

NESTLÉ S.A.

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9 March 2011

EXPOSURE DRAFT- ED/2010/13 HEDGE ACCOUNTING

Ladies and Gentlemen,

Please find below our answer to your invitation to comment on the above mentioned exposure draft. We outline general comments below and answer the specific questions of the ED in the annexe.

GENERAL COMMENTS

We welcome this ED as an improvement over the current financial instrument standards applicable to hedge accounting. The proposals alleviate some of the onerous requirements and aim to align hedge accounting with the economics of hedging transactions. This should make hedge accounting more accessible for preparers and more understandable for users, in particular:

- Hedging of certain aggregate exposures which may include derivatives (question 3);
- Hedging risk components of non-financial items (question 4);
- Elimination of the 80-125% highly effective test and retrospective assessment (question 6).

Notwithstanding the above we have some concerns with certain aspects of the proposals which may create additional complexity such as:

- Mandatory 'rebalancing' just because the most optimal hedge ratio is no longer observed (question 7);
- The accounting and presentation of ineffectiveness in other comprehensive income (OCI) for fair value hedges and the creation of additional line items in the balance sheet (question 9), however, the proposal to have one model is welcomed;
- How and when to recycle the time value of options out of OCI and having to calculate hypothetical options in cases where the critical terms of the option do not exactly match the exposure (question 10); and
- The restriction of applying cash flow hedging of a net position when the offsetting cash flows affect profit or loss in the same period (question 11).

Moreover, we believe that the final standard should allow entities to hedge equity investments, if this is part of their management strategy (question 1), permit intra-group monetary items denominated in a foreign currency as hedging instruments (question 2) and to hedge more than the cash flows of the hedged item, for example, the issuance of debt at sub-libor rates (question 4).

In addition, we would welcome further clarification on the following matters:

- How to account for the derivative which is hedged as part of an aggregate exposure (question 3);
- The hedge ratio to minimise ineffectiveness is not necessarily the "most optimal", however, we agree it should be in line with the risk management objectives (question 6);
- More practical guidance around the rebalancing proposals (question 7); and
- In order to avoid unintended consequences, the amendment to IAS 32 for the scope out of the own use exemption should be made clear that it only applies to certain specific situations.

The above points are explained further in the Annexe.

Thank you very much for your attention to the above.

Yours very truly,

NESTLÉ S.A.



H. Wirz

Senior Vice President
Head of Group Accounting and Reporting

Encl.

ANSWERS TO SPECIFIC QUESTIONS

OBJECTIVE OF HEDGE ACCOUNTING**Question 1**

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

We welcome the objective to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. This conveys a principle based approach which should help align risk management to hedge accounting. However, we would propose that this principle is extended to entities that would like to hedge the price risk of equity investments (with fair value changes through OCI) from impacting equity. One could consider that ineffectiveness on such a hedge recorded to the income statement is unusual as the equity investment will never impact profit or loss. However, we believe it would be more appropriate to extend the objective to such hedges otherwise it contradicts the overall objective of the ED which is to align the risk management strategy with hedge accounting. In fact, entities may even decide against such a strategy purely due to the volatility they would have in profit or loss.

INSTRUMENTS THAT QUALIFY FOR DESIGNATION AS HEDGING INSTRUMENTS**Question 2**

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

We agree that a non-derivative financial asset or liability measured at fair value through profit or loss should be an eligible hedging instrument.

We disagree with paragraph 7 of the ED which requires the hedging instrument to be a contract with a party external to the reporting entity. Instead we believe that a difference arising from translation of intra-group monetary items in the consolidated financial statements should be eligible as a hedging instrument. Paragraph 17 allows such a difference to be eligible as a hedged item which is not consistent with paragraph 7. We believe that the Board should remove this inconsistency by making a consequential change to IAS 21 rather than waiting for a project on foreign currency translation as noted in BC47. This would be useful when an entity is to hedge an acquisition or disposal in a foreign currency by designating a foreign currency intra-group monetary item as the hedging instrument. Under the current proposals an entity would need to take out two derivative contracts which are both equal and opposite, for example, one FX forward to hedge the foreign currency impact of the intra-group loan and another equal but opposite FX forward to hedge the forecast sale (or purchase) of the subsidiary. Such duplication of external derivatives only creates additional cost, complexity and counterparty credit risk for entities which is caused by the rule in paragraph 7.

