and $4 million in 2006; and was paid in the third quarter of 2008.

Other 2008 cost reduction initiatives

In addition to investments in exit or disposal activities, we undertook various other cost reduction initiatives during 2008.

We incurred $10 million of expense in connection with a payment for the restructuring of our labor force at a manufacturing facility in Mexico. This cost was recorded in cost of goods sold in the Latin America operating segment.

We also incurred $17 million of expense for the elimination of the accelerated ownership feature of certain employee stock options. Refer to Note 8 within Notes to Consolidated Financial Statements for further information. This expense was recorded in SGA expense within corporate results.

During 2008, we also began a lean manufacturing initiative in certain U.S., Latin American and European manufacturing facilities. We are referring to this initiative as K LEAN which stands for Kellogg's lean, efficient, agile network. This program will ensure we are optimizing our manufacturing network, reducing waste, developing best practices across our global facilities and reducing future capital expenditures. We incurred costs of $12 million for consulting recorded in cost of goods sold primarily within our North America operating segment. The total cost and cash outlay for this program is estimated to be $65 million. This project is expected to be primarily complete by the end of 2009.

Interest expense

As illustrated in the following table, annual interest expense for the 2006-2008 period has been relatively steady, which reflects a stable effective interest rate on total debt and a relatively constant debt balance throughout most of that time. Interest income (recorded in other income (expense), net) increased from approximately $11 million in 2006 to $20 million in 2008, resulting in net interest expense of approximately $288 million for 2008. We currently expect that our 2009 gross interest expense will be approximately $280 million.

				Change vs. prior year	
(dollars in millions)	**2008**	2007	2006	**2008**	2007
Reported interest expense (a)	**$308**	$319	$307		
Amounts capitalized	**6**	5	3		
Gross interest expense	**$314**	$324	$310	**−3.1%**	4.5%

(a) Reported interest expense for 2007 includes charges of approximately $5 related to the early redemption of long-term debt.

Other income (expense), net

Other income (expense), net includes non-operating items such as interest income, charitable donations, and gains and losses related to foreign currency exchange and commodity derivatives. Other income (expense), net for the periods presented was (in millions): 2008–$(12); 2007–$(2); 2006–$13. The variability in other income (expense), net, among years reflects the timing of certain charges explained in the following paragraph.

Charges for contributions to the Kellogg's Corporate Citizenship Fund, a private trust established for charitable giving were as follows (in millions): 2008–$4; 2007–$12; 2006–$3. Interest income was (in millions): 2008–$20; 2007–$23; 2006–$11. Net foreign currency exchange gains (losses) were (in millions): 2008–$5; 2007–$(8); 2006–$(2). Income (expense) recognized for premiums on commodity options was (in millions): 2008–$(12); 2007–$(7); 2006–$0. Gains (losses) on Company Owned Life Insurance ("COLI"), due to changes in cash surrender value, were (in millions): 2008–$(12); 2007–$9; 2006–$12.

Income taxes

Our long-term objective is to achieve a consolidated effective income tax rate of approximately 30% in comparison to a U.S. federal statutory income tax rate of 35%. We pursue planning initiatives globally in order to move toward our target. Excluding the impact of discrete adjustments and the cost of repatriating foreign earnings, our sustainable consolidated effective income tax rate for 2008 was 31% and was 32% for both 2007 and 2006. We currently expect our 2009 sustainable rate to be approximately 31%. Our reported rates of 29.7% for 2008 and 28.7% for 2007 were lower than the sustainable rate due to the favorable effect of various discrete adjustments such as

audit settlements, international restructuring initiatives and statutory rate changes. (Refer to Note 11 within Notes to Consolidated Financial Statements for further information.) For 2009, we expect our consolidated effective income tax rate to be approximately 30% to 31%. This 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. Fluctuations in foreign currency exchange rates could also impact the effective tax rate as it is dependent upon the U.S. dollar earnings of foreign subsidiaries doing business in various countries with differing statutory tax rates.

Subsequent event

On January 14, 2009, we announced a precautionary hold on certain *Austin* and *Keebler* branded peanut butter sandwich crackers and certain *Famous Amos* and *Keebler* branded peanut butter cookies while the U.S. Food and Drug Administration and other authorities investigated Peanut Corporation of America ("PCA"), one of Kellogg's peanut paste suppliers for the cracker and cookie products. On January 16, 2009, Kellogg voluntarily recalled those products because the paste ingredients supplied to Kellogg had the potential to be contaminated with salmonella. The recall was expanded on January 31, February 2 and February 17, 2009 to include certain *Bear Naked*, *Kashi* and *Special K* products impacted by PCA ingredients.

