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June 19, 2009

Mr. Russell Golden  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

**Subject:** File Number 1660-100 - Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers

Dear Mr. Golden:

Honeywell is a Fortune 100 diversified technology and manufacturing leader, serving customers worldwide with aerospace products and services; control technologies for buildings, homes and industry; automotive products; turbochargers; and specialty materials. Based in Morris Township, N.J., Honeywell's shares are traded on the New York, London, and Chicago Stock Exchanges.

We appreciate the opportunity to review and comment upon the Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, issued jointly by the Financial Accounting Standard Board (FASB) and International Accounting Standards Board (IASB) ("the Boards"). While we support the joint effort by the Boards to create a revenue recognition model that reduces and streamlines the various standards in place today, we are concerned about the adoption of a single revenue recognition model that applies to all markets and industries, without consideration to the differences and nuances of those markets and industries. We believe that standards currently exist that align well with the economics of specific transactions. Treatment of items such as warranty obligations and sales incentives are expense rather than revenue items. Jeopardizing this accounting structure for the sake of a single set of standards may not be in the best interest of the preparer and investment communities, as it would move the accounting treatment away from an alignment with economic reality.

If, however, a change in the current set of standards is inevitable, we recommend the adoption of a dual standard model, with one standard applicable to long-term construction/production-type contracts (comparable to Statement of Position (SOP) 81-1), and a second standard applicable to all other contracts (comparable to Staff Accounting Bulletin (SAB 104)). We believe such an approach will both more closely align the accounting models of the various industry revenue transactions to the economics

of the transaction, and provide sufficient useful information to the investment community.

Notwithstanding our request for your consideration of our proposed dual standard approach, we would like to describe the significant impact that the Discussion Paper guidance would have on our business, and recommend a clarification or modification of the guidance with respect to these matters. We have segregated our discussion of these matters into three categories, those (1) impacting both categories of contracts, (2) that affect long-term construction/production-type contracts, and (3) that affect all other contracts, as follows.

- **Matters impacting all contracts**

- Warranty items

Under the Discussion Paper, warranty items fall under the definition of a performance obligation, and deferral of revenue recognition is recommended. Currently under U.S. GAAP, standard warranty provisions do not preclude recognition of revenue, rather warranty expenses are estimated and accrued for when the item is sold. This practice of accruing estimated warranty expense is based on the expected cost of future warranty claims utilizing historical trends. Conversely, the proposed warranty treatment requires a portion of sales revenues be deferred over the entire warranty period (for standard and extended warranties) and recognized as the warranty services are transferred to the customer. The discussion paper is unclear as to how the revenue would be recognized over the warranty period, be it on a straight-line basis or as a percentage of actual costs. The proposed method of accounting for warranties also creates additional work from an accounting and systems resource requirement perspective, and we do not believe the results of the additional costs creates better information for users of the financial statements. We believe that the current approach for accounting for warranties is appropriate.

- Sales incentives

We understand the Board's basis for classifying certain sales incentives as performance obligations considering the overall methodology of the proposed model. However, we believe that incentive programs are an additional expense associated with the contract and should not be considered a future performance obligation. This belief is based on the notion that a sales incentive program is responsible for deriving incremental sales and as a result, the cost of the program should be recognize at the time such costs are incurred. This methodology more accurately reflects the economics of these transactions. The concept of deferring revenue for a coupon for a customer discount of future purchases does not seem to match the economics with the accounting.

➤ Multi-Element Arrangements with Functional Dependencies

The Discussion Paper sets forth a multi-element painting example in which paint is delivered to a customer site prior to the delivery of the painting services. The Discussion Paper states that the paint and painting service could be separated if transfer of control of the paint and painting services occurs in different periods. If the customer has physical possession and title to the paint prior to the provision of services, the customer can derive value from the paint if the painting company is unable to deliver the service. Therefore, the customer can receive stand-alone value from the paint if it has the right to the paint in the event of the painter's nonperformance. However, in more complicated product and product/services arrangements, the customer may not receive any value from the delivered item (despite physical control and title). For example, to what extent does a customer obtain value if an airplane manufacturer delivers a plane without the required avionics? Clearly, the customer has tangible pieces of aluminum and steel, but the mere fact that the company delivered materials to the customer should not be the basis for determining whether the seller has fulfilled its responsibilities within the terms and conditions of the contract. The materials as delivered do not provide the value promised in the agreement to the customer. We therefore believe that revenue should not be recognized in this situation. Such cases raise the question of what is "promised in the contract?" We believe that in instances in which the value of the delivered asset is solely dependent upon the delivery of an undelivered asset, the delivered item cannot produce the economic benefits intended under the arrangement and, thus, should not be viewed as a stand-alone accounting unit. In those cases, the provision of the total completed unit (a flight worthy airplane) is the unit of account, as the customer cannot derive economic benefits from the incremental component assets that make up the plane.

