

KRAFT FOODS INC
Form 10-Q/A
August 09, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q/A
(Amendment No. 1)**

(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, 2006

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 1-16483

Kraft Foods Inc.

(Exact name of registrant as specified in its charter)

Virginia
(State or other jurisdiction of
incorporation or organization)

Three Lakes Drive, Northfield, Illinois
(Address of principal executive offices)

52-2284372
(I.R.S. Employer
Identification No.)

60093
(Zip Code)

Registrant's telephone number, including area code **(847) 646-2000**

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Former name, former address and former fiscal year, if changed since last report

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

At July 31, 2006, there were 471,739,795 shares of the registrant's Class A Common Stock outstanding, and 1,180,000,000 shares of the registrant's Class B Common Stock outstanding.

EXPLANATORY NOTE

Kraft Foods Inc. (the Company) is filing this Amendment No. 1 on Form 10-Q/A (this Form 10-Q/A) to correct two errors that were included in Part I, Item 1 of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (the Original Form 10-Q). These errors occurred during the process of preparing the Original Form 10-Q for filing with the Securities and Exchange Commission (the SEC) through the SEC's EDGAR system. The two errors in the Original Form 10-Q that are being corrected in this Form 10-Q/A are:

- In the Condensed Consolidated Statements of Shareholders' Equity For the Year Ended December 31, 2005 and the Six Months Ended June 30, 2006 on page 7 of the Original Form 10-Q, the caption Accumulated Other Comprehensive Earnings/(Losses) was incorrectly placed above the columns titled Additional Paid-in Capital and Earnings Reinvested in the Business. The Accumulated Other Comprehensive Earnings/(Losses) caption has been corrected in this Form 10-Q/A to only appear above the Currency Translation Adjustments, Other and Total columns.
- In Note 11. Benefit Plans of the Notes to Condensed Consolidated Financial Statements (Unaudited) on page 25 of the Original Form 10-Q, the table under the heading Components of Net Periodic Benefit Cost contained two numbers in the Other expense line item that were placed in the incorrect column. The 11 appearing under the U.S. Plans caption for the Six Months Ended June 30, 2006 should have appeared instead under the column for the Six Months Ended June 30, 2005, and the 4 appearing under the U.S. Plans caption for the Six Months Ended June 30, 2005 should have appeared instead under the Non-U.S. Plans caption for the Six Months Ended June 30, 2005.

In accordance with Rule 12b-15 under the Securities Exchange Act of 1934, as amended, this Form 10-Q/A amends and restates in its entirety Part I, Item 1. Items included in the Original Form 10-Q that are not included herein are not amended and remain in effect as of the date of the filing of the Original Form 10-Q with the SEC. In addition, no attempt has been made in this Form 10-Q/A to modify or update disclosures that were included in the Original Form 10-Q to reflect developments at the Company subsequent to the date of the filing of the Original Form 10-Q.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(in millions of dollars)

(Unaudited)

| | June 30, 2006 | December 31, 2005 |
|--|------------------|----------------------|
| ASSETS | | |
| Cash and cash equivalents | \$ 402 | \$ 316 |
| Receivables (less allowances of \$85 in 2006 and \$92 in 2005) | 3,549 | 3,385 |
| Inventories: | | |
| Raw materials | 1,484 | 1,363 |
| Finished product | 2,066 | 1,980 |
| | | 3,550 3,343 |
| Deferred income taxes | 625 | 879 |
| Other current assets | 248 | 230 |
| Total current assets | 8,374 | 8,153 |
| Property, plant and equipment, at cost | 17,046 | 16,598 |
| Less accumulated depreciation | 7,284 | 6,781 |
| | | 9,762 9,817 |
| Goodwill | 24,985 | 24,648 |
| Other intangible assets, net | 10,428 | 10,516 |
| Prepaid pension assets | 3,690 | 3,617 |
| Other assets | 983 | 877 |
| TOTAL ASSETS | \$ 58,222 | \$ 57,628 |

See notes to condensed consolidated financial statements.

Continued

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Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (Continued)

(in millions of dollars)

(Unaudited)

| | June 30, 2006 | December 31, 2005 |
|--|------------------|----------------------|
| LIABILITIES | | |
| Short-term borrowings | \$ 1,105 | \$ 805 |
| Current portion of long-term debt | 2,268 | 1,268 |
| Due to Altria Group, Inc. and affiliates | 485 | 652 |
| Accounts payable | 2,084 | 2,270 |
| Accrued liabilities: | | |
| Marketing | 1,451 | 1,529 |
| Employment costs | 637 | 625 |
| Other | 1,270 | 1,338 |
| Income taxes | 398 | 237 |
| Total current liabilities | 9,698 | 8,724 |
| Long-term debt | 7,478 | 8,475 |
| Deferred income taxes | 5,869 | 6,067 |
| Accrued postretirement health care costs | 1,980 | 1,931 |
| Other liabilities | 2,829 | 2,838 |
| Total liabilities | 27,854 | 28,035 |
| Contingencies (Note 7) | | |
| SHAREHOLDERS EQUITY | | |
| Class A common stock, no par value (555,000,000 shares issued in 2006 and 2005) | | |
| Class B common stock, no par value (1,180,000,000 shares issued and outstanding in 2006 and 2005) | | |
| Additional paid-in capital | 23,525 | 23,835 |
| Earnings reinvested in the business | 10,578 | 9,453 |
| Accumulated other comprehensive losses (including currency translation of \$(856) in 2006 and \$(1,290) in 2005) | (1,205) | (1,663) |
| | | 32,898 |
| Less cost of repurchased stock (81,646,640 Class A shares in 2006 and 65,119,245 Class A shares in 2005) | (2,530) | (2,032) |
| Total shareholders equity | 30,368 | 29,593 |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | \$ 58,222 | \$ 57,628 |

See notes to condensed consolidated financial statements.

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Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(in millions of dollars, except per share data)

(Unaudited)

| | For the Six Months Ended | |
|---|---------------------------------|-------------|
| | June 30, | |
| | 2006 | 2005 |
| Net revenues | \$ 16,742 | \$ 16,393 |
| Cost of sales | 10,626 | 10,379 |
| Gross profit | 6,116 | 6,014 |
| Marketing, administration and research costs | 3,477 | 3,538 |
| Asset impairment and exit costs | 428 | 179 |
| Losses (gains) on sales of businesses, net | 11 | (115) |
| Amortization of intangibles | 5 | 5 |
| Operating income | 2,195 | 2,407 |
| Interest and other debt expense, net | 243 | 350 |
| Earnings from continuing operations before income taxes and minority interest | 1,952 | 2,057 |
| Provision for income taxes | 262 | 598 |
| Earnings from continuing operations before minority interest | 1,690 | 1,459 |
| Minority interest in earnings from continuing operations, net | 2 | 2 |
| Earnings from continuing operations | 1,688 | 1,457 |
| Loss from discontinued operations, net of income taxes | | (272) |
| Net earnings | \$ 1,688 | \$ 1,185 |
| Per share data: | | |
| Basic earnings per share: | | |
| Continuing operations | \$ 1.02 | \$ 0.86 |
| Discontinued operations | | (0.16) |
| Net earnings | \$ 1.02 | \$ 0.70 |
| Diluted earnings per share: | | |
| Continuing operations | \$ 1.02 | \$ 0.86 |
| Discontinued operations | | (0.16) |

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| | | |
|--------------------|---------|---------|
| Net earnings | \$ 1.02 | \$ 0.70 |
| Dividends declared | \$ 0.46 | \$ 0.41 |

See notes to condensed consolidated financial statements.

