



LETTER OF COMMENT NO. 17



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Russell G. Golden
Director of Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Subject: File Reference: Proposed Issue E23

Dear Director:

Eaton Corporation appreciates the opportunity to respond to the Financial Accounting Standards Board's (the Board) Statement 133 Implementation Issue No. E23 on *Hedging-General: Issues Involving the Application of the Shortcut Method under Paragraph 68*. For your information, Eaton Corporation is a diversified industrial manufacturing company with 2006 annual sales of \$12.4 billion and over 62,000 employees, selling products to customers in over 125 countries.

Summary

Eaton Corporation does not support the issuance of this proposed Implementation Issue. As discussed further in this letter, this Issue will eliminate many valid hedge accounting relationships, the effect of which will limit many companies from being able to apply any hedge accounting. We recommend allowing the short cut method to be applied to a qualifying fair value hedge whether the hedge relationship is designated on or after the trade date of both the swap and the hedged item, provided the remaining terms of the swap and hedged item (e.g., debt) match. The qualifications under the short-cut method ensure that the economic relationship driving the hedge exists, which we feel is a primary concern of Statement 133. The reasons for our recommendation include retaining the spirit of the original pronouncement widely used by companies' derivatives programs, maintaining consistency in reporting, and having the financials continue to best reflect the economics of the hedge transactions. Furthermore, preserving the short-cut method eliminates an unnecessary administrative burden imposed under the long-haul method for zero economic gain or reporting advantage.

Shortcut Method Available for Hedges

We agree with the Board's recommendation of continuing the use of the short cut method for interest rate swaps. The concept of differences in value of the hedged item due to the discount or premium in effect from the rounding of the coupon at issuance of the hedged item, the premise of differences in value of the hedging instrument from the bid/ask spread between the entry transaction and hypothetical exit transaction, and the difference in value between the hedged item and the principal amount due to differences in the trade date and the settlement date of the debt should not preclude the use of the short cut method for fair value hedge accounting of interest bearing assets or liabilities and interest rate swaps.

Matching of Notional Amounts

We also agree with the edits in Paragraph 68 a. regarding the notional amount of the swap matching the principal amount of the interest bearing asset or liability being hedged. Consistent with plain vanilla interest rate swaps, the new guidance further requires that the notional amount of the fixed leg of the swap matches the notional amount of the variable leg of the swap throughout the life of the hedging relationship. We agree that this is a critical requirement to the use of the short cut method.

Conventional Use of Interest Rate Swaps

We strongly disagree with the elimination of application of the short cut method for interest rate swaps placed post issuance of debt instruments. Late hedges are much more common than hedges placed at the inception of the debt. Companies place fixed to floating swaps on and take them off regularly as interest rate market conditions change. The fundamental nature of the debt and interest rate swap markets is to look at each instrument on a forward looking basis and match exposure to interest rate movements completely, effectively, and efficiently.

The short cut method has been used extensively for late hedges since FAS 133 was first put in place in 2000. The original premise of the short cut method was to lift the administrative burden of these plain vanilla interest swaps, whose value moves predictably with that of the underlying hedged item. To eliminate the shortcut method now would disrupt the marketplace and redirect critical accounting and finance resources of companies from true areas of risk. To perform the long haul testing for each and every interest rate swap represents an extraordinary additional administrative burden for no expected economic value. Having to complete the long haul testing for each interest rate swap will also negatively impact a company's ability to close the books in a timely manner. This drain on both companies like Eaton and the banking industry will make it extremely difficult and costly to meet internal and external financial reporting deadlines.

Representation of Economics

The short cut method when applied to fixed/floating interest rate swaps best matches the accounting for the economics of the transaction. The rationale for

placing interest rate swaps is not to hedge or offset the change in value of the underlying hedged item (as if the company intended to repurchase the debt), but rather in order to swap the fixed coupon on the debt to a floating or variable rate as market conditions dictate. Shortcut is the best representation of the transaction that has been placed, where the interest rate accrual difference on the fixed versus floating rate is reflected in earnings and the value changes of the debt and swap instrument offset on the Balance Sheet.

