ISSUE-E23

IBM

LETTER OF COMMENT NO. 8

September 19, 2007

New Orchard Road
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Russell G. Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT -06856

Re - Proposed DIG Issue No. E 23: Issues Involving the Application of the Shortcut Method under Paragraph 68.

Dear Mr. Golden:

International Business Machines Corp. appreciates the opportunity to respond to the proposed Derivative Implementation Group Issue No. E-23: "Issues Involving the Application of the Shortcut Method under Paragraph 68." (the "Proposed Issue").

We generally support issuing guidance to clarify the application of the shortcut method and agree with the majority of the clarifications proposed by this guidance.

However, we disagree with the proposed amendment to paragraph 68 (e) which would prohibit, except under certain narrow circumstances, the application of the shortcut method for fair value hedging relationships where the fair value of the debt does not equal par value at hedge inception. This proposed amendment would automatically disallow shortcut method application for hedge relationships that commence subsequent to the initial recognition of the hedged item (hereafter referred to as "Late Hedges").

According to the Proposed Issue, a fair value hedge relationship that begins subsequent to initial recognition of the hedged item would not meet the requirement of paragraph 68 (e) due to the fact that the fair value of the debt at inception of the hedge relationship would not be equal to the par value of the debt. Such differences in the par value and the fair value of the bond would generate a discount or a premium which would need to be amortized over the life of the bond. The Board considers this discount/premium amortization to be ineffectiveness which would violate the requirement of perfect effectiveness per paragraph 68(e). Therefore, the Proposed Issue suggests that FAS 133 in its current form implicitly requires the fair value for the bond to equal par value at inception of the hedge to qualify for the shortcut method.

We disagree that the discount/premium generated on the bond would constitute ineffectiveness. We believe that the discount/premium generated and the amortization of such amounts into income over the life of the bond would be governed by the principles of other applicable accounting literature and should not impact the hedge effectiveness assessment required by FAS 133.

In addition, we do not agree with the Board's conclusion that FAS 133 in its current form implicitly requires the fair value for the bond to equal par value at inception of the hedge to qualify for the shortcut method. There is no direct or indirect reference in FAS 133 to this effect. In fact, contrary to the Board's view, FAS 133 explicitly recognizes the existence of purchase premiums and discounts and does not consider such amounts to impact the assessment of hedge effectiveness in a fair value hedge. Paragraph 115 of FAS 133 provides an example of the application of the shortcut method in a fair value hedge relationship, where it is noted that "the trade date of the derivative and the borrowing date of the bond would not need to match for assumption of perfect ineffectiveness to be appropriate". This statement clearly suggests that the existence of discounts and premiums and the amortization thereof would not preclude the assumption of perfect effectiveness in an interest rate fair value hedge.

We have further noted that the Proposed Issue carves out a specific scope exception for instances where the fair value of the bond does not equal par value at inception due to rounding of coupon rates, which is a commonly accepted market convention. In the Basis for Conclusions section of the Proposed Issue, the Board notes that "due to certain market realities, the par value of the bond rarely, if ever, equals fair value at inception of the hedge relationship." Given the practical market realities, the Board has allowed the shortcut method to be used for such hedges despite the existence of purchase premiums/discounts. Given that the Board is allowing the application of shortcut method in certain instances where purchase discounts/premiums exist, we believe that there is no technical basis to selectively impose this additional requirement for certain hedge relationships and not others. It should be noted that the argument of "practical market realities" that was used to provide exemption for hedges with coupon rate rounding differences can easily be extended to Late Hedges as well, since it has been very common industry practice to apply the shortcut method for Late Hedges since adoption of FAS 133.

In addition, we also note that the Board has already added a project to its agenda on Accounting for Derivatives and Hedging Activities to address the widespread implementation issues surrounding the application of FAS 133. This project is expected to focus on all aspects of hedging under FAS 133 and could result in the replacement of the current model of risk based hedge accounting with a fair value based approach. We are given to understand that an exposure draft on this issue could be released as early as fiscal 2008. Given this potential timing and the breadth of the changes contemplated by this project, stopgap measures to fix the existing accounting model would appear to be counterproductive, particularly considering the additional effort and cost companies would have to bear to comply with the requirements of a standard that is likely to be superseded in the near term.

In light of the above considerations, we believe that the Board should amend the Proposed Issue to exclude the additional requirement of fair value to equal par value in fair value hedges of debt, to qualify for the shortcut method. In addition, any substantial changes proposed to currently existing accounting rules in this area should only be made in connection with the hedge accounting project already on the Board's agenda. This will allow a more coherent transition to the new standards in this area and will afford the financial reporting community the opportunity to appropriately react to such changes.

Notwithstanding the above, should the Board feel compelled to make the change with respect to Late Hedges in the Proposed Issue, we believe it would considerably ease the implementation burden on preparers if such change was only required on a prospective basis for hedge relationships designated after the adoption of the Proposed Issue instead of requiring all existing hedge relationships to comply with the new requirements on adoption date.

Sincerely,

Richard J. Carroll

Richard J. Carroll
IBM Chief Accountant