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Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(in millions of dollars, except per share data)

(Unaudited)

| | For the Three Months Ended | |
|---|-----------------------------------|-------------|
| | June 30, | |
| | 2006 | 2005 |
| Net revenues | \$ 8,619 | \$ 8,334 |
| Cost of sales | 5,435 | 5,275 |
| Gross profit | 3,184 | 3,059 |
| Marketing, administration and research costs | 1,770 | 1,777 |
| Asset impairment and exit costs | 226 | 29 |
| Losses on sales of businesses, net | 8 | 1 |
| Amortization of intangibles | 3 | 2 |
| Operating income | 1,177 | 1,250 |
| Interest and other debt expense, net | 147 | 174 |
| Earnings from continuing operations before income taxes and minority interest | 1,030 | 1,076 |
| Provision for income taxes | 347 | 316 |
| Earnings from continuing operations before minority interest | 683 | 760 |
| Minority interest in earnings from continuing operations, net | 1 | 2 |
| Earnings from continuing operations | 682 | 758 |
| Loss from discontinued operations, net of income taxes | | (286) |
| Net earnings | \$ 682 | \$ 472 |
| Per share data: | | |
| Basic earnings per share: | | |
| Continuing operations | \$ 0.41 | \$ 0.45 |
| Discontinued operations | | (0.17) |
| Net earnings | \$ 0.41 | \$ 0.28 |
| Diluted earnings per share: | | |
| Continuing operations | \$ 0.41 | \$ 0.45 |
| Discontinued operations | | (0.17) |

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| | | |
|--------------------|---------|----------|
| Net earnings | \$ 0.41 | \$ 0.28 |
| Dividends declared | \$ 0.23 | \$ 0.205 |

See notes to condensed consolidated financial statements.

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Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Shareholders Equity

For the Year Ended December 31, 2005 and

the Six Months Ended June 30, 2006

(in millions of dollars, except per share data)

(Unaudited)

| | Class A and B Common Stock | Additional Paid-in Capital | Earnings Reinvested in the Business | Accumulated Other Comprehensive Earnings/(Losses) Currency Translation Adjustments | Other | Total | Cost of Repurchased Stock | Total Share- holders Equity |
|--|-------------------------------------|----------------------------------|---|--|-----------|-------------|---------------------------------|--------------------------------------|
| Balances, January 1, 2005 | \$ | \$ 23,762 | \$ 8,304 | \$ (890) | \$ (315) | \$ (1,205) | \$ (950) | \$ 29,911 |
| Comprehensive earnings: | | | | | | | | |
| Net earnings | | | 2,632 | | | | | 2,632 |
| Other comprehensive losses, net of income taxes: | | | | | | | | |
| Currency translation adjustments | | | | (400) | | (400) | | (400) |
| Additional minimum pension liability | | | | | (48) | (48) | | (48) |
| Change in fair value of derivatives accounted for as hedges | | | | | (10) | (10) | | (10) |
| Total other comprehensive losses | | | | | | | | (458) |
| Total comprehensive earnings | | | | | | | | 2,174 |
| Exercise of stock options and issuance of other stock awards | | 52 | (12) | | | | 118 | 158 |
| Cash dividends declared (\$0.87 per share) | | | (1,471) | | | | | (1,471) |
| Class A common stock repurchased | | | | | | | (1,200) | (1,200) |
| Other | | 21 | | | | | | 21 |
| Balances, December 31, 2005 | | 23,835 | 9,453 | (1,290) | (373) | (1,663) | (2,032) | 29,593 |
| Comprehensive earnings: | | | | | | | | |
| Net earnings | | | 1,688 | | | | | 1,688 |
| Other comprehensive earnings (losses), net of income taxes: | | | | | | | | |
| Currency translation adjustments | | | | 434 | | 434 | | 434 |
| Additional minimum pension liability | | | | | (21) | (21) | | (21) |
| | | | | | 1 | 1 | | 1 |

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| | | | | | | | | | |
|--|----|-------|--------|-------|--------|----|-------|---------|--------|
| Change in fair value of derivatives accounted for as hedges | | | | | | | | | |
| Other | | 44 | | 44 | | | | 44 | |
| Total other comprehensive earnings | | | | | | | | 458 | |
| Total comprehensive earnings | | | | | | | | 2,146 | |
| Exercise of stock options and issuance of other stock awards | | (310) | | 202 | | | 127 | 19 | |
| Cash dividends declared (\$0.46 per share) | | | | (765) | | | | (765) | |
| Class A common stock repurchased | | | | | | | (625) | (625) | |
| Balances, June 30, 2006 | \$ | \$ | 23,525 | \$ | 10,578 | \$ | (856) | \$ | (349) |
| | | | | | | | \$ | (1,205) | \$ |
| | | | | | | | | (2,530) | \$ |
| | | | | | | | | | 30,368 |

Total comprehensive earnings were \$1,043 million and \$262 million, respectively, for the quarters ended June 30, 2006 and 2005 and \$957 million for the first six months of 2005.

See notes to condensed consolidated financial statements.

Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(in millions of dollars)

(Unaudited)

| | For the Six Months Ended June 30, | |
|---|--|-------------|
| | 2006 | 2005 |
| CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES | | |
| Net earnings | \$ 1,688 | \$ 1,185 |
| Adjustments to reconcile net earnings to operating cash flows: | | |
| Depreciation and amortization | 433 | 436 |
| Deferred income tax benefit | (56) | (222) |
| Losses (gains) on sales of businesses, net | 11 | (115) |
| Loss on sale of discontinued operations | | 32 |
| Asset impairment and exit costs, net of cash paid | 325 | 92 |
| Cash effects of changes, net of the effects from acquired and divested companies: | | |
| Receivables, net | (59) | 80 |
| Inventories | (216) | (296) |
| Accounts payable | (93) | (193) |
| Income taxes | 103 | 591 |
| Amounts due to Altria Group, Inc. and affiliates | (202) | 84 |
| Other working capital items | (442) | (392) |
| Change in pension assets and postretirement liabilities, net | 14 | (101) |
| Other | 100 | 111 |
| Net cash provided by operating activities | 1,606 | 1,292 |
| CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES | | |
| Capital expenditures | (450) | (441) |
| Proceeds from sales of businesses | 91 | 1,640 |
| Other | 63 | 16 |
| Net cash (used in) provided by investing activities | (296) | 1,215 |

See notes to condensed consolidated financial statements.

Continued

Kraft Foods Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Continued)

(in millions of dollars)

(Unaudited)

| | For the Six Months Ended | |
|--|---------------------------------|-------------|
| | June 30, | |
| | 2006 | 2005 |
| CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES | | |
| Net issuance (repayment) of short-term borrowings | \$ 294 | \$ (945) |
| Long-term debt proceeds | 32 | 34 |
| Long-term debt repaid | (35) | (739) |
| Increase in amounts due to Altria Group, Inc. and affiliates | 35 | 187 |
| Repurchase of Class A common stock | (633) | (375) |
| Dividends paid | (769) | (700) |
| Other | (173) | 144 |
| Net cash used in financing activities | (1,249) | (2,394) |
| Effect of exchange rate changes on cash and cash equivalents | 25 | 1 |
| Cash and cash equivalents: | | |
| Increase | 86 | 114 |
| Balance at beginning of period | 316 | 282 |
| Balance at end of period | \$ 402 | \$ 396 |

See notes to condensed consolidated financial statements.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 1. Accounting Policies:

Basis of Presentation

The interim condensed consolidated financial statements of Kraft Foods Inc. (Kraft), together with its subsidiaries (collectively referred to as the Company), are unaudited. It is the opinion of the Company s management that all adjustments necessary for a fair statement of the interim results presented have been reflected therein. All such adjustments were of a normal recurring nature. Net revenues and net earnings for any interim period are not necessarily indicative of results that may be expected for the entire year.

