



Eaton Corporation  
1111 Superior Avenue  
Cleveland, OH. 44114  
tel: 216.523.  
fax: 216.

August 15, 2008

Technical Director  
Financial Accounting Standards Board  
of the Financial Accounting Foundation  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116



LETTER OF COMMENT NO. 113

**Subject: File Reference No. 1590-100**

Dear Director:

Eaton Corporation appreciates the opportunity to respond to the Financial Accounting Standards Board's (the Board) Exposure Draft of a Proposed Statement of Financial Accounting Standards regarding *Accounting for Hedging Activities - an amendment of FASB Statement No. 133*. For your information, Eaton Corporation is a diversified industrial manufacturing company with 2007 annual sales of \$13 billion and over 81,000 employees, selling products to customers in over 150 countries.

### **Summary**

Overall we see the Exposure Draft as changing the nature of the complexity surrounding derivatives accounting and, at the same time, negatively affecting and prohibiting the use of the most common and simplest forms of economically driven risk management hedges. Instead of providing a "simplification" of hedge accounting, this proposal presents a different set of complicated and less intuitive rules. In our opinion, as drafted, it does not improve financial reporting or the transparency of the financial statements. It will also limit the use of some of the most basic hedge strategies due to higher unknown volatility to be recorded in earnings.

The majority of our comments focus on the hardships to interest rate swaps under the Exposure Draft, as this is the area we see as most negatively impacted by the proposal. Below please find our discussion on some of the key issues highlighted in the Exposure Draft as well as other matters.

## **Hedged Risk**

**Issue 1: For the reasons stated in paragraph A16 of this proposed Statement, the Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not to manage as part of a particular hedging relationship.**

**Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?**

We see the proposed statement as a radical change that will impair the usefulness of financial statements by preventing the company's ability to hedge individual risks. For example, the intent of entering an interest rate swap of a company's own debt (from fixed to floating) is to hedge exposure to the benchmark interest rate; it is not to hedge the risk of having to repurchase or refinance the underlying outstanding debt (i.e. to capture or offset changes in par or the credit risk of the company). The new rules would attempt to capture this risk in the total fair market valuation approach.

Eliminating the bifurcation of risk requires that changes in the fair value of a derivative (e.g. in the case of an interest rate swap) must be expected to reasonably offset all of the changes in the fair value of a recognized debt instrument to qualify for hedge accounting. Under the proposed rules, management's only recourse to fully offset probable ineffectiveness would be to buy protection (in addition to an interest rate swap) on a company's own credit. This raises other concerns such as the moral dilemma of betting against oneself and costs not present in hedging simple interest rate risk. Furthermore, it can be very costly to hedge the credit risk of your own company, in particular for those companies, large and small, with infrequently traded bonds (i.e. illiquid market, difficult to find counterparty). The effort required in calculating the change in credit spread driving the ineffectiveness between the swap and the hedged debt is significant. Further, this component of ineffectiveness is likely (unless the company's credit improves or worsens significantly between periods) causing only a small portion of the fair market value change.

The proposal would require companies to estimate changes in value of the underlying item (i.e. debt) that are not being hedged, not presented as a risk to the company, nor regularly or uniformly assessed. This impact would otherwise not be reflected in earnings had the hedge not been in place nor hedge accounting elected. The statement falls short in the absence of a clearly defined and consistent method (i.e. some sort of long haul example calculation within the statement) to capture the change in fair market value due to credit and the benchmark interest rate of the underlying debt. We expect that the financial statements will have increased volatility and inconsistency across companies due to different methods of valuation.

Under the proposed statement, as the typical interest rate swap provides no protection for changes in credit risk of the issuer, it is questionable whether an interest rate swap would qualify for fair value hedge accounting at all (even with a less stringent “reasonably effective” standard). Periods of stable interest rates but significant changes in the credit condition of the company would result in amounts recorded in earnings (for only the amount of the debt against which the hedge was placed) for a change in credit risk that was absent in the construction of the interest rate hedge. Our thoughts are that the Exposure Draft as written will cause distortion and reduce the comparability of earnings (both historically and across peers) by recording un-hedged risk changes, an impact that is completely inconsistent with the actions and intent of management in hedging interest rate risk. Maintaining the short cut method would prevent this disparity.

