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PAAinE DISCUSSION PAPER (DP) - PERFORMANCE REPORTING

Ladies and Gentlemen,

Nestlé, the world's leading Nutrition, Health and Wellness company, with sales of CHF 109.9 bio in 2008, is following closely the work of the IASB in general and concerning performance reporting in particular. We welcome the issue of the PAAinE Discursion Paper (the DP) and we outline some general comments below and answer the specific questions of the DP in the annexe.

GENERAL COMMENTS

We consider that the DP plays in important role in the performance reporting debate, which is critical to the communication between preparers and users. We would agree with paragraph 1.1 of the DP that states that *" the primary objective of all accounting standards and all standard-setting effort is to maximise the usefulness of the performance reporting aspects of the financial statements*". We would also agree with § 3.31 stating that (quoting PwC) "*users appear to have little interest in comprehensive income as a key performance measure*". However we have difficulties to understand why the DP is saying in § 4.23 that there is no reason to believe that the bottom line of a performance statement is a key line. Without criticising the work of the DP (which we appreciate), we believe that this apparent contradiction stems from the fact that there has never been a real debate on whether performance should be based on an income generation approach or on an enhancement of value approach, i.e., the difference between two balance sheets (excluding the transactions with equity owners).

In practice, however, public entities and their investors and analysts communicate on the basis of metrics such as EBIT, net profit and EPS. A study published by Pricewaterhouse Coopers in 2007 revealed that the most important primary financial statement for the users is the income statement. Therefore it seems that an income approach to performance is prevailing, which we believe militates for maintaining the statement of profit or loss (income statement) and net profit which represent the result management is accountable for. The revised IASB Framework which recognises stewardship as a qualitative characteristic provides the conceptual justification for it. However, despite the acknowledgment of stewardship, the IASB downgrades the primacy of the statement of profit or loss as a mere sub-total in a comprehensive statement of income and views performance as an enhancement of value. We therefore strongly consider that there is a need for a conceptual definition of net profit based on stewardship, which requires an income approach and to remove the movements of fair value when they are not linked to the business model of an entity and to place them into a separate statement of comprehensive income.

Thank you very much for your attention to our comment letter.

Yours very truly,

NESTEC S. A.

Philippe Gaberell
Assistant Vice President
Head of Financial Reporting Guidelines

Encl.

cc : Mr. H. Wirz, Senior Vice President Nestlé S.A., Head of Group Accounting and Reporting

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ANNEXE

ANSWERS TO SPECIFIC QUESTIONS

Chapter 2

Question 1 – Do you think there is anything else in the development of existing standards (apart from that discussed in chapter 2) that should be taken into account when considering the way forward for performance reporting?

In the basis for conclusion of IAS 1 as revised in 2007, § BC58, the IASB considers that "*the items included in profit or loss do not possess any unique characteristics that allow them to be distinguished from items that are included in other comprehensive income.*". EFRAG has also noted this in § 2.6 of the DP i.e., that "*each of these items of net income and expenses outside net income is not always articulated in the relevant accounting standard and, where it is, the reasons given are not consistent*". At its 22 October meeting the IASB tentatively decided to remove the option of IAS 1 § 81 to allow the preparation of a statement of profit or loss and a statement of other comprehensive income. The Staff Update of this meeting relates that "*the staff emphasised, and the Board agreed, that nothing in the proposals would change which items can or must be presented in OCI or whether an item must be reclassified (i.e. recycled) upon derecognition. The main aspects of the proposals are simply to remove options*". We disagree with the IASB and its Staff and we consider that that the division between profit or loss and other comprehensive income as a key element of reporting the performance of an entity. Profit or loss is the result that management is accountable for in accordance of its stewardship duties (please also see the answer to question 2 below) while other comprehensive income is limited to hypothetical transactions that stem mainly from changes in fair value of assets and liabilities related to financial instruments, pensions etc. and from exchange differences. They therefore do not have the same predictive value as profit or loss items. We consequently believe that what the IASB considers as a mere presentation issue is in fact a fundamental distinction that is critical to entities be either in Europe and elsewhere that EFRAG should convey to the IASB.

Chapter 3

Question 2 - Do you agree with the observation in this chapter that, at the level at which standards are written, there is no generally agreed notion of what represents "performance" and that in fact performance is a complex, multi-faceted issue that cannot be encompassed in one or a few numbers? If you do not, please explain your reasoning.