These statements should be read in conjunction with the Company s consolidated financial statements and related notes, which are included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

In June 2005, the Company sold substantially all of its sugar confectionery business for pre-tax proceeds of approximately \$1.4 billion. The Company has reflected the results of its sugar confectionery business prior to the closing date as discontinued operations on the condensed consolidated statements of earnings.

In October 2005, the Company announced that, effective January 1, 2006, its Canadian business will be realigned to better integrate it into the Company s North American business by product category. Beginning in the first quarter of 2006, the operating results of the Canadian business are being reported throughout the North American food segments. In addition, in the first quarter of 2006, the Company s international businesses were realigned to reflect the reorganization announced within Europe in November 2005. The two revised international segments, which are reflected in these condensed consolidated financial statements and notes, are European Union; and Developing Markets, Oceania & North Asia, the latter to reflect the Company s increased management focus on developing markets. Accordingly, prior period segment results have been restated.

Stock-Based Compensation Expense

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), Share-Based Payment, (SFAS No. 123(R)) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on date of grant and recognition of compensation over the service periods for awards expected to vest. The fair value of restricted stock and rights to receive shares of stock is determined based on the number of shares granted and the market value at date of grant. The fair value of stock options is determined using a modified Black-Scholes methodology. The impact of adoption was not material.

The Company previously applied the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and provided the pro forma disclosures required by SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). No compensation expense for employee stock options was reflected in net earnings in 2005, as all stock options granted under those plans had an exercise price equal to the market value of the common stock on the date of the grant. Historical condensed consolidated statements of earnings already include the compensation expense for restricted stock and rights to receive shares of stock. The following table illustrates the effect on net earnings and earnings per share (EPS) if the Company had applied the fair value recognition provisions of SFAS No. 123 to measure stock-based compensation expense for stock option awards in 2005:

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Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

| | For the Six Months Ended June 30, 2005 (in millions, except per share data) | For the Three Months Ended June 30, 2005 |
|--|---|---|
| Net earnings, as reported | \$ 1,185 | \$ 472 |
| Deduct: | | |
| Total stock-based employee compensation expense determined under fair value method for all stock option awards, net of related tax effects | 4 | 2 |
| Pro forma net earnings | \$ 1,181 | \$ 470 |
| Earnings per share: | | |
| Basic as reported | \$ 0.70 | \$ 0.28 |
| Basic pro forma | \$ 0.70 | \$ 0.28 |
| Diluted as reported | \$ 0.70 | \$ 0.28 |
| Diluted pro forma | \$ 0.69 | \$ 0.28 |

The adoption of SFAS No. 123(R) in the first quarter of 2006 resulted in a cumulative effect gain of \$6 million, which is net of \$3 million in taxes, in the condensed consolidated statements of earnings for the six months ended June 30, 2006. This gain resulted from the impact of estimating future forfeitures on restricted stock and rights to receive shares of stock in the determination of periodic expense for unvested awards, rather than recording forfeitures only when they occur. The gross cumulative effect was recorded in marketing, administration and research costs in the first quarter of 2006.

Under SFAS No. 123(R), tax shortfalls occur when actual tax deductible compensation expense is less than cumulative stock-based compensation expense recognized in the financial statements. Tax shortfalls of \$10 million were recognized for the six months ended June 30, 2006, and were recorded in additional paid-in capital.

Note 2. Asset Impairment, Exit and Implementation Costs:

Restructuring Program:

In January 2004, the Company announced a three-year restructuring program with the objectives of leveraging the Company's global scale, realigning and lowering its cost structure, and optimizing capacity utilization. In January 2006, the Company announced plans to expand its restructuring efforts through 2008. The entire restructuring program is expected to result in \$3.7 billion in pre-tax charges reflecting asset disposals, severance and implementation costs. As part of this program, the Company anticipates the closure of up to 40 facilities and the elimination of approximately 14,000 positions. Approximately \$2.3 billion of the \$3.7 billion in pre-tax charges are expected to require cash payments. Pre-tax restructuring program charges during 2006 are expected to be approximately \$1 billion, including \$348 million incurred for the six months ended June 30, 2006. Total pre-tax restructuring charges incurred since the inception of the program in January 2004 were \$1.3 billion.

During the second quarter of 2006, the Company announced a seven-year, \$1.7 billion agreement to receive information technology services from Electronic Data Systems (EDS). The agreement, which includes data centers, web hosting, telecommunications and IT workplace services, began on June 1, 2006. Pursuant to the agreement, approximately 670 employees, who provide certain IT support to the Company, were transitioned to EDS. As a result, in the second quarter of 2006, the Company incurred pre-tax asset impairment and exit costs of \$3 million and implementation costs of \$11 million related to the transition. These costs were included in the pre-tax restructuring program charges discussed above.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Restructuring Costs:

During the six months and three months ended June 30, 2006, pre-tax charges under the restructuring program of \$318 million and \$226 million, respectively, were recorded as asset impairment and exit costs on the condensed consolidated statements of earnings. During the six months and three months ended June 30, 2005, pre-tax charges under the restructuring program of \$86 million and \$29 million, respectively, were recorded as asset impairment and exit costs on the condensed consolidated statements of earnings. The pre-tax charges for the six months ended June 30, 2006 resulted from the announcement of the closing of seven plants, for a total of 26 since January 2004, and the continuation of a number of workforce reduction programs. Approximately \$133 million of the pre-tax charges incurred during the first six months of 2006 will require cash payments.

Pre-tax restructuring liability activity for the six months ended June 30, 2006 was as follows:

| | Severance (in millions) | Asset Write-downs | Other | Total |
|------------------------------------|----------------------------|----------------------|-------|--------|
| Liability balance, January 1, 2006 | \$ 114 | \$ | \$ 1 | \$ 115 |
| Charges | 123 | 184 | 11 | 318 |
| Cash spent | (97) | | (6) | (103) |
| Charges against assets | (3) | (184) | (1) | (188) |
| Currency | 3 | | | 3 |
| Liability balance, June 30, 2006 | \$ 140 | \$ | \$ 5 | \$ 145 |

Severance costs in the above schedule, which relate to the workforce reduction programs, include the cost of related benefits. Specific programs announced since 2004, as part of the overall restructuring program, will result in the elimination of approximately 8,600 positions. At June 30, 2006, approximately 7,200 of these positions have been eliminated. Asset write-downs relate to the impairment of assets caused by the plant closings and related activity. Other costs incurred relate primarily to contract termination costs associated with the plant closings and the termination of leasing agreements.