**Issue 2: For the reasons stated in paragraphs A18–A20, the Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt (that is, its liability for funds borrowed), if hedged at inception, and (b) foreign currency exchange risk. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.**

**Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?**

Yes, we believe that entities should be able to designate these risks individually; in the example of Interest Rate Swaps, we feel the interest rate risk should be able to be hedged not only at inception of the debt, but also after issuance during the life of the bond (as is the current practice). The intent of entering interest rate swaps is to hedge changing interest rates (i.e. the risk that a fixed rate being paid is greater than current funding rates in the market), not an attempt to hedge or time the fair market value of the debt on a company’s balance sheet (i.e. for repurchase).

## **Hedge Effectiveness**

**Issue 3: This proposed Statement would eliminate the shortcut method and critical terms matching. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for the hedging relationship, an entity would be required, in all cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction.**

**Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?**

**Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?**

Our belief is that requiring the calculation of ineffectiveness for fair value and cash flow hedging relationships on a hedged item by hedged item basis places a significant resource demand on companies. Adding the requirement to calculate ineffectiveness for fair value hedging relationships and cash flow hedging relationships where potential ineffectiveness is minimal is administratively burdensome for little demonstrated benefit.

In the example of interest rate swaps, in order to determine any ineffectiveness, each and every fixed-to-floating interest rate swap would require a long haul calculation of the change in value of the underlying debt due to movements between periods in: the benchmark interest rate, credit of the issuer, and supply/demand changes in the market (i.e. new issue premium). This value adjustment is then compared with the change in value of the interest rate swap (with changes in the benchmark interest rate) to record any ineffectiveness. For companies with multi-billion dollar debt and swap portfolios, this would require significant manual effort and estimations for changes in the credit and market across varying times of debt issuance and swap placement. The impact becomes multiplicative when you factor in differences in the timing of the original issuance and the hedge placements across the entire debt portfolio.

Also, as the Exposure Draft is constructed, the guidance on determining the changes in fair value is either absent or at best unclear. In the instance of the interest rate swap, there are multiple methods of capturing the change in the market credit condition of a company: analysis of the secondary bond trading levels (difficult for companies whose bonds do not trade very often), changes in the credit default swap (CDS) (volatile and not easily priced for long term bonds for every company), or indications from the third party banks (may bring into question ethical concerns in their attempt to win a company's debt issuance and hedge business).

Different methods will yield inconsistent results across companies. In our view this worsens the comparability of statements of companies versus the standardized practice today (i.e. shortcut method with strict critical terms match with no ineffectiveness hedge relationship assumption).

**Issue 4: This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from *highly effective* to *reasonably effective* at offsetting changes in fair value or variability in cash flows.**

**Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?**

**For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity's own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy? If not, would you (a) modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments, or (d) adopt some other strategy for managing risk?**

Generally we see the change in the threshold of effectiveness from "highly" to "reasonably" as positive. In some hedging relationships, while the instrument was very effective in offsetting the hedged items economic risk, strict statistical testing (i.e. regression) was not always met with an auditor's approval to pass the "highly effective" standards (even though "highly" was never clearly defined, most interpretations by auditing firms were stringent and disallowed hedges that did not meet the test with minimal variance).

As drafted, however, we feel that the document is still unclear as to what "reasonably" effective means. This gives companies much greater latitude in determining a hedge relationship as effective and implementing hedge accounting. A clearer definition of what is "reasonable" could improve the standardization of accounting and results across companies by allowing similar hedges. The statement reads as allowing the standards for hedge accounting as being loosened, but introducing the likelihood of inconsistent application of fair value accounting. Further, while the detailed calculations required to pass the "highly effective" criteria may be lessened by softer standards, it may prove even harder to calculate the ineffectiveness generated from the unhedged risks.

In response to the second question, we would agree that using a reasonably effective standard our plain vanilla interest rate swaps would qualify for hedge accounting. Unfortunately, as interest rate swaps are designed to hedge specific risks (i.e. changes in interest rates) and not all of the risks to the fair value, in some instances this requirement may result in disqualifying some of the most simple and effective hedging strategies currently used. Specifically, companies with very volatile credit changes may not qualify under the new guidance. There is no proven correlation between interest rates (that drives the change in value of the swap) and credit (now a component to be factored into the change in fair value of the debt). In these instances, the ability to qualify for hedge accounting is reduced.