We have incurred costs associated with the recalls and in accordance with U.S. GAAP we recorded certain items associated with this subsequent event in our fiscal year 2008 financial results.

The charges associated with the recalls reduced North America full-year 2008 operating profit by $34 million or $0.06 of EPS. We expect a similar impact in 2009. Of the total 2008 charges, $12 million related to estimated customer returns and consumer rebates and was recorded as a reduction to net sales; $21 million related to costs associated with returned product and the disposal and write-off of inventory which was recorded as cost of goods sold; and $1 million related to other costs which were recorded as SGA expense.

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.

Credit environment

The U.S. and global economies began a period of uncertainty starting in 2007. Financial markets continue to experience unprecedented volatility. Beginning in the third quarter of 2008 and thereafter, global capital and credit markets, including commercial paper markets, experienced increased instability and disruption.

Our Company's financial strength was evident throughout this period of uncertainty, as we continued to have access to the U.S. and Canadian commercial paper markets. Although interest rates on our U.S. commercial paper increased by an average of 200 basis points during the period from mid-September through October 2008, the average interest rate we paid for commercial paper borrowings in 2008 declined to 3.5% from an average of 5.4% in 2007. Our commercial paper and term debt credit ratings have not been affected by the changes in the credit environment, and the amount of our total debt outstanding remained relatively flat over the past three years.

If needed, we have additional sources of liquidity available to us. These sources include our access to public debt and/or equity markets, and the ability to sell trade receivables. Our Five-Year Credit Agreement, which expires in 2011, allows us to borrow up to $2.0 billion on a revolving credit basis. This source of liquidity is unused and available on an unsecured basis, although we do not currently plan to use it.

We monitor the financial strength of our third-party financial institutions, including those that hold our cash and cash equivalents as well as those who serve as counterparties to our credit facilities, our derivative financial instruments, and other arrangements.

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

Operating activities

The principal source of our operating cash flow is net earnings, meaning cash receipts from the sale of our products, net of costs to manufacture and market our products. Our cash conversion cycle (defined as days of inventory and trade receivables outstanding less days of trade payables outstanding, based on a trailing 12 month average) is relatively short, equating to approximately 22 days for 2008, 24 days for 2007 and 26 days for 2006. The decrease in 2008 was the result of a decrease in days of inventory outstanding, while the decrease in 2007 reflected an increase in days of trade payables outstanding.

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

(dollars in millions)	2008	2007	2006
Operating activities			
Net earnings	**$1,148**	$1,103	$1,004
year-over-year change	***4.1%***	*9.9%*	
Items in net earnings not requiring (providing) cash:			
Depreciation and amortization	**375**	372	353
Deferred income taxes	**157**	(69)	(44)
Other (a)	**119**	183	235
Net earnings after non-cash items	**1,799**	1,589	1,548
year-over-year change	***13.2%***	*2.6%*	
Pension and other postretirement benefit plan contributions	**(451)**	(96)	(99)
Changes in operating assets and liabilities:			
Core working capital (b)	**121**	16	(138)
Other working capital	**(202)**	(6)	99
Total	**(81)**	10	(39)
Net cash provided by operating activities	**$1,267**	$1,503	$1,410
year-over-year change	***−15.7%***	*6.6%*	

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

(b) Inventory, trade receivables and trade payables.

Our net cash provided by operating activities for 2008 was $236 million lower than 2007, due primarily to a substantial increase in pension and other postretirement benefit plan contributions in 2008 and an unfavorable year-over-year variance in other working capital. Partially offsetting the decrease was the impact of changes in deferred income taxes and a favorable variance in core working capital.

Our net cash provided by operating activities for 2007 was $93 million higher than the comparable period of 2006, due primarily to growth in cash-basis earnings and favorable total working capital performance. As compared to 2006, the favorable movement in core working capital during 2007 was related principally to higher accounts payable, which were due in part to increased payment terms in international locations.

In 2008, core working capital was an average of 6.2% of net sales, an improvement of 0.6% compared with 2007. In 2007, core working capital was an average of 6.8% of net sales, consistent with 2006. We manage core working capital through timely collection of accounts receivable, extending terms on accounts payable and careful monitoring of inventory.