DERIVATIVES THAT QUALIFY FOR DESIGNATION AS HEDGED ITEMS**Question 3**

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree that an entity should be able to designate as the hedged item an aggregate exposure that consists of an exposure and a derivative. This is in line with the objective of the ED to align hedge accounting with the risk management strategy. However, it is not clear from the ED how such an aggregate exposure would be accounted for. For example, B9 (b) appears to permit "synthetic accounting" for the derivative and exposure. It would seem that during the hedging relationship the cross-currency interest rate swap would be measured at amortised cost rather than having its changes in fair value recognised in profit or loss. The Board should clarify the accounting treatment for such aggregate exposures in the final standard.

DESIGNATION OF RISK COMPONENTS AS HEDGED ITEMS

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We welcome the proposals which permit an entity to hedge a risk component of a non-financial item as already discussed during the outreach with the staff. This is particularly important to Nestlé due to its hedging of price risk related to various types of commodities through futures contracts this will greatly simplify our accounting for commodity instruments. The ED will now align the risk management strategy with hedge accounting in this particular area which was not the case in the past.

We, however, disagree that an entity cannot designate a component where the cash flows are more than the total cash flows of the hedged item. An example is issuance of debt at a sub-libor rate. In such a case an entity is precluded from hedging the benchmark rate, libor, and therefore will result in some ineffectiveness, whereas entities that issue debt at libor plus some basis points are able to minimise ineffectiveness by designating only the libor risk component. Consequently, an entity with a good credit rating can have more ineffectiveness and therefore volatility in profit or loss than an entity with a worse credit rating. We believe this counter-intuitive result should be addressed in the new standard by permitting an entity to still designate only the libor component even in cases where the debt being hedged was issued at a below libor rate.

DESIGNATION OF A LAYER COMPONENT OF THE NOMINAL AMOUNT

Question 5

- a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?*
- b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?*

We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item. This increased flexibility supports the objective of the ED by providing more possibility that an entity is able to align its risk management strategy to hedge accounting.

HEDGE EFFECTIVENESS REQUIREMENTS TO QUALIFY FOR HEDGE ACCOUNTING**Question 6**

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We welcome the removal of the "highly effective" rule of 80-125%, replaced by more flexible requirements that aim to better align the risk management strategy with hedge accounting. One of these new requirements is to demonstrate that the designation is unbiased by calculating the hedge ratio expected to minimise ineffectiveness (B30). In cases where the critical terms do not match, our concern is that one could interpret this as a requirement to calculate the "most optimal" hedge ratio at inception and throughout the life of the hedge, for example, by performing detailed regression analysis. This could create additional discussions between preparers and auditors on what is the most optimal hedge ratio since one could use a variety of data points and time periods to arrive at different conclusions. This would add complexity to hedge accounting which goes against one of the main objectives of the ED.

We agree that in most cases companies would want to calculate the most optimal hedge ratio in order to minimise volatility in the profit or loss. However, to avoid the possible interpretation of the most optimal hedge ratio, we believe the ED should clarify that the hedge ratio should be assessed in order to minimise hedge ineffectiveness which is consistent with the risk strategy of management and is not necessarily the most optimal.

REBALANCING OF A HEDGING RELATIONSHIP**Question 7**

- a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?*
- b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?*

While rebalancing could represent a progress compared to dynamic hedging (de-designating and starting new hedge relationships) we do not consider that it should be required as it would contradict the alignment with the entity's risk management policies.

However, since the concept of rebalancing is new it would be helpful if the Board conducts some field tests and provides some examples on how this will work from an operational perspective. In addition, the most optimal hedge ratio should be clarified as mentioned in our response to Q6 above. Without this clarification, one could interpret B52 as meaning that entities must rebalance just because the most optimal hedge ratio is no longer the one currently used. (B52 "...if changes in the extent of offset indicate that the fluctuation is around a hedge ratio that is different from the hedge ratio currently used for that hedging relationship, or that there is a trend leading away from that hedge ratio, hedge ineffectiveness can be minimised by adjusting the hedge ratio whereas retaining the hedge ratio would increasingly produce a biased result and hedge ineffectiveness. Hence, in such circumstances, the change in the extent of offset is a matter of adjusting the hedge ratio and therefore requires rebalancing the hedging relationship."