Today hedges of interest rate risk of a company's own debt are extremely common for small, medium, and large public and non-public companies, with the purpose being to simply swap the interest rate. Eaton uses this tool regularly to manage our exposure to interest rate risk in response to changes in interest rates after the original issuance of debt. By disallowing hedges to be insulated from changes in credit and other market risks, however, this practice would likely be less used by companies wary of the non-hedged credit risk volatility introduced into earnings. In this manner users of the financial statements and investors of a company are harmed by eliminating a critical risk management instrument from a company's toolbox.

**Issue 5: This proposed Statement always would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.**

**Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period?**

**Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? If so, why?**

Assuming that the definition of reasonably effective is clarified, creating a process that will determine when a hedging relationship is no longer reasonably effective should not be onerous.

It is difficult to predict if a reduction in the discontinuation of hedging relationships would result as the shift to the reasonably effective requirement might encourage companies to enter into hedging relationships with a greater element of risk of ineffectiveness, such as foreign exchange contracts using tandem currencies.

**Issue 6: The Board considered but decided against eliminating any assessment of effectiveness after the inception of the hedging relationship. The Board believes that eliminating such an assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be reasonably effective. Some observe that an implication of the decision to not eliminate any assessment after the inception of the hedging relationship could be that hedge accounting results would be reflected in some reporting periods and not in other reporting periods throughout the life of the relationship. Also, in a hedge accounting model that generally does not permit hedging of individual risks, changes in the relationship between the individual risks being managed and those not being managed could increase the likelihood that the hedging relationship would no longer be reasonably effective. That would result in hedge accounting no longer being permitted for a portion of an expected hedge term. That “in and out” of hedge accounting would make it more difficult for users to interpret financial statements.**

**Do you agree with the Board’s decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging**

**relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?**

We agree with Board's proposal assuming that in the case of interest rate swaps the provisions of the shortcut method are retained.

**Issue 7: In the statement of operations, Statement 133 does not prescribe the presentation of gains and losses associated with hedging instruments, including the effective portion, the ineffective portion, and any amounts excluded from the evaluation of effectiveness, such as forward points. Some have suggested that such a prescription would improve financial reporting by creating consistency in the presentation of these amounts across all entities. Others observe that FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, requires disclosure about that information, and they question whether a prescriptive approach is appropriate given the diverse hedge accounting strategies employed by entities.**

**Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.**

Yes, the proposed split referenced above between interest expense and other income makes sense based upon the intent of placing the hedge. The effective portion of the hedge would be the offset to the interest rate risk (intent of hedging) and belongs within interest expense. Meanwhile, the "other" non-specific changes in fair market value of the hedged item not intended to be hedged are more appropriately classified as other income or loss.

## **Effective Date and Transition**

**Issue 8: The Board's goal is to issue a final Statement by December 31, 2008. The proposed Statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years.**

**Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?**

As written we do not believe the Exposure Draft provides enough time for entities to adopt the proposed Statement. The guidance is too open ended and does not provide for the simplification intended. Auditors will need time to review and comment upon each company's proposed method of valuation without the benefit of a model from the FASB to follow. Systems will need to be updated with the necessary resources to manage the new processes.

**Issue 9: The Board did not prescribe any specific transition disclosures upon the**

**adoption of this Statement.**

**Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.**

We do not believe any additional disclosure is necessary beyond what is required in FAS 161.

**Issue 10: The Board decided to permit an entity a one-time fair value option election under FASB Statements No. 156, *Accounting for Servicing of Financial Assets*, and No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, for (a) servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this proposed Statement.**

**Do you agree with the Board's decision to allow a one-time fair value option at the initial adoption of this proposed Statement? Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?**

No comment.

### **Benefit-Cost Considerations**

**Issue 11: The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The benefit-cost considerations considered by the Board are provided in paragraphs A43–A50 in Appendix B of this proposed Statement.**

**Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?**

With the lack of clarity provided regarding methods to be used in assessing effectiveness and performing changes in fair value calculations, we disagree with the premise that users of financial statements will be better off to assess the effect of hedging activities on an entity's performance. Different methods used by different companies will lead to inconsistent entries for, in the event of a plain fixed to floating interest rate swap, very simple instruments. We would agree that there is more transparency to the risk *not* being managed by the company in using the hedging instrument, but the benefit in requiring journal entries for items previously unaccounted for and not intended to be hedged under the executed instrument is questionable.