Other working capital in 2008 reflected an increase in cash paid associated with hedging programs, cash paid for advertising and promotion, and the impact of changes in accrued salaries and wages. Other working capital in 2007 was a use of cash versus a source of cash in 2006. The difference related to a year-over-year increase in the amount of income tax payments.

Recent adverse conditions in the equity markets caused the actual rate of return on our pension and postretirement plan assets to be significantly below our assumed long-term rate of return of 8.9%. As a result, we decided to make additional contributions to our pension and postretirement plans amounting to $400 million in the fourth quarter of 2008. Our total pension and postretirement plan funding for 2008 totaled $451 million, while funding in 2007 and 2006 amounted to $96 million and $99 million, respectively.

In 2006, the Pension Protection Act (PPA) became law in the United States. The PPA revised the basis and methodology for determining defined benefit plan minimum funding requirements as well as maximum contributions to and benefits paid from tax-qualified plans. The PPA will ultimately require us to make additional contributions to our U.S. plans. We believe that we will not be required to make any contributions under PPA requirements until 2011. Our projections concerning timing of PPA funding requirements are subject to change primarily based on general market conditions affecting trust asset performance and our future decisions regarding certain elective provisions of the PPA.

We currently project that we will make total U.S. and foreign plan contributions in 2009 of approximately $100 million. Actual 2009 contributions could be different from our current projections, as influenced by our decision to undertake discretionary funding of our benefit trusts versus other competing investment priorities, future changes in government requirements, trust asset performance, renewals of union contracts, or higher-than-expected health care claims cost experience.

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

(dollars in millions)	2008	2007	2006
Net cash provided by operating activities	**$1,267**	$1,503	$1,410
Additions to properties	**(461)**	(472)	(453)
Cash flow	**$806**	$1,031	$957
year-over-year change	***−21.8%***	*7.7%*	

Our 2008 cash flow (as defined) reflects the impact of the additional pension contributions we made in the fourth quarter of 2008. For 2009, we are expecting cash flow (as defined) in the range of $1,050 million to $1,150 million. This projection assumes an adverse impact on 2009 cash flow of approximately $100 million associated with changes in foreign currency exchange rates. We expect to achieve our target principally through operating profit growth, lower contributions to pension and other postretirement benefit plans in 2009, and continued prudent management of our working capital.

Investing activities

Our net cash used in investing activities for 2008 amounted to $681 million, an increase of $80 million compared with 2007. Net cash used in investing activities of $601 million in 2007 increased by $156 million compared with 2006.

Cash paid for acquisitions during 2008 and 2007 were the primary drivers of increases in cash used in investing activities, as we expanded our platform for future growth with acquisitions in Russia, China, the U.S. and Australia. Acquisitions are discussed in Note 2 within Notes to Consolidated Financial Statements.

Cash paid for additions to properties as a percentage of net sales amounted to 3.6% in 2008, 4.0% in 2007 and 4.2% in 2006. In 2008, capital spending consisted primarily of construction costs to increase capacity in Europe and to expand our global research center in Battle Creek, Michigan. In 2007, we made capacity expansions to accommodate sales growth, including the purchase of a previously leased snacks manufacturing facility in Chicago, Illinois.

We expect our K LEAN manufacturing efficiency initiative to result in a trend toward lower capital spending. Going forward, our long-term target for capital spending is between 3.0% and 4.0% of net sales.

Our 2009 capital plan includes spending for a new facility to manufacture ready-to-eat cereal in Mexico and continued spending on the ongoing project to expand the global research center in Battle Creek, Michigan. The expansion of the W. K. Kellogg Institute for Food and Nutrition Research reflects our commitment to research and innovation which is a key driver to the growth of our business.

Financing activities

Our net cash used in financing activities for 2008, 2007 and 2006 amounted to $780 million, $788 million and $789 million, respectively.

In March 2008, we issued $750 million of five-year 4.25% fixed rate U.S. Dollar Notes under an existing shelf registration statement. We used proceeds of $746 million from issuance of this long-term debt to retire a portion of our commercial paper. In conjunction with this debt issuance, we entered into interest rate swaps with notional amounts totaling $750 million, which effectively converted this debt from a fixed rate to a floating rate obligation for the duration of the five-year term. In 2008, we had cash outflows of $465 million in connection with the repayment of five-year U.S. Dollar Notes at maturity in June 2008. That debt had an effective interest rate of 3.35%.

