NESTLÉ S.A.

HERMANN WIRZ
SENIOR VICE PRESIDENT

EFRAG
13 - 14 Avenue des Arts

B 1210 - BRUXELLES

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PAAinE DISCUSSION PAPER (DP) - THE FINANCIAL REPORTING OF PENSIONS

Ladies and Gentlemen,

We welcome the work of the ASB and the publication of this paper by EFRAG. We outline some general considerations below and then answer your specific questions.

1. GENERAL COMMENTS

While we consider that the DP without doubt contributes to the improvement of the financial reporting of pension assets and liabilities when it suggests to remove the "corridor", we regret that it pre-empts on the financial reporting debate by considering a single statement of comprehensive income as granted, ignoring the fact the preparers and many analysts consider that the Income Statement and the Statement of Recognised Income and Expense, SORIE (or Statement of Other Comprehensive Income, OCI) should be maintained. Consequently the DP dismisses important issues such as the recycling of actuarial gains and losses and the treatment of pension plan investments as Available-for-Sale instruments in accordance with IAS 39.

Expressed otherwise, we regret that the DP goes into the direction of full fair value accounting and consequently fails to recognise that pension assets and liabilities and their consequential income and expenses refer to liabilities that will crystallise only in a very long time frame of some 25 years or even more and consequently introduce unwarranted volatility in the accounts of enterprises.

AVENUE NESTLÉ 55 CH-1800 VEVEY (SWITZERLAND) TELEPHONE 021 924 21 11 TELEFAX 021 921 18 85

2. ANSWERS TO SPECIFIC QUESTIONS AND OTHER POINTS

Chapter 2: Liabilities to pay benefits

Question 1 – Should a liability to pay benefits that is recognised be based on expectations of employees' pensionable salaries when they leave service, or on current salaries (including non - discretionary increases)?

We would see this issue as a measurement one. Accordingly, the liability for pension benefits should be aligned with near retirement salaries which take into account expected future increases based on a constructive obligation. We consider that those future salary increases should be restricted to inflation and general changes of an entity's salary scale because there is a valid expectation from the employees that they would receive such increases (constructive obligation).
Conversely we do not believe that salary increases related to promotions should be included because they may or may not happen in future and the degree of ambition of the employees is very variable. Therefore we consider that any projection of a promotion rate would not be reliable.
In short: not considering projected salaries and their impact on benefit at all means deferring in the later years of service the recognition of the cost to provide benefits. Therefore we favour maintaining salary projections.

Question 2 - Should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? What consequences do you consider your view has for the recognition and measurement of pension obligations?

The premise should be that the liability is owed to the workforce and this should be used in the unit of account. We don't think that such a scoping for unit of account would have a material impact on recognition and measurement, as this would remain broadly consistent with the overall economics (including trends and valuations) behind pension accounting and reporting.

Question 3 - Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?

We agree though we believe that the DP defines this too narrowly in terms of constructive obligations. Please see also our answer to question 1 above.

Chapter 3: Assets and liabilities: reporting entity considerations

Question 4 - Do you agree that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate?

While this might appear logical at first sight, this would not happen for several pension schemes that are organised as foundations or trusts, whose founding members do not enjoy any rights whatsoever to obtain economic benefits of these entities. Moreover, although these entities may be managed by the employers, their business is conducted in the interests of the employees and retirees and not on behalf of the employer, which does not create an evidence of control in the sense of IAS 27. Last but not least, one can add that often the legal framework does not allow the employer to control the plan.

As regards schemes which might be deemed to meet risks and rewards and control criteria, we consider that this applies only to the assets in excess of the liabilities which may be withdrawn by the employer. Therefore we consider that a fair presentation of the economics of such schemes is better reflected by an offsetting of their assets and liabilities as currently done.

Should a pension standard require to consolidate pension plans that are deemed to be controlled, we would have consolidated pension plans and non-consolidated pension plans. We consider that this would confuse the users, who could not have a comprehensive view of an entity pension obligations or rights on the balance sheet.

Chapter 4: Recognition of pension assets and liabilities

Question 5 - Do you agree that changes in assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods or left unrecognised provided they are within certain limits (a 'corridor') approach?