Regarding the costs related to this proposed statement, as highlighted in Issue 3 comments above, initial and ongoing costs to perform long-haul ineffectiveness calculations are significant. The cost savings from eliminating the need to formally assess hedge effectiveness do not apply for simple interest rate swaps. Today these are recorded using the short cut method without the need to assess effectiveness post designation (where the presumption of zero ineffectiveness lives until maturity of the swap and debt). This proposal thus adds significant time and systems costs to monthly close cycles, not only by companies but also by auditing firms that must come to understand and publish their thoughts on the appropriate accounting.

The concept of eliminating de-designation options (requiring that the hedge be cashed out or perfectly offset with a second hedge versus terminating the relationship through documentation) will also increase transaction costs for companies with dynamic hedging programs. Even swaps that are partially grandfathered and protected from assessing changes in credit risk under this proposal will now require some sort of long haul testing that was not necessary before (extrapolated across every swap of the company at each month and quarter end). In our opinion, there are not clear benefits (i.e. reduced evidence of distortion of earnings or improved usefulness of financial statements) that by eliminating short cut and other similar FAS 133 provisions justify the initial and ongoing higher costs.

## **Additional Matters**

### **Forecasted Transactions Involving Debt Instruments / Cash Flow Hedge**

A rate lock (i.e. Treasury Lock or Forward Starting Swap) is a very common and simple instrument used by companies to hedge the forecasted issuance of corporate debt. The proposed guidance, however, increases the complexity of using such an instrument.

By eliminating the ability to designate only interest rate risk (which is what a rate lock protects against) requires an entity to designate the overall changes in cash flows of the instrument as the hedged risk. Issuers of a rate lock (and other cash flow hedges) would be required to make hypothetical subjective estimates for monthly mark to market journal entries by assessing changes between periods of its creditworthiness, risk of default, and marketplace supply and demand factors. Such factors drive the spread level above Libor (or other benchmark) at which the company will ultimately issue the debt. This calculation will be very difficult if there is not an observable derivative market for that company's own credit spread. Beyond complexity, this introduces earnings manipulation risk with the absence of clear guidelines within the statement of how these assessments should be made by companies. In the end, companies may abandon this prudent risk management strategy due to the moral hazard issue and the complex hypothetical calculations for the un-hedgeable risks.

Further, in the case of other cash flow hedges, the statement proposes that there will be ineffectiveness in earnings when the actual hedge mark to market is *less* than the hypothetical derivative mark-to-market (despite the absence of additional economic risk). This in effect eliminates the asymmetrical treatment of over and under hedges on cash flow hedges.

Requiring an accounting entry to true up to the hypothetical hedge that does not reflect anything that has happened economically is questionable.

**Elimination of the Ability to Hedge Forecasted Intercompany Transactions**

We disagree with the amendment made to Paragraph 40. Many multinational companies actively hedge intercompany transactions with foreign exchange implications because, unhedged there is an impact to consolidated earnings. Multinational companies with global operations rely heavily on this risk management tool. Any interpretation that would eliminate the ability to hedge the forecasted intercompany foreign exposure risk would remove this valuable tool, and potentially impact decision-making processes regarding business strategy.

**IASB (pending revisions to IAS 39: Financial Instruments: Recognition and Measurement)**

We understand that there is ongoing convergence of US standards to International Financial Reporting Standards (IFRS) and that the board admits that this proposal, while a step in that direction, does not achieve this convergence. It would seem more reasonable to work towards a consistent standard now, rather than requiring US companies to adopt different and more complex accounting standards today and address convergence at a later date.

**Conclusion**

One important consideration not yet mentioned is that this proposal effectively forces companies to make a one-time decision to go to floating rate debt at issuance in order to achieve the most favorable accounting treatment. Effectively, this takes away a prudent risk management tool by not being able to decide to go to floating interest rates when market conditions permit. Otherwise, you are penalized with harsher valuations and the assessment of different risks for the placement of the same hedge instrument. Further, the benefit of achieving hedge accounting in order to reduce earnings volatility may be less attractive, or in the best case, a lesser benefit to earnings stability.

Eaton has been using the short-cut method and critical terms match over the past eight years. We have invested time in applying the principles responsibly and have been diligent in using it correctly. Its application and our results have also been audited and found appropriate. *Why should we now be penalized and forced to switch to a more complicated methodology?*

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) 523-4175.

Sincerely,

Billie K. Rawot

Senior Vice President and Controller