In January 2007, we increased our available credit via a $400 million unsecured 364-Day Credit Agreement. The $400 million Credit Agreement expired in January 2008 and we decided not to renew it. In February 2007, we redeemed Euro Notes for $728 million. To partially finance this redemption, we established a program to issue euro commercial paper notes up to a maximum aggregate amount outstanding at any time of $750 million or its equivalent in alternative currencies. In December 2007, the Company issued $750 million of five-year 5.125% fixed rate U.S. Dollar Notes under the existing shelf registration statement, using the proceeds to replace a portion of our U.S. commercial paper.

During 2008, 2007 and 2006, we repurchased $650 million of our common stock each year under programs authorized by our Board of Directors. The number of shares repurchased amounted to approximately 13 million, 12 million and 15 million shares, respectively, in 2008, 2007 and 2006. The 2006 activity consisted principally of a private transaction with the W. K. Kellogg Foundation Trust to repurchase approximately 13 million shares for $550 million. On February 4, 2009, the Board of Directors authorized a $650 million share repurchase authorization for 2009 that we plan to execute largely in the second half of the year. The Board also canceled a $500 million share repurchase authorization that it had authorized in third quarter 2008. We made no purchases under the $500 million share repurchase authorization because of our decision to use cash to fund pension plans and reduce commercial paper in the fourth quarter of 2008.

We paid quarterly dividends to shareholders totaling $1.30 per share in 2008, $1.202 per share in 2007 and $1.137 per share in 2006. Cash paid for dividends increased by 8.2% in 2008, and by 5.7% in 2007. Our objective is to maintain our dividend pay-out ratio between 40% and 50% of reported net earnings.

At January 3, 2009, our total debt was $5.5 billion, approximately level with the balance at year-end 2007. Our long-term debt agreements contain customary covenants that limit the Company and some of its subsidiaries from incurring certain liens or from entering into certain sale and lease-back transactions. Some agreements also contain change in control provisions. However, they do not contain acceleration of maturity clauses that are dependent on credit ratings. A change in the Company's credit ratings could limit our access to the U.S. short-term debt market and/or increase the cost of refinancing long-term debt in the future. However, even under these circumstances, we would continue to have access to our aforementioned credit facilities.

We continue to believe that we will be able to meet our interest and principal repayment obligations and maintain our debt covenants for the foreseeable future, while still meeting our operational needs, including the pursuit of selected bolt-on acquisitions. This will be accomplished through our strong cash flow, our short-term borrowings, and our maintenance of credit facilities on a global basis.

OFF-BALANCE SHEET ARRANGEMENTS AND OTHER OBLIGATIONS

Off-balance sheet arrangements

As of January 3, 2009 and December 29, 2007 the Company did not have any material off-balance sheet arrangements.

Contractual obligations

The following table summarizes future estimated cash payments to be made under existing contractual obligations. Further information on debt obligations is contained in Note 7 within Notes to Consolidated Financial Statements. Further information on lease obligations is contained in Note 6. Further information on uncertain tax positions is contained in Note 11.

Contractual obligations	Payments due by period						
(millions)	Total	2009	2010	2011	2012	2013	2014 and beyond
Long-term debt:							
Principal	$4,041	$ 1	$ 1	$1,428	$ 751	$ 752	$1,108
Interest (a)	2,329	236	233	191	147	88	1,434
Capital leases	6	1	1	1	1	—	2
Operating leases	627	135	119	99	75	56	143
Purchase obligations (b)	361	278	50	23	10	—	—
Uncertain tax positions (c)	35	35	—	—	—	—	—
Other long-term (d)	1,141	99	56	155	221	239	371
Total	$8,540	$785	$460	$1,897	$1,205	$1,135	$3,058

(a) Includes interest payments on long-term fixed rate debt and variable rate interest swaps.

(b) Purchase obligations consist primarily of fixed commitments under various co-marketing agreements and to a lesser extent, of service agreements, and contracts for future delivery of commodities, packaging materials, and equipment. The amounts presented in the table do not include items already recorded in accounts payable or other current liabilities at year-end 2008, nor does the table reflect cash flows we are likely to incur based on our plans, but are not obligated to incur. Therefore, it should be noted that the exclusion of these items from the table could be a limitation in assessing our total future cash flows under contracts.