Fair Value of Debt Must Equal Par

At the time when FAS 133 came into effect, there was no discussion that the fair value of the debt had to equal par when an interest rate swap is placed. Paragraph 68 succinctly laid out the requirements for application of the short cut method. Paragraph 68(a) states that, "The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged." Paragraph 68 (b) clarifies that the fair value of the swap must be equal to zero at inception. No other condition exists that the fair value of the hedged item must equal its principal amount. If the fair value equaling par concept had been a consideration, Statement 133 would have mentioned it via when originally introduced.

Within Statement 133, paragraph 114 spells out the computational steps of the shortcut method for a fair value hedge, highlighting the amortization of the purchase premium and discount consideration. Paragraph 115 explicitly states in the footnote that the Trade date and borrowing date of the Interest Rate Swap and Fixed-Rate Debt need not match for the assumption of no ineffectiveness to be appropriate. We believe that this guidance explicitly permits the hedged item to have a purchase premium or discount while still qualifying for the shortcut method.

Further, Statement 133 Implementation Issue No. E10, "Application of the Shortcut Method to Hedges of Similar Interest-Bearing Asset or Liability (or Its Related Interest) or a Portfolio of Similar Interest-Bearing Assets or Liabilities," mentions either the "principal" amount or the "notional" amount of the hedged item, without reference to the fair value of the hedged item.

Zero Coupon Bonds

We understand that part of the reasoning for examining the short cut method for interest rate swaps of interest bearing debt began with the consideration of swaps of zero coupon bonds and their fair value not equaling par. Specifically, the deep discount to par value of the zero coupon debt, the financing of the fixed element of the swap, and the inconsistency of matching the notional amount of the fixed leg of the swap with the notional amount of the variable leg throughout the life of the swap were concerns.

We can understand the valid concerns about the use of the short cut method for zero coupon bonds and are not arguing to allow short cut for zero coupon bonds. However, we believe those concerns do not apply to swaps of interest bearing bonds and that it does not make sense to apply the standard to them.

Fair Value Option Project

We also understand that the FASB also has a project for 2008 that is reconsidering Fair Value hedge accounting altogether. In this project, the Board is considering whether to permit entities a one-time election to report certain financial and non-financial instruments at fair value with the changes in fair value included in earnings. The swap and the debt would be each marked to market at their full FV. Our challenge is that if this project is imminent and may include a *required* entirely new approach, why would the Board add this interim step through E23 by requiring long-haul effectiveness testing now? Ultimately, this interim step is administratively burdensome, invites questions, introduces complexity, and increases cost across multiple industries of the hedging process for the same end result.

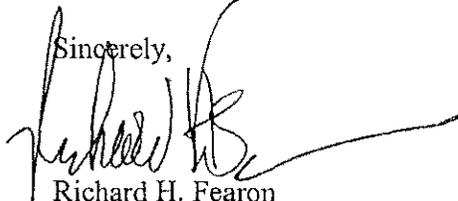
Suggested Alternative

We agree with the three dissenting Board members' opinion that changes in the fair value of the underlying debt instrument prior to placing the hedge transaction do not distort the effectiveness of the hedging relationship going forward. Assuming the terms of the swap match the remaining terms of the underlying debt, it is reasonable to assume no ineffectiveness and that changes in the fair value of the swap will be highly effective in offsetting subsequent changes in the fair value of the debt due to movements in the benchmark interest rate being hedged.

We recommend allowing the short cut method to be applied to a qualifying fair value hedge whether the hedge relationship is designated on or after the trade date of both the swap and the hedged item, provided the remaining terms of the swap and hedged item (debt) match. This method should be carried forward at a minimum pending the resolution of the Fair Value Option project referenced above. The reasons as highlighted above include reducing unnecessary administrative burden for no gain, retaining the spirit of the original pronouncement widely used by companies' derivatives programs, maintaining consistency, and having the financials continue to best reflect the economics of the hedge transactions.

We appreciate the Board's consideration of these important matters and welcome the opportunity to discuss ~~any and all issues~~ with the Board at its convenience. If you have questions regarding this letter, please call me at (216) 523-4336.

Sincerely,



Richard H. Fearon

Executive Vice President – Chief Financial and Planning Officer
Eaton Corporation