We agree that the current "corridor" approach results in carrying to the balance sheet assets and liabilities that do not meet the definition of the Framework and we agree with the removal of this approach, which is strongly criticised by the users. Nevertheless, we would not agree with an immediate recognition of actuarial gains or losses to the income statement because this would create an unwarranted volatility to the yearly results of an entity.

Standard setters have to acknowledge that pension liabilities are long term and that recognising their volatility immediately to the income statement would imply that they are viewed as trading assets or liabilities, which would be against the reliability and relevance concepts. Therefore we would recommend to continue to recognise actuarial gains or losses to the Statement of Recognised Income and Expense (SORIE) but we would suggest that they are recycled to the income statement on the basis of an equilibrium mechanism as currently allowed under US GAAP (i.e., paragraphs 29 and 32 of FAS87, as amended by FAS158).

Chapter 5: Measurement of liabilities to pay benefits

Question 6 - Do you agree with the paper's views in the measurement of liabilities to pay benefits?

- *Regulatory measures should not replace measures derived from general accounting principles?*

  While we agree that there should be no replacement in theory, we nevertheless consider that this issue should be viewed pragmatically. Therefore regulatory measures could be accepted inasmuch as they lead to results that are materially in line with those derived from general accounting principles.

- *The discount rate should reflect the time value of money only, and therefore should be a risk - free rate?*

  While the proposal might certainly be a better reflection of time value of money, the application of risk free rate only could fail to measure the liabilities accurately by ignoring other attributes specific to the nature of such liabilities. In particular we consider that an AA corporate bond rate better reflects the economics of pension liabilities which represent borrowings of an entity from its plan members or the risks inherent to the scheme.

- *Information about the riskiness of a liability (i.e. the risk that the amount of pension benefits will differ from today's expectations) is best conveyed by disclosure rather than by adjusting the amount of the reported liability?*

  Sensitivity measures are a good tool in order to assess the riskiness respectively the inherent risks of a pension plan. Therefore we recommend to maintain them.

  On the other hand, simply adjusting downward the amount of reported liability could hinder transparency and comparison ability for the readers of the financial statements, except if there are clear requirements on how to adjust the liability.

- *The liability should not be reduced to reflect its credit risk?*

  We consider that this question affects the measurement of all liabilities and not only that of pensions. Therefore we would propose to leave this question open for the IASB Framework conceptual project. Until such time, we would recommend to continue with the use of an AA corporate bond rate as stated above without necessarily committing to any general principle of exclusion of an entity's own credit risk.

- *Expenses of administering the plan's accrued benefits should be reflected in the liability?*

  We are of the opinion that expected return on plan assets should be determined gross of expenses. Although it is not fully compliant with transparency requirements, we believe that we should avoid to "pollute" the liability valuation with such considerations, even more so, as fees arise on various instances throughout the value chain, they can be hidden or not and it is relatively difficult if not outright arbitrary to assess the administration cost of a pension plan.

Question 7 - Where employees have options to receive benefits in different ways, should the liability be reported at the highest amount or at an amount that reflects the probability of different outcomes ?

We think that the amount of liability should reflect weighted probabilities of all available outcomes, estimated e.g. on the basis of available historic information.

<u>Chapter 6: Measurement of assets held to pay benefits</u>

Question 8 - Do you agree that assets held to pay benefits should be reported at current values?

While we would agree with the principle from a balance sheet measurement standpoint, we would consider that the IAS 39 Available-for-Sale classification whereby fair value gains and losses are recycled upon the sale of the instruments would better fit the nature of pension assets. Please also see our answer to question 5 about recycling.

Chapter 7: Measurement of employer interests in assets and liabilities of trusts and similar entities

Question 9 - Do you agree that a 'net' asset or liability should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly?

Yes, we agree.

Chapter 8: Presentation in the financial statements

Question 10 - Do you agree that different components of changes in liabilities and/or assets should be presented separately?

In our opinion, presentation of pension expenses / income is totally dependant on a satisfactory solution of the presentation of financial statement debate. Despite the fact that preparers and several users have advocated to maintain the income statement and the SORIE (or OCI), the DP seems to pre-empt one single statement of comprehensive income.