(c) In addition to the $35 million reported in the 2009 column and classified as a current liability, the Company has $97 million recorded in long-term liabilities for which it is not reasonably possible to predict when it may be paid.

(d) Other long-term contractual obligations are those associated with noncurrent liabilities recorded within the Consolidated Balance Sheet at year-end 2008 and consist principally of projected commitments under deferred compensation arrangements, multiemployer plans, and supplemental employee retirement benefits. The table also includes our current estimate of minimum contributions to defined benefit pension and postretirement benefit plans through 2014 as follows: 2009–$69; 2010–$35; 2011–$124; 2012–$203; 2013–$220; 2014–$217.

CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT ACCOUNTING ESTIMATES

Promotional expenditures

Our promotional activities are conducted either through the retail trade or directly with consumers and include activities such as in-store displays and events, feature price discounts, consumer coupons, contests and loyalty programs. The costs of these activities are generally recognized at the time the related revenue is recorded, which normally precedes the actual cash expenditure. The recognition of these costs therefore requires management judgment regarding the volume of promotional offers that will be redeemed by either the retail trade or consumer. These estimates are made using various techniques including historical data on performance of similar promotional programs. Differences between estimated expense and actual redemptions are normally insignificant and recognized as a change in management estimate in a subsequent period. On a full-year basis, these subsequent period adjustments have rarely represented more than 0.3% of our Company's net sales. However, our Company's total promotional expenditures (including amounts classified as a revenue reduction) represented approximately 40% of 2008 net sales; therefore, it is likely that our results would be materially different if different assumptions or conditions were to prevail.

Goodwill and other intangible assets

We follow Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," in evaluating impairment of intangibles. We perform this evaluation at least annually during the fourth quarter of each year in conjunction with our annual budgeting process. Under SFAS No. 142, goodwill impairment testing first requires a comparison between the carrying value and fair value of a reporting unit with associated goodwill. Carrying value is based on the assets and liabilities associated with the operations of that reporting unit, which often requires allocation of shared or corporate items among reporting units. The fair value of a reporting unit is based primarily on our assessment of profitability multiples likely to be achieved in a theoretical sale transaction. Similarly, impairment testing of other intangible assets requires a comparison of carrying value to fair value of that particular asset. Fair values of non-goodwill intangible assets are based primarily on projections of future cash flows to be generated from that asset. For instance, cash flows related to a particular trademark would be based on a projected royalty stream attributable to branded product sales. These estimates are made using various inputs including historical data, current and anticipated market conditions, management plans, and market comparables.

We also apply the principles of SFAS No. 142 in evaluating the useful life over which a non-goodwill intangible asset is expected to contribute directly or indirectly to the cash flows of the Company. An intangible asset with a finite useful life is amortized; an intangible asset with an indefinite useful life is not amortized, but is evaluated annually for impairment. Reaching a determination on useful life requires significant judgments and assumptions regarding the future effects of obsolescence, demand, competition, other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels), the level of required maintenance expenditures, and the expected lives of other related groups of assets.

At January 3, 2009, goodwill and other intangible assets amounted to $5.1 billion, consisting primarily of goodwill and trademarks associated with the 2001 acquisition of Keebler Foods Company. Within this total, approximately $1.4 billion of non-goodwilll intangible assets were classified as indefinite-lived, comprised principally of Keebler trademarks. We currently believe that the fair value of our goodwill and other intangible assets exceeds their carrying value and that those intangibles so classified will contribute indefinitely to the cash flows of the Company. However, if we had used materially different assumptions regarding the future performance of our North American snacks business or a different weighted-average cost of capital in the valuation, this could have resulted in significant impairment losses and/or amortization expense.

Retirement benefits

Our Company sponsors a number of U.S. and foreign defined benefit employee pension plans and also provides retiree health care and other welfare benefits in the United States and Canada. Plan funding strategies are influenced by tax regulations and asset return performance. A substantial majority of plan assets are invested in a globally diversified portfolio of equity securities with smaller holdings of debt securities and other investments. We follow SFAS No. 87 "Employers' Accounting for Pensions" and SFAS No. 106 "Employers' Accounting for Postretirement Benefits Other Than Pensions" (as amended by SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans") for the measurement and recognition of obligations and expense related to our retiree benefit plans. Embodied in both of these standards is the concept that the cost of benefits provided during retirement should be recognized over the employees' active working life. Inherent in this concept is the requirement to use various actuarial assumptions to predict and measure costs and obligations many years prior to the settlement date. Major actuarial assumptions that require significant management judgment and have a material impact on the measurement of our consolidated benefits expense and accumulated obligation include the long- term rates of

return on plan assets, the health care cost trend rates, and the interest rates used to discount the obligations for our major plans, which cover employees in the United States, United Kingdom, and Canada.

