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**PAAinE DISCUSSION PAPER (DP) - DISTINGUISHING BETWEEN
LIABILITIES AND EQUITY**

Ladies and Gentlemen,

We welcome the publication of this discussion paper of the Accounting Standards Committee of Germany by EFRAG. We outline some general considerations below and then answer your specific questions.

1. GENERAL COMMENTS

While we acknowledge that the current definitions of liabilities and equity have some shortcomings, we do not consider that the loss absorption approach would represent a robust concept for distinguishing liabilities from equity. In particular, we believe that the loss absorption approach would result in a residual definition of liabilities whereas both liabilities and equity should be defined. Moreover the loss absorption approach ignores the participation in profits, focuses on the liquidation (which contradicts the going concern concept) and would be difficult to apply in consolidated financial statements because it is more geared towards an individual entity. Nevertheless we consider that the loss absorption approach may be a good principle to solve the specific issue of puttable instruments.

In any case, we believe that the distinction between liabilities and equity could continue to be based on IAS 32 and there is no need for a fundamental review of this apart from the previously mentioned shortcomings and, especially, the issue of puttable instruments.

2. ANSWERS TO SPECIFIC QUESTIONS AND OTHER POINTS

Question 1

We agree and consider that it is necessary to define two different classes of capital on the credit side of the balance sheet because of the different economic characteristics of the funds provided on the one hand by the owners or members of entity and on the other hand by financial institutions and suppliers.

Question 2

We believe that the listing of claims and their ranking by a criterion (that has yet to be defined) might in theory provide useful information. However this would raise issues of comparability across different types of entities and we doubt that this could be achieved from a practical point of view. Therefore, we would favour to maintain two classes on the balance sheet and to give additional information about ranking in the notes.

Question 3

We consider that the analysis of the characteristics is relevant but we would like to suggest a hierarchy among the characteristics.

We consider that instruments that confer social rights such as participation at a shareholders or partners' meeting and / or control rights have equity characteristics as noted on the table of para. 1.11. Therefore these characteristics should prevail over financial characteristics such as repayment features. Although those social rights are indeed conferred by law, we do not believe that this could be seen as a prominence of the legal form. On the contrary the economic substance of the legal effects demonstrates that those instruments should, indeed, be classified as equity. This is especially the case of investments in legal entities such as co-operatives, and partnerships such as "Kommanditgesellschaften" or "sociétés en commandite" that are very common in Continental Europe.

As regards the instruments that confer only financial rights we consider that those which have no redemption features or that are redeemable only out of an excess of liquidation have predominantly equity characteristics.

Question 4

We agree and consider that in case one or more capital criterion is used, a combined definition needs to be applied.

Question 5

While we agree that a view should be selected, we consider that a more thorough discussion is needed in the context of the conceptual framework project. In relation to this, we would recommend that a general discussion should take place and we believe that even with an entity view as currently expressed by IAS 32, a proprietary view could also be considered as it is a subset of the entity view.

Question 6

We agree that the needs of the users should be addressed. However, as already said in our answer to question 3 above, the economic effects of legal characteristics have a great importance especially when they deal with preferred instruments that have limitation on the distribution to the shareholders. These issues have to be properly addressed because these are important for preparers, rating agencies and regulators.

Question 7

We agree that the distinction based on risk capital is important because users rely on it for their assessment.

Question 8

We doubt whether the definition of accounting losses is robust enough to prevent structuring where accounting losses deviate substantially from economic losses. As stated in the paper the operationalisation has yet to be reviewed.

Question 9

We do not agree that the loss absorption approach is explained clearly enough because we do not see why the participation in profit has not been considered. We believe that a criterion of classification between equity and liabilities cannot be asymmetrical. This creates a bias towards conservatism and does not reflect the economic substance of the legal rights conferred by the equity instruments that participate both in profit and losses.

Question 10

We agree that the classification of an instrument as equity or liability should be based on the terms and conditions of the instrument.

Question 11

We agree that linkage should be considered especially when the substance of certain transactions establishes that some instruments constitute a single one, while this could prove to be difficult where no contracts are in place.

Question 12

We agree with the discussion on split accounting, i.e., that equity and liability elements must be separated.

Question 13

We believe that the loss absorption approach would be difficult to apply in complex groups because the equity of the parent may not be loss-absorbing for the equity of the subsidiaries, neither the equity of the subsidiaries would absorb the equity of the parent. Subject to our remark to question 9, a similar approach that would also consider profit features may work in individual entities.

Question 14

We have doubts and consider that the example mostly illustrate the complexity of the loss-absorption approach. Examples for other instruments such as preferred shares should also be prepared.

Question 15

As expressed above in this comment letter, we have doubts that the loss absorption approach might be a possible general definition of equity but it might be useful in order to solve the puttable instruments issue. However a robust definition of liabilities would be equally needed, we believe that the loss absorption approach has too many shortcomings to represent a viable solution.

Finally we disagree that it is the role of accounting standard setters to limit structuring opportunities. The objective of standard setters should be to issue standards that are practicable for the preparers, understandable for the users and enforceable for the regulators. However, standards should be established with the presumptions that they will be applied in good faith and they should not contain anti-abuse clauses. It is then the role of auditors and regulators to prevent structuring that defeats the clauses of the standards.

Question 16

As said in our answer to question 14 above, more application examples should be papered to give a full visibility of the loss absorption approach.

Question 17

We agree with the shortcomings of the current IFRS doctrine regarding liabilities and equity.


Question 18

As said in our answer to question 15, we consider that the loss absorption approach, or a modification thereof, could be useful to solve the issue of puttable instruments but we consider that, due to its shortcomings it could not be used a single conceptual approach to distinguish liabilities and equity.

Thank you very much for your attention to the above.

Yours very truly,

NESTLE S.A.



H. Wirz

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