Implementation Costs:

The Company recorded pre-tax implementation costs associated with the restructuring program. These costs include the discontinuance of certain product lines and incremental costs related to the integration and streamlining of functions and closure of facilities. Substantially all implementation costs incurred in 2006 will require cash payments. These costs were recorded on the condensed consolidated statements of earnings as follows:

| | For the Six Months Ended June 30, 2006 | | For the Three Months Ended June 30, 2006 | |
|--|--|-------|--|-------|
| | 2006 (in millions) | 2005 | 2006 | 2005 |
| Net revenues | \$ | \$ 1 | \$ | \$ 1 |
| Cost of sales | 11 | 26 | 5 | 11 |
| Marketing, administration and research costs | 19 | 18 | 12 | 14 |
| Implementation Costs | \$ 30 | \$ 45 | \$ 17 | \$ 26 |

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Asset Impairment Charges:

In July 2006, the Company completed the sale of its pet snacks brand and assets for \$580 million and recorded additional taxes of approximately \$60 million related to the sale. This sale and the additional taxes were recorded in the third quarter of 2006. The Company incurred a pre-tax asset impairment charge of \$86 million in the first quarter of 2006 in recognition of this sale. The charge, which included the write-off of a portion of the associated goodwill, and intangible and fixed assets, was recorded as asset impairment and exit costs on the condensed consolidated statement of earnings.

During the second quarter of 2005, the Company completed the sale of its fruit snacks assets for approximately \$30 million. The Company incurred a pre-tax asset impairment charge of \$93 million in the first quarter of 2005 in recognition of the sale. The charge, which included the write-off of all associated intangible assets, was recorded as asset impairment and exit costs on the condensed consolidated statement of earnings.

During the first quarter of 2006, the Company completed its annual review of goodwill and intangible assets and recorded non-cash pre-tax charges of \$24 million related to an intangible asset impairment for biscuits assets in Egypt and hot cereal assets in the United States. These charges were recorded as asset impairment and exit costs on the condensed consolidated statement of earnings. During the first quarter of 2005, the Company completed its annual review of goodwill and intangible assets and no charges resulted from this review.

Total:

The pre-tax asset impairment, exit and implementation costs discussed above, for the six months and three months ended June 30, 2006 and 2005, were included in the operating companies income of the following segments:

| | For the Six Months Ended June 30, 2006 | | Total Asset Impairment and Exit Costs | Implementation Costs | Total |
|---|---|---------------------|---|-------------------------|--------|
| | Restructuring Costs (in millions) | Asset Impairment | | | |
| North America Beverages | \$ 9 | \$ | \$ 9 | \$ 4 | \$ 13 |
| North America Cheese & Foodservice | 66 | | 66 | 1 | 67 |
| North America Convenient Meals | 52 | | 52 | 4 | 56 |
| North America Grocery | 13 | | 13 | 4 | 17 |
| North America Snacks & Cereals | 15 | 99 | 114 | 4 | 118 |
| European Union | 99 | | 99 | 9 | 108 |
| Developing Markets, Oceania & North Asia | 64 | 11 | 75 | 4 | 79 |
| Total | \$ 318 | \$ 110 | \$ 428 | \$ 30 | \$ 458 |

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

For the Six Months Ended June 30, 2005

| | Restructuring Costs (in millions) | Asset Impairment | Total Asset Impairment and Exit Costs | Implementation Costs | Total |
|---|---|---------------------|---|-------------------------|--------|
| North America Beverages | \$ 4 | \$ | \$ 4 | \$ 3 | \$ 7 |
| North America Cheese & Foodservice | 8 | | 8 | 4 | 12 |
| North America Convenient Meals | 2 | | 2 | 2 | 4 |
| North America Grocery | 11 | 93 | 104 | | 104 |
| North America Snacks & Cereals | 4 | | 4 | 23 | 27 |
| European Union | 47 | | 47 | 10 | 57 |
| Developing Markets, Oceania & North Asia | 10 | | 10 | 3 | 13 |
| Total | \$ 86 | \$ 93 | \$ 179 | \$ 45 | \$ 224 |

For the Three Months Ended June 30, 2006

| | Restructuring Costs (in millions) | Asset Impairment | Total Asset Impairment and Exit Costs | Implementation Costs | Total |
|---|---|---------------------|---|-------------------------|--------|
| North America Beverages | \$ 7 | \$ | \$ 7 | \$ 3 | \$ 10 |
| North America Cheese & Foodservice | 60 | | 60 | (3) | 57 |
| North America Convenient Meals | 35 | | 35 | 4 | 39 |
| North America Grocery | 8 | | 8 | 3 | 11 |
| North America Snacks & Cereals | 10 | | 10 | 3 | 13 |
| European Union | 81 | | 81 | 6 | 87 |
| Developing Markets, Oceania & North Asia | 25 | | 25 | 1 | 26 |
| Total | \$ 226 | \$ | \$ 226 | \$ 17 | \$ 243 |

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

For the Three Months Ended June 30, 2005

| | Restructuring Costs (in millions) | Asset Impairment | Total Asset Impairment and Exit Costs | Implementation Costs | Total |
|---|---|---------------------|---|-------------------------|-------|
| North America Beverages | \$ 1 | \$ | \$ 1 | \$ 2 | \$ 3 |
| North America Cheese & Foodservice | 1 | | 1 | 1 | 2 |
| North America Convenient Meals | | | | 1 | 1 |
| North America Grocery | 3 | | 3 | | 3 |
| North America Snacks & Cereals | | | | 14 | 14 |
| European Union | 17 | | 17 | 6 | 23 |
| Developing Markets, Oceania & North Asia | 7 | | 7 | 2 | 9 |
| Total | \$ 29 | \$ | \$ 29 | \$ 26 | \$ 55 |

Note 3. Related Party Transactions:

At June 30, 2006, Altria Group, Inc. owned 88.1% of the Company's outstanding shares of capital stock. Altria Group, Inc.'s subsidiary, Altria Corporate Services, Inc., provides the Company with various services, including planning, legal, treasury, auditing, insurance, human resources, office of the secretary, corporate affairs, information technology, aviation and tax services. Billings for these services, which were based on the cost to Altria Corporate Services, Inc. to provide such services and a 5% management fee based on wages and benefits, were \$102 million and \$126 million for the six months ended June 30, 2006 and 2005, respectively, and \$50 million and \$63 million for the three months ended June 30, 2006 and 2005, respectively.

At June 30, 2006, the Company had short-term amounts payable to Altria Group, Inc. of \$485 million. The amounts payable to Altria Group, Inc. generally include accrued dividends, taxes and service fees. Interest on intercompany borrowings is based on the applicable London Interbank Offered Rate.

In the second quarter of 2006, the Company purchased certain real estate and certain personal property located in Wilkes Barre, Pennsylvania, from Altria Corporate Services, Inc., for an aggregate purchase price of \$9.3 million. In addition, during the second quarter of 2006, the Company assumed all of Altria Corporate Services, Inc.'s rights under a lease for certain real property located in San Antonio, Texas. The Company also purchased certain personal property located in San Antonio, Texas from Altria Corporate Services, Inc., for an aggregate purchase price of \$6.0 million.

Also, see Note 12. *Income Taxes* regarding the impact to the Company of the closure of an Internal Revenue Service review of Altria Group, Inc.'s consolidated federal income tax return recorded during the first quarter of 2006.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 4. Divestitures:*Discontinued Operations:*

In June 2005, the Company sold substantially all of its sugar confectionery business for pre-tax proceeds of approximately \$1.4 billion. The sale included the *Life Savers*, *Crema Savers*, *Altoids*, *Trolli* and *Sugus* brands. The Company has reflected the results of its sugar confectionery business prior to the closing date as discontinued operations on the condensed consolidated statements of earnings.