Most rational companies would rebalance in order to minimise ineffectiveness. However, provided that management are satisfied that the hedge relationship is still in line with the risk management strategy, an entity should not be required to recalculate the most optimal hedge ratio just because there is another ratio which is better at minimising ineffectiveness. In any case ineffectiveness would be recorded to profit or loss.

DISCONTINUING HEDGE ACCOUNTING**Question 8**

- a) *Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?*
- b) *Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?*

We agree that if the qualifying criteria are still met, for example, the risk management objective for the hedging relationship has not changed then it would be unusual for an entity to want to voluntarily stop the hedging relationship. However, since hedge accounting is not mandatory, why should an entity be forced to continue just because the economic hedge continues? This could create an issue if an entity had designated a derivative into a hedging relationship and then, at some future date, would like to use the derivative to hedge another risk which is now deemed to be more important. In such cases, the mandatory requirement to continue hedge accounting will force entities to seek approval from the relevant risk management committee to prove that the strategy has changed. This makes hedge accounting less flexible than at present.

ACCOUNTING FOR FAIR VALUE HEDGES**Question 9**

- a) *Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?*
- b) *Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?*
- c) *Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?*

a) We agree that the complexity of hedge accounting would be reduced if the mechanics of fair value and cash flow hedges were aligned. However, presenting the gross changes in fair value of the hedging instrument and hedged item within OCI and then reclassifying the ineffective portion into the profit or loss would seem to be overly complex. Moreover, since most people understand that hedge accounting changes the normal rules of accounting an alternative approach would be for an entity to book the ineffective portion directly to the profit or loss with the effective portions, i.e. the hedge compliant part, recorded directly to OCI.

b) We understand the proposals aim to resolve a current issue of IAS 39 that the hedged item is neither at amortised cost nor fair value which is confusing to a reader. However, we are not convinced that presenting the "fair value" adjustment on a separate line item beneath the hedged item on the face of the balance sheet will make the accounting any easier to understand. In fact, adding more line items to the face of the balance sheet is likely to cause further confusion. We therefore concur with the dissenting views of AV12 that "the line item amount is not an asset or liability in its own right and it changes over time because of hedging activity, amortisation and derecognition of the underlying asset or

liability". Instead, we propose to maintain the current approach in IAS 39 to adjust the hedged item for the risk being hedged and then disclose in the notes the amortised cost, "fair value" adjustment and amount reported in the balance sheet.

c) We concur with the arguments in BC128 and therefore agree that linked presentation should not be permitted.

ACCOUNTING FOR THE TIME VALUE OF OPTIONS FOR CASH FLOW AND FAIR VALUE HEDGES

Question 10

- a) *Do you agree that for transaction related hedge items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?*
- b) *Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?*
- c) *Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?*

a,b) We welcome the proposal to record the changes in time value of an option to other comprehensive income (OCI) (when it is excluded from the hedge relationship) rather than trading through profit or loss. However, we agree with the dissenting opinion of John T Smith that there should be no basis adjustment for the time value when the transaction results in the recognition of a non-financial asset as it has the effect of spreading the cost into future periods for which protection is not provided (AV11). We are also concerned that this would create complexity in practice. Moreover, the proposals in (c), see below, would complicate matters even further. A more simplified approach which would be in line with the spirit of the ED would be to amortise the original time value portion of the premium paid to profit or loss over the life of the option with subsequent changes in time value being accumulated to OCI. This would be an improvement over the current standard while not creating additional complexities.

We also question why these proposals are made for options but not for forward contracts. In our opinion, an FX forward contract is exactly the same as an FX call option, except the holder does not have the option to exercise or not.

c) While we accept the conceptual arguments we disagree from a practical standpoint. The proposal to calculate a hypothetical option (when the critical terms do not match the exposure) in order to determine what portion of the time value is hedging and the portion which is trading would add too much complexity from an operational standpoint. In fact, such a proposal is likely to result in entities changing their risk management strategy to use different derivatives, for example, a forward, so that they avoid the accounting/administrative burden created by the proposals of (c).