➤ Measurement of Performance Obligations

We agree with the Discussion Paper that performance obligations should be measured initially at the transaction price. We also generally concur with the IASB's April 1, 2009 decision to allow estimation and recognition of contingent revenue items; however, we recommend a best-estimate approach (similar to that promulgated under Statement of Financial Accounting Standard No. 5, *Accounting for Contingencies*), instead of a probability-weighted estimation approach. In most circumstances, a best-estimate approach is more precise as it is predicated on the single "most likely" probability outcome, as compared to a probability-weighted estimate that can be skewed by "unlikely" probability outcomes. We thus believe the best-estimate approach is a better reflection of current performance under a contract. We also believe that a best-estimate approach allows for judgment as to whether it is inappropriate to include amounts attributable to contingent items when the weighted probability is less likely than not. For example, consider a contract that embodies a two-state incentive fee in which the fee awarded is based upon whether a company achieves a specified goal. If the

company achieves the goal it receives a \$25M fee; if it does not make the goal, it does not receive any fee. Assuming the probability of achieving the goal is 25%, and the probability of not making the goal is 75%, the application of the probability-weighted approach would result in a \$6.25M estimate of contingent revenue, when the best estimate of that contingent revenue is zero. We believe it is inappropriate to value the contingent revenue in this example at \$6.25M when most third parties would likely discount it significantly more than that given the fact pattern

We also believe the proposed guidance for measuring performance obligations needs to be clarified for:

- treatment of contingent fees as well as variable pricing;
  - the level at which to assess whether a contract is onerous; and
  - the frequency which performance obligation should be remeasured.
- **Long-term construction/production-type contracts**

➤ Identification of Performance Obligations

We believe performance obligations should be closely linked with the economics of the underlying contract. The revenue recognition model set forth in the Discussion Paper does not work effectively in those situations where the product or services being delivered:

- are highly customized to meet a customer's specifications and cannot be easily transferred to another customer upon contractual default by the original customer;
- require an extended period of time to complete, involve complex activities or products which are produced in relatively low quantities for a given customer with significant oversight by the customer during the construction or performance period; and
- are governed by an extensively detailed contractual relationship between the contractor and the customer.

For the types of transactions listed above, we believe the use of a long term contract method comparable to the existing SOP 81-1 more closely reflects the economics of the aforementioned transactions.

➤ Measuring Progress (Input / Output Measures)

While we believe performance obligations are satisfied via a continuous transfer of control (i.e., a percentage-of-completion (POC) model is appropriate), the question arises as to how we can best measure progress toward completion. We agree conceptually that where they can be established and monitored objectively and reliably, output measures are the most direct measure of progress toward completion. Indeed, this is consistent with current practice as recommended in paragraph 47 of SOP 81-1. However, we also acknowledge that for any measure, input or output is merely a proxy for actual progress toward completion, and each has costs and benefits. Costs incurred should be endorsed as a reasonable proxy for progress toward completion on long-term construction/production-type contracts when reliable, representative output measures cannot be determined.

Unfortunately, we frequently encounter difficulty in defining output measures, as our contracts typically involve a few, large deliverables over a protracted term. In other cases, our contracts may involve numerous back-end loaded deliverables despite the fact that we may make significant progress toward completion of the total contract effort before we deliver the first unit. As a result, we predominantly use input measures, particularly costs incurred, to measure progress, as input measures best reflect the underlying economics of the contractual relationship. It is for these reasons that we support a long term contract approach be incorporated into the proposed model as this approach better reflects the economics of the underlying transaction.

Matching revenue with expenses in accordance with SOP 81-1 is a better basis for measuring progress in those industries where there are large numbers of deliverables that are back-end loaded in the contract, even though the contractor has made significant progress towards completion of the total contract.

➤ Cost Capitalization

We have entered into contracts under which certain costs (i.e., production costs) are incurred in the early stages of the project, but the satisfaction of such units of delivery occurs throughout the contract term, this occurs when the learning curve (or upfront costs) on the units cause the initial few individual units to cost more than subsequent units. We believe additional guidance for the accounting of these types of costs is needed. Under the Discussion Paper, these costs are front-loaded, and losses may be incurred in the early stages of a contract, while the same type of units produced later under the contract will generate significantly skewed higher margins as the aforementioned costs will have already been incurred.

➤ Service Agreements

Companies often enter into agreements with customers to perform services. Generally, these agreements are accounted for in accordance with Financial Accounting Standards Board Technical Bulletin 90-1, *Accounting for*

*Separately Priced Extended Warranty and Product Maintenance Contracts* (FTB 90-1). FTB 90-1 requires such agreements be accounted for either on an individual contract basis (i.e., where each customer has a large fleet of aircraft), or on a pool basis (i.e., where there are a large number of homogeneous contracts covering individual operators, each with a small number of aircraft).