To conduct our annual review of the long-term rate of return on plan assets, we model expected returns over a 20-year investment horizon with respect to the specific investment mix of each of our major plans. The return assumptions used reflect a combination of rigorous historical performance analysis and forward-looking views of the financial markets including consideration of current yields on long-term bonds, price-earnings ratios of the major stock market indices, and long-term inflation. Our U.S. plan model, corresponding to approximately 70% of our trust assets globally, currently incorporates a long-term inflation assumption of 2.5% and an active management premium of 1% (net of fees) validated by historical analysis. Although we review our expected long-term rates of return annually, our benefit trust investment performance for one particular year does not, by itself, significantly influence our evaluation. Our expected rates of return are generally not revised, provided these rates continue to fall within a "more likely than not" corridor of between the 25th and 75th percentile of expected long-term returns, as determined by our modeling process. Our assumed rate of return for U.S. plans in 2008 of 8.9% equated to approximately the 50th percentile expectation of our 2008 model. Similar methods are used for various foreign plans with invested assets, reflecting local economic conditions. Foreign trust investments represent approximately 30% of our global benefit plan assets.

Based on consolidated benefit plan assets at January 3, 2009, a 100 basis point reduction in the assumed rate of return would increase 2009 benefits expense by approximately $31 million. Correspondingly, a 100 basis point shortfall between the assumed and actual rate of return on plan assets for 2008 would result in a similar amount of arising experience loss. Any arising asset-related experience gain or loss is recognized in the calculated value of plan assets over a five-year period. Once recognized, experience gains and losses are amortized using a declining-balance method over the average remaining service period of active plan participants, which for U.S. plans is presently about 13 years. Under this recognition method, a 100 basis point shortfall in actual versus assumed performance of all of our plan assets in 2008 would reduce pre-tax earnings by approximately $1 million in 2010, increasing to approximately $5 million in 2014. For each of the three fiscal years, our actual return on plan assets exceeded/(was less than) the recognized assumed return by the following amounts (in millions): 2008–$(1,528); 2007–$(99); 2006–$257.

To conduct our annual review of health care cost trend rates, we model our actual claims cost data over a five-year historical period, including an analysis of pre-65 versus post-65 age groups and other important demographic components of our covered retiree population. This data is adjusted to eliminate the impact of plan changes and other factors that would tend to distort the underlying cost inflation trends. Our initial health care cost trend rate is reviewed annually and adjusted as necessary to remain consistent with recent historical experience and our expectations regarding short-term future trends. In comparison to our actual five-year compound annual claims cost growth rate of approximately 5%, our initial trend rate for 2009 of 7.5% reflects the expected future impact of faster-growing claims experience for certain demographic groups within our total employee population. Our initial rate is trended downward by 0.5% per year, until the ultimate trend rate of 4.5% is reached. The ultimate trend rate is adjusted annually, as necessary, to approximate the current economic view on the rate of long-term inflation plus an appropriate health care cost premium. Based on consolidated obligations at January 3, 2009, a 100 basis point increase in the assumed health care cost trend rates would increase 2009 benefits expense by approximately $15 million. A 100 basis point excess of 2009 actual health care claims cost over that calculated from the assumed trend rate would result in an arising experience loss of approximately $9 million. Any arising health care claims cost-related experience gain or loss is recognized in the calculated amount of claims experience over a four-year period. Once recognized, experience gains and losses are amortized using a straight-line method over 15 years, resulting in at least the minimum amortization prescribed by SFAS No. 106. The net experience gain arising from recognition of 2008 claims experience was approximately $4 million.