HEDGES OF A GROUP OF ITEMS

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

It is difficult to respond to this item when the proposals on portfolio hedging are not yet finalised.

Notwithstanding the above, we agree with the Boards reasoning in BC160 and BC161 that groups of items (including net positions) should be eligible for hedge accounting. However, we disagree with the proposal to limit the application of cash flow hedge accounting of a group of items that constitutes a net position. The proposals to only permit net positions as eligible hedged items when the offsetting cash flows affect profit or loss in the same period is likely to make this proposal redundant as it could only be achieved at certain times of the year (i.e. not at year end). Management and users would find it difficult to understand that certain risk management strategies (hedging net positions in a cash flow hedge) can only be applied at certain times of the year, a "seasonal hedge", as a result of hedge accounting restrictions.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

We agree with B81 that when hedging a group of items which have offsetting risk positions then an entity shall present the reclassified hedging instrument gains or losses in a separate line item in the income statement.

As stated in our response to question 9(b) we disagree with paragraph 38 of the ED which states that assets and liabilities that are hedged together as a group in a fair value hedge, the gain or loss on the assets and liabilities shall be presented on a gross basis next to each line item that includes the related asset or liability.

DISCLOSURES

Question 13

a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

We are concerned that the proposals in paragraph 46 of the ED could result in entities disclosing price sensitive market data. The example provided on page 5 of the staff agenda paper 20D shows an example disclosure of price risk whereby an entity discloses its forecast production of oil for the next three years (being the period it is hedging). For companies such as Nestlé this could mean disclosing the price risk relating to forecast purchases of commodities. Based on our understanding of paragraph 46, such disclosures would show a user its expected purchases for subsequent periods, amounts hedged and the average hedged rate (as required by 46(c)). This information is unlikely to benefit a user who does not have knowledge about the future expectations of the commodity markets. However, a sophisticated user such as a competitor (a private company) could wait until publication of the Nestlé results and then use this information to their advantage. Likewise, speculators (hedge funds) could even use the information to profit by taking opposite positions (in cases where a company is a major user of the particular commodity). Also, customers would have a clear view on the main pricing component of their future purchases and therefore have an unfair advantage in negotiations. Such disclosures would result in IFRS reporters being at a disadvantage to those who are not bound by these sensitive disclosure requirements, i.e. it would not be a level playing field. We consider that these proposals are unfair and will result

in the accounting rules driving the business decisions. For example, perhaps companies would hedge less until they see what their competitors are doing, or in fact avoid hedge accounting altogether so the disclosures are not applicable and just accept the volatility in profit or loss. We propose that the Board consider these proposals very carefully as their implications are likely to be significant.

ACCOUNTING ALTERNATIVES TO HEDGE ACCOUNTING

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

We support the Board in trying to avoid an accounting mismatch in certain cases where an entity hedges a commodity contract, which is treated as an executory contract due to the own use exemption, by requiring the commodity contract to be measured at fair value. However, the proposed amendment to paragraph 8 of IAS 32 states that such a contract is accounted for as a derivative "if that accounting is in accordance with the entity's underlying business model and how the contracts are managed". Since the wording is general, our concern is whether one could interpret this amendment and apply it to situations where it was not intended. We would recommend that this doubt is removed by making the scope out for the own use exemption more clear by providing an example.

Question 15

- a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?*
- b) If not, which of the three alternatives considered by the Board in paragraphs BC226-BC246 should the Board develop further and what changes to that alternative would you recommend and why?*

We do not consider that this is relevant to our group to date.

EFFECTIVE DATE AND TRANSITION

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We agree that the standard should be applied prospectively and can only be applied if all existing IFRS 9 requirements are also adopted at the same time. In our recent comment letter responding to *Request for Views on Effective Dates and Transition Methods*, we proposed that IFRS 9 should be mandatory from 1 January 2014 with early application permitted should the Board want this standard to be effective at a later date.