Summary results of operations for the sugar confectionery business were as follows:

| | For the Six Months Ended June 30, 2005 (in millions) | For the Three Months Ended June 30, 2005 |
|--|--|---|
| Net revenues | \$ 228 | \$ 112 |
| Earnings before income taxes | \$ 41 | \$ 19 |
| Provision for income taxes | (16) | (8) |
| Loss on sale of discontinued operations | (297) | (297) |
| Loss from discontinued operations, net of income taxes | \$ (272) | \$ (286) |

The loss on sale of discontinued operations, above, for the six months and three months ended June 30, 2005, related largely to taxes on the transaction.

Other:

During the second quarter of 2006, the Company sold its industrial coconut assets. During the first quarter of 2006, the Company sold certain Canadian assets and a small U.S. biscuit brand, and incurred pre-tax asset impairment charges of \$176 million in the fourth quarter of 2005 in recognition of these sales. During the second quarter of 2005, the Company sold its fruit snacks assets and incurred a pre-tax asset impairment charge of \$93 million in the first quarter of 2005 in recognition of this sale. During the first quarter of 2005, the Company sold its U.K. desserts assets, its U.S. yogurt assets and a minor trademark in Mexico. The aggregate proceeds received from these sales during the first six months of 2006 and 2005 were \$91 million and \$221 million, respectively. The Company recorded pre-tax losses from sales of businesses of \$11 million during the first six months of 2006, and recorded pre-tax gains from sales of businesses of \$115 million during the first six months of 2005.

In July 2006, the Company completed the sale of its pet snacks brand and assets for \$580 million and recorded additional taxes of approximately \$60 million related to the sale. This sale and the additional taxes were recorded in the third quarter of 2006. The Company incurred a pre-tax asset impairment charge of \$86 million in the first quarter of 2006 in recognition of this sale.

The operating results of the other divestitures, discussed above, in the aggregate, were not material to the Company's consolidated financial position, results of operations or cash flows in any of the periods presented.

Note 5. Stock Plans:

Under the Kraft 2005 Performance Incentive Plan (the 2005 Plan), the Company may grant to eligible employees awards of stock options, stock appreciation rights, restricted stock, restricted and deferred stock units, and other awards based on the Company's Class A common stock, as well

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as performance-based annual and long-term incentive awards. A maximum of 150 million shares of the Company's Class A common stock may be issued under the 2005 Plan, of which no more than 45 million shares may be awarded as restricted stock. In addition, under the Kraft 2006 Stock Compensation Plan for Non-Employee Directors (the 2006 Directors Plan), the Company may grant up to 500,000 shares of Class A common stock to members of the Board of Directors who are not full-time employees of the Company or Altria Group, Inc., or their subsidiaries, over a five-year period. Shares available to be granted under the 2005 Plan and the 2006 Directors Plan at June 30, 2006, were 143,326,485 and 481,555, respectively. Restricted shares available for grant under the 2005 Plan at June 30, 2006, were 38,326,485.

Kraft Foods Inc. and Subsidiaries

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Generally, stock options are granted at an exercise price equal to the fair value of the underlying stock on the date of the grant, become exercisable on the first anniversary of the grant date and have a maximum term of ten years. However, the Company has not granted stock options to its employees since 2002. Restricted stock generally vests on the third anniversary of the grant date.

Stock Option Plan

Stock option activity was as follows for the six months ended June 30, 2006:

| | Shares Subject to Option | Weighted Average Exercise Price | Average Remaining Contractual Term | Aggregate Intrinsic Value |
|------------------------------|--------------------------|---------------------------------|------------------------------------|---------------------------|
| Balance at January 1, 2006 | 15,145,840 | \$ 31.00 | | |
| Options exercised | (133,750) | 31.00 | | |
| Options cancelled | (324,910) | 31.00 | | |
| Balance at June 30, 2006 | 14,687,180 | 31.00 | 5 years | \$ |
| Exercisable at June 30, 2006 | 14,687,180 | 31.00 | 5 | |

The total intrinsic value of options exercised was \$0.1 million and \$0.6 million during the six months ended June 30, 2006 and 2005, respectively, and \$0.1 million and \$0.2 million, during the three months ended June 30, 2006 and 2005, respectively.

Prior to the initial public offering (IPO), certain employees of the Company participated in Altria Group, Inc. s stock compensation plans. Altria Group, Inc. does not intend to issue additional Altria Group, Inc. stock compensation to the Company s employees, except for reloads of previously issued options.

Pre-tax compensation cost and the related tax benefit for Altria stock option awards for reloads totaled \$2.0 million and \$0.7 million, respectively, for the six months ended June 30, 2006 and \$0.6 million and \$0.2 million, respectively, for the three months ended June 30, 2006. The fair value of the awards was determined using a modified Black-Scholes methodology using the following assumptions for Altria Group, Inc. common stock:

| | Risk-Free Interest Rate | Weighted Average Expected Life | Expected Volatility | Expected Dividend Yield | Fair Value at Grant Date |
|-------------------------|-------------------------|--------------------------------|---------------------|-------------------------|--------------------------|
| 2006 Altria Group, Inc. | 4.88 | % 4 years | 26.54 | % 4.44 | % \$ 12.56 |
| 2005 Altria Group, Inc. | 3.73 | 4 | 33.79 | 4.43 | 13.98 |

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Kraft Foods Inc. and Subsidiaries

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The Company's employees held options to purchase the following number of shares of Altria Group, Inc. stock at June 30, 2006:

| | Shares Subject to Option | Weighted Average Exercise Price | Average Remaining Contractual Term | Aggregate Intrinsic Value |
|------------------------------|--------------------------|---------------------------------|------------------------------------|---------------------------|
| Balance at June 30, 2006 | 18,313,200 | \$ 40.25 | 3 years | \$608 million |
| Exercisable at June 30, 2006 | 18,205,817 | 40.06 | 3 | 608 |

Restricted Stock Plans

The Company may grant shares of restricted stock and rights to receive shares of stock to eligible employees, giving them in most instances all of the rights of stockholders, except that they may not sell, assign, pledge or otherwise encumber such shares and rights. Such shares and rights are subject to forfeiture if certain employment conditions are not met.

The fair value of the restricted shares and rights at the date of grant is amortized to expense ratably over the restriction period. The Company recorded pre-tax compensation expense related to restricted stock and rights of \$61 million (including the pre-tax cumulative effect gain of \$9 million from the adoption of SFAS No. 123(R)) and \$76 million for the six months ended June 30, 2006 and 2005, respectively, and \$38 million for the three months ended June 30, 2006 and 2005. The deferred tax benefit recorded related to this compensation expense was \$22 million and \$28 million for the six months ended June 30, 2006 and 2005, respectively, and \$14 million, for the three months ended June 30, 2006 and 2005. The unamortized compensation expense related to the Company's restricted stock and rights was \$292 million at June 30, 2006 and is expected to be recognized over a weighted average period of two years.