To conduct our annual review of discount rates, we use several published market indices with appropriate duration weighting to assess prevailing rates on high quality debt securities, with a primary focus on the *Citigroup Pension Liability Index®* for our U.S. plans. To test the appropriateness of these indices, we periodically conduct a matching exercise between the expected settlement cash flows of our plans and the bond maturities, consisting principally of AA-rated (or the equivalent in foreign jurisdictions) non-callable issues with at least $25 million principal outstanding. The model does not assume any reinvestment rates and assumes that bond investments mature just in time to pay benefits as they become due. For those years where no suitable bonds are available, the portfolio utilizes a linear interpolation approach to impute a hypothetical bond whose maturity matches the cash flows required in those years. During 2008, we refined our methodology for setting our discount rate by inputting the cash flows for our pension, postretirement and postemployment plans into the spot yield curve underlying the *Citigroup* index. The measurement dates for our defined benefit plans are consistent with our fiscal year end. Accordingly, we select discount rates to measure our benefit obligations

that are consistent with market indices during December of each year.

Based on consolidated obligations at January 3, 2009, a 25 basis point decline in the weighted-average discount rate used for benefit plan measurement purposes would increase 2009 benefits expense by approximately $13 million. All obligation-related experience gains and losses are amortized using a straight-line method over the average remaining service period of active plan participants.

Despite the previously-described rigorous policies for selecting major actuarial assumptions, we periodically experience material differences between assumed and actual experience. As of January 3, 2009, we had consolidated unamortized prior service cost and net experience losses of approximately $1.9 billion, as compared to approximately $0.6 billion at December 29, 2007. The year-over-year increase in net unamortized amounts was attributable primarily to poor asset performance during 2008. Of the total unamortized amounts at January 3, 2009, approximately $1.5 billion was related to asset losses during 2008, with the remainder largely related to discount rate reductions and net unfavorable health care claims experience (including upward revisions in the assumed trend rate) prior to 2008. For 2009, we currently expect total amortization of prior service cost and net experience losses to be approximately $11 million higher than the actual 2008 amount of approximately $58 million. Total employee benefit expense for 2009 is expected to be slightly higher than 2008 due to increased amortization of experience losses which is offset by assumed asset returns on our 2008 contributions. Based on our current actuarial assumptions, we expect 2010 pension expense to increase significantly primarily due to the amortization of net experience losses.

During 2008 we made contributions in the amount of $354 million to Kellogg's global tax-qualified pension programs. This amount was mostly discretionary. We anticipate having to make additional contributions in future years to make up for the poor performance of global equity markets during 2008. Additionally we contributed $97 million to our retiree medical programs; most of this contribution was also discretionary and largely used to fund benefit obligations related to our union retiree healthcare benefits.

Assuming actual future experience is consistent with our current assumptions, annual amortization of accumulated prior service cost and net experience losses during each of the next several years would increase versus the 2008 amount.

Income taxes

Our consolidated effective income tax rate is influenced by tax planning opportunities available to us in the various jurisdictions in which we operate. Judgment is required in evaluating our tax positions to determine how much benefit should be recognized in our income tax expense. We establish tax reserves in accordance with FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" (FIN No. 48) which we adopted at the beginning of 2007. FIN No. 48 is based on a benefit recognition model, which we believe could result in a greater amount of benefit (and a lower amount of reserve) being initially recognized in certain circumstances. Prior to the adoption of FIN No. 48, our policy was to establish reserves that reflected the probable outcome of known tax contingencies. Favorable resolution was recognized as a reduction to our effective tax rate in the period of resolution. The initial application of FIN No. 48 resulted in a net decrease to the Company's consolidated accrued income tax and related interest liabilities of approximately $2 million, with an offsetting increase to retained earnings.

The Company evaluates a tax position in two-steps in accordance with FIN No. 48. The first step is to determine whether it is more-likely-than not that a tax position will be sustained upon examination based upon the technical merit of the position. In weighing the technical merits of the position, we consider the facts and circumstances of the position; we assume the reviewing tax authority has full knowledge of the position; and we consider the weight of authoritative guidance. The second step is measurement; a tax position that meets the more-likely-than not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. While reviewing the ranges of probable outcomes, the Company records the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. The tax position will be derecognized when it is no longer more-likely-than not of being sustained.

For the periods presented, our income tax and related interest reserves have averaged approximately $175 million. Reserve adjustments for individual issues have rarely exceeded 1% of earnings before income taxes annually. Significant tax reserve adjustments impacting our effective tax rate would be separately presented in the rate reconciliation table of Note 11 within Notes to Consolidated Financial Statements.

The current portion of our tax reserves is presented in the balance sheet within accrued income taxes and the amount expected to be settled after one year is recorded in other liabilities. Likewise, the current portion of related interest reserves are presented in the balance sheet within accrued other current liabilities, with the amount expected to be settled after one year recorded in other liabilities.