Moreover we consider that the presentation of finance costs of pensions within financing is debatable from a consistency standpoint because, when an entity insures its pension liabilities, all the insurance premium is treated as operating. If the entity does some kind of "insourcing" of its pension costs by means of a defined benefit pension plan, we do not see why costs that have the same economic should be presented differently and disaggregated in the income statement.

Question 11 - Do you agree that the financial performance of an entity should reflect the actual return on assets, rather than the expected return, and that the expected return should be required to be disclosed?

We disagree with the assumption made for component reporting (from the phase B of IAS1's revision project) which underlies the posted question. Reverting back to the question itself, we think that expected returns allow to better represent the long term nature of pension obligations.

Chapter 9: Disclosures in the employer's financial statements

Question 12 - Do you agree with the objectives of disclosure that are identified in this Chapter? Are there specific disclosure requirements that should be added to or deleted from those proposed?

We think that objectives of the discussed disclosures are in-line with the spirit of existing ones and, as such, we do not think there is a need for additional / prescriptive guidance. However, it might be worthwhile considering the management's choice in providing disclosures either in the notes or in the management report. As far as the specific disclosures are concerned, we disagree with the suggestion to apply IFRS 7-style disclosures to pension liabilities' related financial instruments. As pension plan disclosures are already substantial in the entities' consolidated financial statements, we would urge standard setters to limit disclosures of key item information of those of the major pension plans that represent a substantive part of the total pension assets and liabilities.

However we would accept a limited number of key risk measures for the main plans (e.g. sensitivity of the liability to a +/- 1% discount rate movement. Cf. also our answer to question 6.

Chapter 10: Accounting for multi-employer plans

Question 13 - Do you agree that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan? How, in your view, should an accounting standard require that this be implemented in practice?

While the reporting for multi-employer plans should be classified and reported in the same way as single employer plans when it is practicable, we believe that the economic characteristics of such plans should prevail. For example, in certain jurisdictions multi-employer pension plans are more akin to state plans than to entities' pension plans because the individual reporting entities have only the obligation to contribute to the plan and have very little, if any, influence on the management of such plans. Therefore an allocation of the plan assets, liabilities, income and expenses could lead to meaningless information in the individual entities' financial statements.

Chapter 11: Financial reporting by pension plans

Question 14 - Do you agree that a pension plan's general purpose financial report should include its liabilities to pay benefits in the future? Do you agree that the plan's liabilities for future benefits should be quantified using the same principles as an employer's liability?

We consider that the financial reporting by pension plans meets the same objective as statutory reporting of the entities. Therefore it should not be governed by standard setters but by the rules and regulations of the local jurisdictions in which the pension plans are based. Moreover, we do not see any use to oblige pension funds to use the same principles as the employer. Take the example of multi-employer pension plans or insurance arrangements where the reporting entity has only the obligation to contribute to the plan. Why should the employer's view on – let's say – salary increases influence the financial reporting of the multi-employer plan ?

Question 15 - Do you agree that a pension plan's statement of financial position should reflect an asset in respect of amounts potentially receivable under an employer's covenant, and that this should reflect the employer's credit risk?

Examples in UK show, that it is extremely difficult to measure an employer's covenant, because the reporting entity in fact has to measure the credit risk of the employer. While for listed companies such covenant might be measured at a fair value, based on a objective approach, for smaller companies or privately held companies, there is no such measure. Please see also our answer to question 14 above.

General questions

Question 16 - Are there types of pension arrangements that require further consideration? Please identify the specific features of these arrangements and suggest how the principles of this paper would require development to secure appropriate financial reporting for them.

To the best of our knowledge we do not believe that there are any.

Question 17 - Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?

We know from experience that several issues may arise regarding the practical application of pension plan accounting in the consolidated financial statements of the employers.

Therefore we list below the issues that we have encountered when applying employee benefit standards :

- medical benefits,
- death and disability benefits, and
- asset ceiling.

Thank you very much for your attention to the above.

Yours very truly,

N E S T L E S. A.

H. Wirz
Senior Vice President
Head of Group Accounting and Reporting