The Company's restricted stock and rights activity was as follows for the six months ended June 30, 2006:

| | Number of Shares | Weighted-Average Grant Date Fair Value Per Share |
|----------------------------|------------------|--|
| Balance at January 1, 2006 | 15,085,116 | \$ 33.80 |
| Granted | 6,776,035 | 29.12 |
| Vested | (4,007,117) | 36.50 |
| Forfeited | (1,400,728) | 32.62 |
| Balance at June 30, 2006 | 16,453,306 | 31.32 |

The weighted average grant date fair value of restricted stock and rights granted during the six months ended June 30, 2006 and 2005 was \$197 million and \$196 million, respectively, or \$29.12 and \$33.31 per restricted share or right, respectively. The total fair value of restricted stock and rights vested during the six months ended June 30, 2006 and 2005 was \$117 million and \$1 million, respectively.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 6. Earnings Per Share:

Basic and diluted EPS from continuing and discontinued operations were calculated using the following:

| | For the Six Months Ended | |
|---|-----------------------------------|----------|
| | June 30, 2006 (in millions) | 2005 |
| Earnings from continuing operations | \$ 1,688 | \$ 1,457 |
| Loss from discontinued operations | | (272) |
| Net earnings | \$ 1,688 | \$ 1,185 |
| Weighted average shares for basic EPS | 1,652 | 1,694 |
| Plus incremental shares from assumed conversions of stock options, restricted stock and stock rights | 9 | 7 |
| Weighted average shares for diluted EPS | 1,661 | 1,701 |

| | For the Three Months Ended | |
|---|-----------------------------------|--------|
| | June 30, 2006 (in millions) | 2005 |
| Earnings from continuing operations | \$ 682 | \$ 758 |
| Loss from discontinued operations | | (286) |
| Net earnings | \$ 682 | \$ 472 |
| Weighted average shares for basic EPS | 1,647 | 1,691 |
| Plus incremental shares from assumed conversions of stock options, restricted stock and stock rights | 9 | 7 |
| Weighted average shares for diluted EPS | 1,656 | 1,698 |

For the three months ended June 30, 2006 and 2005, the number of stock options excluded from the calculation of weighted average shares for diluted EPS because their effects were antidilutive (i.e. the cash that would be received upon exercise is greater than the average market price of the stock during the period) was immaterial.

Note 7. Contingencies:

Kraft and its subsidiaries are parties to a variety of legal proceedings arising out of the normal course of business, including a few cases in which substantial amounts of damages are sought. While the results of litigation cannot be predicted with certainty, management believes that the final outcome of these proceedings will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Third-Party Guarantees: At June 30, 2006, the Company's third-party guarantees, which are primarily derived from acquisition and divestiture activities, approximated \$24 million. Substantially all of these guarantees expire through 2013, with \$12 million expiring through June 30, 2007. The Company is required to perform under these guarantees in the event that a third party fails to make contractual payments or achieve performance measures. The Company has a liability of \$16 million on its condensed consolidated balance sheet at June 30, 2006, relating to these guarantees.

Kraft Foods Inc. and Subsidiaries

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Note 8. Goodwill and Other Intangible Assets, Net:

Goodwill by reportable segment was as follows:

| | June 30, 2006 (in millions) | December 31, 2005 |
|--|--------------------------------|-------------------|
| North America Beverages | \$ 1,372 | \$ 1,372 |
| North America Cheese & Foodservice | 4,227 | 4,216 |
| North America Convenient Meals | 2,167 | 2,167 |
| North America Grocery | 3,058 | 3,058 |
| North America Snacks & Cereals | 8,965 | 8,990 |
| European Union | 4,178 | 3,858 |
| Developing Markets, Oceania & North Asia | 1,018 | 987 |
| Total goodwill | \$ 24,985 | \$ 24,648 |

Intangible assets were as follows:

| | June 30, 2006 Gross Carrying Amount (in millions) | Accumulated Amortization | December 31, 2005 Gross Carrying Amount | Accumulated Amortization |
|-----------------------------------|---|-----------------------------|--|-----------------------------|
| Non-amortizable intangible assets | \$ 10,399 | | \$ 10,482 | |
| Amortizable intangible assets | 94 | \$ 65 | 95 | \$ 61 |
| Total intangible assets | \$ 10,493 | \$ 65 | \$ 10,577 | \$ 61 |

Non-amortizable intangible assets consist substantially of brand names purchased through the Nabisco acquisition. Amortizable intangible assets consist primarily of certain trademark licenses and non-compete agreements. Amortization expense for intangible assets was \$5 million for the six months ended June 30, 2006 and 2005, and \$3 million and \$2 million for the three months ended June 30, 2006 and 2005, respectively. Amortization expense for each of the next five years is currently estimated to be approximately \$10 million or less.

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The movement in goodwill and gross carrying amount of intangible assets from December 31, 2005, is as follows:

| | Goodwill (in millions) | Intangible Assets |
|------------------------------|---------------------------|----------------------|
| Balance at December 31, 2005 | \$ 24,648 | \$ 10,577 |
| Changes due to: | | |
| Currency | 348 | (3) |
| Asset impairment | (25) | (79) |
| Other | 14 | (2) |
| Balance at June 30, 2006 | \$ 24,985 | \$ 10,493 |

Note 9. Segment Reporting:

The Company manufactures and markets packaged food products, consisting principally of beverages, cheese, snacks, convenient meals and various packaged grocery products. Kraft manages and reports operating results through two units, Kraft North America Commercial and Kraft International Commercial. Reportable segments for Kraft North America Commercial are organized and managed principally by product category. Kraft International Commercial's operations are organized and managed by geographic location.

In October 2005, the Company announced that, effective January 1, 2006, its Canadian business will be realigned to better integrate it into the Company's North American business by product category. Beginning in the first quarter of 2006, the operating results of the Canadian business are being reported throughout the North American food segments. In addition, in the first quarter of 2006, the Company's international businesses were realigned to reflect the reorganization announced within Europe in November 2005. The two revised international segments are European Union; and Developing Markets, Oceania & North Asia, the latter to reflect the Company's increased management focus on developing markets. Accordingly, prior period segment results have been restated.

The Company's management uses operating companies income, which is defined as operating income before general corporate expenses and amortization of intangibles, to evaluate segment performance and allocate resources. Management believes it is appropriate to disclose this measure to help investors analyze the business performance and trends of the various business segments. Interest and other debt expense, net, and provision for income taxes are centrally managed and, accordingly, such items are not presented by segment since they are not included in the measure of segment profitability reviewed by management.

Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Segment data were as follows:

| | For the Six Months Ended | |
|---|--------------------------|------------------|
| | June 30, 2006 | 2005 |
| | (in millions) | |
| Net revenues: | | |
| North America Beverages | \$ 1,614 | \$ 1,543 |
| North America Cheese & Foodservice | 2,964 | 2,977 |
| North America Convenient Meals | 2,444 | 2,286 |
| North America Grocery | 1,422 | 1,549 |
| North America Snacks & Cereals | 3,144 | 2,949 |
| European Union | 3,006 | 3,203 |
| Developing Markets, Oceania & North Asia | 2,148 | 1,886 |
| Net revenues | \$ 16,742 | \$ 16,393 |
| Earnings from continuing operations before income taxes and minority interest: | | |
| Operating companies income: | | |
| North America Beverages | \$ 262 | \$ 288 |
| North America Cheese & Foodservice | 382 | 450 |
| North America Convenient Meals | 385 | 382 |
| North America Grocery | 498 | 411 |
| North America Snacks & Cereals | 411 | 437 |
| European Union | 215 | 387 |
| Developing Markets, Oceania & North Asia | 133 | 153 |
| Amortization of intangibles | (5) | (5) |
| General corporate expenses | (86) | (96) |
| Operating income | 2,195 | 2,407 |
| Interest and other debt expense, net | (243) | (350) |
| Earnings from continuing operations before income taxes and minority interest | \$ 1,952 | \$ 2,057 |
| For the Three Months Ended | | |
| | June 30, | |
| | 2006 | 2005 |
| | (in millions) | |
| Net revenues: | | |
| North America Beverages | \$ 819 | \$ 771 |
| North America Cheese & Foodservice | 1,495 | 1,487 |
| North America Convenient Meals | 1,230 | 1,146 |
| North America Grocery | 790 | 830 |
| North America Snacks & Cereals | 1,611 | 1,517 |
| European Union | 1,539 | 1,589 |
| Developing Markets, Oceania & North Asia | 1,135 | 994 |
| Net revenues | \$ 8,619 | \$ 8,334 |