We would generally agree with the observation of the question but we would like to add that the IASB has always developed a comprehensive income approach of performance and has not always considered other views expressed by its constituents. Nevertheless, the IASB has now admitted stewardship as a qualitative characteristic in its exposure draft on the Framework revision, chapter 1, § OB12, which says that (emphasis added) : "***management's performance in discharging its stewardship responsibilities usually affects an entity's ability to generate net cash inflows****, management's performance is also of interest to potential capital providers who are interested in providing capital to the entity*". On the basis of the definition of the revised Framework, there should be a definition of performance that reflects profit and cash flow generation of an entity based on management's strategies and objectives. The starting point of such performance should be based on net profit that reflects underlying sustainable earnings and should not include items of related to change in value of assets and liabilities as explained in our answer to question 1.

Chapter 4

Question 3 - Do you agree that key lines are still useful, though only because of their value as a basis for communication to the market and as a starting point for analysis and comparison? If you do not, please explain your reasoning.

We agree that key lines are useful for an efficient communication with the users and we consider that operating performance (quoted in § 3.4 of the DP) is also a key metric of performance that the IASB has retained in its disaggregation model of its DP on Financial Statement Presentation.

Question 4 - Do you agree that, in order to fulfil this function, it is important that there are clear principles that underpin what is included and excluded from the key line(s) (in order to make their content understandable) and those principles need to be such that the content of a key line is standardised to a fair degree (in order to ensure the necessary comparability).

We would agree that key lines should be based on principles. Regarding net income, please see our answer to question 2 and our discussion about management accountability and stewardship. As regards operating performance, it can be described as the result generated on the revenue of an entity by opposition to financial performance generated on investments in financial or real estate assets. While there could be some potential conflicts between the desire for standardisation and the desire for flexibility as stated in § 4.13 of the DP, we consider that these risks may be mitigated if the definition of the line items is based on the business model of the entity. Finally, the definition of the key lines should not drive internal and external performance apart (please also see our comment on this subject in our answer to question 10 below).

Question 5: This chapter discusses the need for standard setters to balance the competing demands of comparability and flexibility, in order to give users fairly consistent starting points for analysis, while allowing management to present income and expenses in a manner that reflects the particular circumstances of the entity. Has the range of approaches to flexibility and comparability given in the chapter been appropriately described? What do you believe would offer the best approach in practice?

We believe that the range of approaches refer to options A to D of § 4.13. While those options appear to have been appropriately described, we do not consider that they are entirely helpful. We consider that the categorisation should be based on principles and that the business model of an entity should prevail as stated above in our answers to questions 3 and 4.

Question 6: This chapter finds no evidence that it is important for the "bottom line" of statement(s) of income and expense to be a key line. Do you agree that it is not important for the "bottom line" of statement(s) of income and expense to be a key line? If you do not, please explain your reasoning.

We do not support the argument of § 4.23 of the DP that there is no reason to believe that the bottom line of a performance statement is a key line. We consider the arguments of § 4.22 that different persons use different statements in different ways is based on the IASB views of the users' behaviour but it ignores the importance of financial reporting in terms of management communication. As we have stated in the answers to question 2, net profit is linked to the stewardship duties of management hence earnings per share are calculated on that basis.

Actually standard setters should acknowledge that there are two views of performance, i.e., on a one hand an income view that measures the current operating performance and provides a basis for the projection of future profits and cash flows as well as insight on how management has delivered its tasks and, on the other hand, an enhancement of value view that measures the change in value of assets and liabilities. These two different views require two statements of performance because their purposes are different.

Question 7: In chapter 4, the paper observes that there is no evidence that it is important for the "bottom line" of statement(s) of income and expense to be a key line. Assuming that is correct, do you agree that it follows that the number of performance statements provided is not particularly important either. And thus that the one or two performance statements debate is a non-issue; the real issues relate to the key lines. Do you agree with this analysis and conclusion? If you do not, please explain your reasoning.

We disagree for the reasons stated in our answer to question 6.

Question 8: Do you agree that recycling is mainly an issue if a realised/unrealised split is the main disaggregation criterion for the statement(s) of income and expense, that therefore recycling is really a secondary issue and that the main issue is which disaggregation model should be used? If you do not, please explain your reasoning.

We agree that cash flow hedging should continue to be recycled but we do not agree with the argument of § 4.32 that it would be the only item to be recycled. Moreover, the DP reasoning is that recycling is not necessary in an environment of operating / investing and financing (§ 4.30) and is about the disaggregating model to be applied (§ 4.31). On the contrary we believe that recycling is useful because it provides information about the realisation of transactions that management is accountable for. Therefore it plays an important role in the determination of performance.