New accounting pronouncements

New accounting pronouncements are discussed in Note 1 within Notes to Consolidated Financial Statements.

FUTURE OUTLOOK

For 2009, despite a tough economic outlook, we expect our business model and strategy will deliver internal net sales growth of 3 to 4% and internal operating profit growth of mid single-digits (4 to 6%) which are in line with our long-term annual growth targets. We expect our earnings per share to grow at high single-digits (7 to 9%) on a currency neutral basis. Gross profit margin percentage is expected to remain approximately flat as our cost reduction initiatives and price realization offset pressure on cost of goods sold. Gross interest expense for 2009 is expected to decline to approximately $280 million driven by lower short-term interest rates. Our effective tax rate is estimated to be approximately 30% to 31%. We continue to remain committed to investing in brand building, cost-reduction initiatives, and other growth opportunities. Lastly, we expect our cash flow performance to remain strong and are currently expecting 2009 cash flow to be between $1,050 million and $1,150 million after capital expenditures.

ITEM 7A. 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. As a matter of policy, we do not engage in trading or speculative transactions. Refer to Note 12 within Notes to Consolidated Financial Statements for further information on our accounting policies related to derivative financial and commodity instruments.

Foreign exchange risk

Our Company is exposed to fluctuations in foreign currency cash flows related to third-party purchases, intercompany loans and product shipments. Our Company is also exposed to fluctuations in the value of foreign currency investments in subsidiaries and cash flows related to repatriation of these investments. Additionally, our Company is exposed to volatility in the translation of foreign currency earnings to U.S. dollars. Primary exposures include the U.S. dollar versus the British pound, euro, Australian dollar, Canadian dollar, and Mexican peso, and in the case of inter-subsidiary transactions, the British pound versus the euro. In addition, we have operations located in Venezuela where the local currency is exposed to a highly volatile economic environment. We assess foreign currency risk based on transactional cash flows and translational volatility and may enter into forward contracts, options, and currency swaps to reduce fluctuations in net long or short currency positions. Forward contracts and options are generally less than 18 months duration. Currency swap agreements are established in conjunction with the term of underlying debt issuances.

The total notional amount of foreign currency derivative instruments at year-end 2008 was $924 million, representing a settlement receivable of $22 million. The total notional amount of foreign currency derivative instruments at year-end 2007 was $570 million, representing a settlement obligation of $9 million. All of these derivatives were hedges of anticipated transactions, translational exposure, or existing assets or liabilities, and mature within 18 months. Assuming an unfavorable 10% change in year-end exchange rates, the settlement receivable would have decreased by approximately $92 million at year-end 2008 and the settlement obligation would have increased by $57 million at year-end 2007. These unfavorable changes would generally have been offset by favorable changes in the values of the underlying exposures.

Interest rate risk

Our Company is exposed to interest rate volatility with regard to future issuances of fixed rate debt and existing and future issuances of variable rate debt. Primary exposures include movements in U.S. Treasury rates, London Interbank Offered Rates (LIBOR), and commercial paper rates. We periodically use interest rate swaps and forward interest rate contracts to reduce interest rate volatility and funding costs associated with certain debt issues, and to achieve a desired proportion of variable versus fixed rate debt, based on current and projected market conditions.

In connection with the issuance of U.S. Dollar Notes on March 6, 2008, we entered into interest rate swaps. Refer to disclosures contained in Note 7 within Notes to Consolidated Financial Statements. There were no interest rate derivatives outstanding at year-end 2007. Assuming average variable rate debt levels during the year, a one percentage point increase in interest rates would have increased interest expense by approximately $21 million in 2008 and $19 million in 2007.

Price risk

Our Company is exposed to price fluctuations primarily as a result of anticipated purchases of raw and packaging materials, fuel, and energy. Primary exposures include corn, wheat, soybean oil, sugar, cocoa, paperboard, natural gas, and diesel fuel. We have historically used the combination of long-term contracts with suppliers, and exchange-traded futures and option contracts to reduce price fluctuations in a desired percentage of forecasted raw material purchases over a duration of generally less than 18 months. During 2006, we entered into two separate 10-year over-the-counter commodity swap transactions to reduce fluctuations in the price of natural gas used principally in our manufacturing processes. The notional amount of the swaps totaled $167 million as of January 3, 2009 and equates to approximately 50% of our North America manufacturing needs. At year-end 2007 the notional amount was $188 million.