Kraft Foods Inc. and Subsidiaries

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(Unaudited)

| | For the Three Months Ended | |
|---|-----------------------------------|-------------|
| | June 30, | |
| | 2006 | 2005 |
| | (in millions) | |
| Earnings from continuing operations before income taxes and minority interest: | | |
| Operating companies income: | | |
| North America Beverages | \$ 115 | \$ 126 |
| North America Cheese & Foodservice | 179 | 231 |
| North America Convenient Meals | 185 | 184 |
| North America Grocery | 294 | 279 |
| North America Snacks & Cereals | 269 | 238 |
| European Union | 86 | 142 |
| Developing Markets, Oceania & North Asia | 98 | 105 |
| Amortization of intangibles | (3) | (2) |
| General corporate expenses | (46) | (53) |
| Operating income | 1,177 | 1,250 |
| Interest and other debt expense, net | (147) | (174) |
| Earnings from continuing operations before income taxes and minority interest | \$ 1,030 | \$ 1,076 |

As discussed in Note 2. *Asset Impairment, Exit and Implementation Costs*, the Company recorded asset impairment, exit and implementation costs of \$458 million and \$243 million, respectively, during the six months and three months ended June 30, 2006, and \$224 million and \$55 million, respectively, during the six months and three months ended June 30, 2005. See Note 2 for a breakdown of these pre-tax charges by segment.

During the second quarter of 2006, the Company sold its industrial coconut assets and recorded a pre-tax loss of \$8 million. This loss is included in the operating companies income of the North America Cheese & Foodservice segment. During the first quarter of 2006, the Company sold certain Canadian assets and recorded a pre-tax loss of \$1 million. This loss is included in the operating companies income of the North America Grocery segment. In addition, during the first quarter of 2006, the Company sold a small U.S. biscuit brand, resulting in a pre-tax loss of \$2 million. This loss is included in the operating companies income of the North America Snacks & Cereals segment.

During the second quarter of 2005, the Company sold its fruit snacks assets and recorded a pre-tax loss of \$2 million. This loss is included in the operating companies income of the North America Grocery segment. Also in the second quarter of 2005, the Company recorded a pre-tax gain of \$1 million from the sale of its U.S. yogurt assets. This gain is included in the operating companies income of the North America Cheese & Foodservice segment. During the first quarter of 2005, the Company sold its U.K. desserts assets and recorded a pre-tax gain of \$115 million. This gain is included in the operating companies income of the European Union segment. In addition, the Company sold a minor trademark in Mexico, resulting in a pre-tax gain of \$1 million. This gain is included in the operating companies income of the Developing Markets, Oceania & North Asia segment.

Kraft Foods Inc. and Subsidiaries

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Net revenues by consumer sector, which include the separation of Foodservice into sector components, were as follows (in millions):

| | For the Six Months Ended June 30, 2006 | | | For the Six Months Ended June 30, 2005 | | |
|------------------|---|--------------------------------------|-----------|---|--------------------------------------|-----------|
| | Kraft North America Commercial | Kraft International Commercial | Total | Kraft North America Commercial | Kraft International Commercial | Total |
| Consumer Sector: | | | | | | |
| Snacks | \$ 2,622 | \$ 1,994 | \$ 4,616 | \$ 2,502 | \$ 1,883 | \$ 4,385 |
| Beverages | 1,744 | 1,868 | 3,612 | 1,671 | 1,829 | 3,500 |
| Cheese & Dairy | 2,343 | 744 | 3,087 | 2,341 | 765 | 3,106 |
| Grocery | 2,295 | 369 | 2,664 | 2,345 | 420 | 2,765 |
| Convenient Meals | 2,584 | 179 | 2,763 | 2,445 | 192 | 2,637 |
| Net revenues | \$ 11,588 | \$ 5,154 | \$ 16,742 | \$ 11,304 | \$ 5,089 | \$ 16,393 |

| | For the Three Months Ended June 30, 2006 | | | For the Three Months Ended June 30, 2005 | | |
|------------------|---|--------------------------------------|----------|---|--------------------------------------|----------|
| | Kraft North America Commercial | Kraft International Commercial | Total | Kraft North America Commercial | Kraft International Commercial | Total |
| Consumer Sector: | | | | | | |
| Snacks | \$ 1,358 | \$ 986 | \$ 2,344 | \$ 1,295 | \$ 886 | \$ 2,181 |
| Beverages | 890 | 994 | 1,884 | 840 | 964 | 1,804 |
| Cheese & Dairy | 1,171 | 386 | 1,557 | 1,147 | 396 | 1,543 |
| Grocery | 1,222 | 204 | 1,426 | 1,240 | 227 | 1,467 |
| Convenient Meals | 1,304 | 104 | 1,408 | 1,229 | 110 | 1,339 |
| Net revenues | \$ 5,945 | \$ 2,674 | \$ 8,619 | \$ 5,751 | \$ 2,583 | \$ 8,334 |

Note 10. Financial Instruments:

During the six months and three months ended June 30, 2006 and 2005, ineffectiveness related to cash flow hedges was not material. At June 30, 2006, the Company was hedging forecasted transactions for periods not exceeding the next eighteen months and expects substantially all amounts reported in accumulated other comprehensive earnings (losses) to be reclassified to the consolidated statement of earnings within the next twelve months.

Kraft Foods Inc. and Subsidiaries

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(Unaudited)

Hedging activities affected accumulated other comprehensive earnings (losses), net of income taxes, as follows:

| | For the Six Months Ended June 30, 2006 (in millions) | | For the Three Months Ended June 30, 2006 | |
|---|---|-------|--|-------|
| | 2005 | | 2005 | |
| (Loss) gain at beginning of period | \$ (4) | \$ 6 | \$ | \$ 27 |
| Derivative losses (gains) transferred to earnings | 10 | (12) | 1 | (15) |
| Change in fair value | (9) | 20 | (4) | 2 |
| (Loss) gain as of June 30 | \$ (3) | \$ 14 | \$ (3) | \$ 14 |

Note 11. Benefit Plans:

The Company sponsors noncontributory defined benefit pension plans covering substantially all U.S. employees. Pension coverage for employees of the Company's non-U.S. subsidiaries is provided, to the extent deemed appropriate, through separate plans, many of which are governed by local statutory requirements. In addition, the Company's U.S. and Canadian subsidiaries provide health care and other benefits to substantially all retired employees. Health care benefits for retirees outside the United States and Canada are generally covered through local government plans.