Question 9: Would the issue of recycling on its own affect your decision as to the best approach to disaggregation? Please explain your reasoning.

Indeed we consider that recycling would affect our decision as to the best approach to disaggregation because as explained above in our answer to question 8, we believe that performance is related to the business model of an entity and to the performance of management. Since that business model approach involves a statement of profit or loss and a statement of OCI recycling is a key element of that cut-off.

Chapter 5

Question 10: Do you have any comments on the basic models of disaggregation presented in this chapter? Are there any other broad types of model that would have been worth exploring?

We consider that the DP properly describes the basic models of disaggregation and we do not believe that any other type of model would have been worth exploring. Nevertheless we consider that it would be worthwhile to note a couple of points.

As mentioned above, we do not consider that rigid criteria could be imposed with the exception of net profit and total other comprehensive income. The distinction between these lines should be based on the business model of the entity. Also consistency between internal and external reporting is a must. Paragraph 5.65 discusses this topic and we consider that a divergence between internal and external reporting not only may but will interfere in the communication between preparers and users. The same paragraph proposes to carry out further research and field testing, which might be useful but we would like to emphasize that divergence between internal and external reporting are not only costly but could create confusion between an external reporting prepared for the mere compliance with accounting standards required for listing regulations and a pro forma reporting utilised for the communication with analysts and investors. Therefore accounting requirements should not drive internal and external reporting apart as a result of requirements that contradict the business model of an entity or on the basis of anti abuse clauses.

In our comment letter to the IASB regarding financial statement presentation, we quoted a study published by Pricewaterhouse Coopers in 2007, which revealed that investment professionals place a high importance among others on the income statement. We also believe that investors and analysts are interested in EBIT and underlying post-tax earnings. The conclusions of the DP appears to be quite evasive on this subject when they say in § 5.66 "*whatever approach is adopted will lead to one or more key lines being established, on of which may or may not be similar to the current notion of net income*". Adopting key line is probably necessary but we have already demonstrated the usefulness of net profit above in this letter. On the basis of the PwC study quoted above we also believe that investors require underlying earnings because these are useful in projecting cash flows on sustainable basis.

Question 11: Is the discussion of the advantages and disadvantages of each disaggregation model fair and complete? If not, how could it be improved?

We consider that the models are appropriately discussed but it seems to us that the paper does not arrive at a conclusion that EFRAG and its constituents could use in the debate with the IASB because certain sections of it endorse what the IASB is saying, which we disagree with (please see our answers to questions 6 and 7).

Question 12: Which of the models of disaggregation—or combinations of models—do you favour and why do you believe it meets the needs of users better than the alternatives?

On the basis of our answers to the previous questions, we would recommend a disaggregation based on functions as determined by the business model of an entity. Our Group (like many others) controls its costs in accordance with the Activity Based Costing / Activity Based Management concept, which means that costs by nature are often lost at the entity level and not reported at Group level, which makes disclosure by nature very difficult.

In paragraphs 5.11 and 5.12 the DP points out that the recurring / non recurring model is highly subjective and quotes the example of restructuring costs by raising comparability issues, i.e., restructuring would be non-recurring in an entity and recurring in another one because it is frequent. We would agree with the conclusion but we consider that the paper fails to discuss the low predictive nature of restructuring costs and item such as impairment or losses on assets. The fact that they may or may not be recurring is not relevant, what is relevant is that the previously mentioned costs have a low predictive nature because it cannot not be predicted that if, e.g., an entity incurred a restructuring (or an impairment) in country X, it would necessarily incur a restructuring in the same country in the future. While the entity may indeed incur restructuring in future in country Y or Z, such restructuring would be different in terms of magnitude. The same would apply to impairment and losses on disposal Such costs reflect the strategies of entities concerning concentration of manufacturing and other facilities and are also the consequence of M&As. Therefore they cannot be mixed with expenses by functions which have a higher degree of predictability.

To conclude we consider that a performance reporting model could be developed on the basis of a combined disaggregation model such as the one exposed in § 5.58, though we would view it slightly differently, to address the issue of performance shown in the form of two statements as illustrated below.

Statement of profit or loss
- revenue
- less expenses by functions

operating profit before other expenses (a)
- other expenses (with low predictive value), i.e. restructuring, impairment and disposal results

operating profit
- financial income and expenses
- taxes

net profit

(a) such a level, and other levels should be permitted in accordance with the business model of the entity.

Statement of comprehensive income
- net profit
- other comprehensive income

Comprehensive income