*Pension Plans***Components of Net Periodic Benefit Cost**

Net periodic pension cost consisted of the following for the six months and three months ended June 30, 2006 and 2005:

| | U.S. Plans For the Six Months Ended June 30, 2006 (in millions) | | Non-U.S. Plans For the Six Months Ended June 30, 2006 | |
|---|---|--------|--|-------|
| | 2005 | | 2005 | |
| Service cost | \$ 85 | \$ 82 | \$ 46 | \$ 41 |
| Interest cost | 177 | 173 | 83 | 86 |
| Expected return on plan assets | (252) | (254) | (99) | (97) |
| Amortization: | | | | |
| Unrecognized net loss from experience differences | 99 | 83 | 34 | 24 |
| Prior service cost | 3 | 2 | 4 | 4 |
| Other expense | | 11 | | 4 |
| Net periodic pension cost | \$ 112 | \$ 97 | \$ 68 | \$ 62 |

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| | U.S. Plans For the Three Months Ended June 30, 2006 (in millions) | | Non-U.S. Plans For the Three Months Ended June 30, 2006 | |
|---|---|--------|--|-------|
| | 2006 | 2005 | 2006 | 2005 |
| Service cost | \$ 41 | \$ 40 | \$ 23 | \$ 21 |
| Interest cost | 88 | 85 | 42 | 43 |
| Expected return on plan assets | (127) | (128) | (50) | (49) |
| Amortization: | | | | |
| Unrecognized net loss from experience differences | 51 | 42 | 17 | 12 |
| Prior service cost | 2 | 1 | 2 | 2 |
| Other expense | | | | 3 |
| Net periodic pension cost | \$ 55 | \$ 40 | \$ 34 | \$ 32 |

Other expense, above, is due primarily to additional pension benefits related to workforce reduction programs under the Company's restructuring program and is included as part of asset impairment and exit costs.

Employer Contributions

The Company presently makes, and plans to make, contributions, to the extent that they are tax deductible and do not generate an excise tax liability, in order to maintain plan assets in excess of the accumulated benefit obligation of its funded U.S. and non-U.S. plans. During the six months ended June 30, 2006, approximately \$135 million and approximately \$50 million of employer contributions were made to U.S. plans and non-U.S. plans, respectively. Currently, the Company anticipates making additional contributions of approximately \$15 million during the remainder of 2006 to its U.S. plans and approximately \$60 million during the remainder of 2006 to its non-U.S. plans, based on current tax law. However, these estimates are subject to change as a result of many factors, including changes in tax and other benefit laws, as well as asset performance significantly above or below the assumed long-term rate of return on pension assets, or significant changes in interest rates. During the six months ended June 30, 2005, approximately \$200 million and approximately \$50 million of employer contributions were made to U.S. plans and non-U.S. plans, respectively.

Postretirement Benefit Plans

Net postretirement health care costs consisted of the following for the six months and three months ended June 30, 2006 and 2005:

| | For the Six Months Ended June 30, 2006 (in millions) | | For the Three Months Ended June 30, 2006 | |
|---------------|---|-------|--|-------|
| | 2006 | 2005 | 2006 | 2005 |
| Service cost | \$ 25 | \$ 24 | \$ 12 | \$ 12 |
| Interest cost | 87 | 85 | 42 | 42 |
| Amortization: | | | | |

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| | | | | |
|---|--------|--------|-------|-------|
| Unrecognized net loss from experience differences | 41 | 29 | 16 | 15 |
| Unrecognized prior service cost | (13) | (12) | (7) | (6) |
| Net postretirement health care costs | \$ 140 | \$ 126 | \$ 63 | \$ 63 |

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(Unaudited)

Note 12. Income Taxes:

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. The U.S. accounts of the Company are included in the consolidated federal income tax return of Altria Group, Inc. Income taxes are generally computed on a separate company basis. To the extent that foreign tax credits, capital losses and other credits generated by the Company, which cannot currently be utilized on a separate company basis, are utilized in Altria Group, Inc.'s consolidated federal income tax return, the benefit is recognized in the calculation of the Company's provision for income taxes. The Company makes payments to, or is reimbursed by, Altria Group, Inc. for the tax effects resulting from its inclusion in Altria Group, Inc.'s consolidated federal income tax return, including current taxes payable and net changes in tax provisions. Significant judgment is required in determining income tax provisions and in evaluating tax positions. The Company establishes additional provisions for income taxes when, despite the belief that existing tax positions are fully supportable, there remain certain positions that are likely to be challenged and that may not be sustained on review by tax authorities. The Company evaluates and potentially adjusts these provisions in light of changing facts and circumstances. The consolidated tax provision includes the impact of changes to accruals deemed necessary. Upon the closure of current and future tax audits in various jurisdictions, significant income tax accrual reversals could continue to occur, which could trigger cash reimbursements from Altria Group, Inc.

The Company is regularly audited by federal, state and foreign tax authorities, and these audits are at various stages at any given time. Any tax contingency reserves in excess of additional assessed liabilities will be reversed at the time the audits close.

In the first quarter of 2006, the United States Internal Revenue Service concluded its examination of Altria Group, Inc.'s consolidated tax returns for the years 1996 through 1999 and issued a final Revenue Agents Report on March 15, 2006. Consequently, Altria Group, Inc. reimbursed the Company in cash for unrequired federal tax reserves of \$337 million and pre-tax interest of \$46 million (\$29 million after-tax). The Company also recognized net state tax reversals of \$39 million, resulting in a total net earnings benefit of \$405 million or \$0.24 per diluted share, for the six months ended June 30, 2006.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for the Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109, which will become effective for the Company on January 1, 2007. The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. The Company and Altria Group, Inc. are presently evaluating the impact of FASB Interpretation No. 48 and currently believe that its adoption will result in an increase to shareholders' equity on January 1, 2007, which might be significant.

Note 13. Subsequent Events:

United Biscuits Agreement

In July 2006, the Company announced an agreement with United Biscuits (UB) to acquire the Spanish and Portuguese operations of UB, and rights to all Nabisco trademarks in the European Union, Eastern Europe, the Middle East and Africa, which UB has held since 2000, for a total cost of approximately \$1.07 billion.

The Spanish and Portuguese operations of UB include its biscuits, dry desserts, canned meats, tomato and fruit juice businesses as well as seven UB manufacturing facilities and 1,300 employees. Together, these businesses generated net revenues of approximately \$400 million in 2005.

The acquisition will be financed by the Company's assumption of approximately \$548 million of debt issued by the acquired business immediately prior to the acquisition, as well as \$522 million of value for the redemption of the Company's outstanding investment in UB, primarily deep-discount securities. The redemption of the Company's interest in UB is expected to result in a gain on closing of approximately \$0.13 per diluted share, subject to currency movements and the finalization of income tax effects.

The transaction is expected to close in the third quarter of 2006, pending regulatory approval.

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Kraft Foods Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Rice Sale

On July 27, 2006, the Company announced that it had agreed to sell its rice brand and assets for approximately \$280 million. The transaction, which is subject to regulatory review, is expected to result in an after-tax gain of approximately \$160 million.

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PART II - OTHER INFORMATION

Item 6. Exhibits.

- 31.1 Certification of the Registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Registrant's Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Registrant's Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signature

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

KRAFT FOODS INC.

/s/ JAMES P. DOLLIVE

James P. Dollive, Executive Vice President and
Chief Financial Officer

August 9, 2006