In a typical services agreement, a customer pays the service provider a set fee per use in exchange for coverage for all or some portion of its fleet. This type of contract presents another problem of segmenting a contract into individual units of accounting and deals with the question of whether those separate deliverables are of value to the customer on an individual basis.

Under the method proposed in the Discussion Paper, the service provider might be required to separately identify and price many individual performance obligations. For example, a service contract could be for a 10-year period, covering 100 pieces of equipment, with each piece of equipment projected to have 20 separate service events over the contract period. Pricing, tracking and updating thousands of types of events would be an arduous task. Each obligation would have its own revenue and margin, which would be a sub-set of the revenue and margin for the entire contract performance obligation.

In today's practice, service agreements are treated as one unit of account. Total contract cost revenues are estimated for the life of the entire agreement to arrive at an overall contract margin. This margin is then applied to all services and costs incurred over the given contract for revenue recognition. This method, which is in accordance with FTB 90-1, is a modified cost-to-cost POC calculation and reflects the economics of the agreement, with the revenue being paid by the customers for the services performed over the entire contract period.

➤ Unit of Accounting

Companies in the aerospace industry account for numerous line items in a contract as one unit of accounting using the percentage-of-completion (POC) method, which allows for revenue recognition as costs are incurred. At times multiple contracts are negotiated and consummated as part of one overall project, with one overall profit objective. Under the SOP 81-1 criteria for combining contracts, these contracts are accounted for and revenue is recognized as if the project had been documented in one contract.

The proposed treatment under this Discussion Paper would require the identification and separation of performance obligations within a contract, and the recognition of revenue for each as that obligation is fulfilled, via transfer of control of the good or service. We believe that the bifurcation of a contract into units of accounting defined by contract line items, even if those line items are individually priced, is not appropriate.

As stated earlier, a contract is typically negotiated as one overall project with the individual line items in the contract used to define tasks to be completed, triggering criteria for payment from the customer and potentially the source within a customer's organization obligated to make the payment. In addition, work performed to satisfy the requirements of specific contract line items is utilized to satisfy the requirements of other contract line items. This matrix relationship between work effort and contract line items would make it difficult, at best, to clearly determine the allocation of the total contract price to the individual line items, in a manner truly representative of each line item's fair value.

➤ Segmented Contract

Segmenting a contract by line item and recognizing revenue upon completion of the separable deliverables will create margin fluctuation throughout a given contract. Under SOP 81-1, a contract is viewed as one profit center and accounted for on a POC basis, with revenue recognized at a flat margin as costs are incurred.

To segment a contract into separate design, prototype and production phases, during which the design phase effort would incur significant costs at little or no margin, ignores the fact that the work performed in the design phase directly relates to the creation of the prototype and ultimate production, and does not recognize the underlying essence of the economic transaction. Thus, to assign greater margin to the prototype phases and no margin to the design phase inappropriately allocates revenue to the segmented line items when there is truly interdependency between the design and prototype deliverables.

Completion and delivery of the prototypes is impossible without the developmental design work that goes before them. Accounting for a contract as one unit allows for revenue to be recognized at a consistent margin over the life of the contract and is more representative of the actual underlying economics.

In the aerospace industry, the delivery of the good or service driving the profit of the overall project is usually years following the (development) resources expended to meet that final obligation. In order to maintain transparency in the financial statements, alignment of revenue recognized with effort expended needs to remain intact. The current method of revenue recognition under SOP 81-1 allows for a better representation of the true profitability of a company on a project by project basis.

Under a long term contracting scenario, we typically enter into an agreement that contractually represents a loss in the design phase, with all of the profit being achieved during the production phase of the contract. If not accounted for as one unit of accounting, companies would be forced to accrue losses on overall profitable contracts because some more granular segments (i.e.,

development would bear a disproportionate share of the overall cost of the project.

In addition, the decision to enter into a given contract is based upon one overall profit margin that takes into account the development, design and production of contractually guaranteed deliverables under a contract. To ask a company to segment these contracts and account for them on a line-by-line basis will not only be highly burdensome but would reduce the predictive value of financial statements. Companies typically have hundreds of contracts, each with numerous line items. As proposed, the discussion paper would require the segmenting and accounting of these thousands of line items as their own separate units of accounting.

There would also be issues with implementing this proposal on a systems basis. Most company systems are not designed to calculate and store different margin rates under the same project. Further, company activities down to time keeping may not support assignment of costs at such a low level. The changes to our systems to adopt these practices could be quite costly.

- **All other contracts**

- Sold goods with right of return

The discussion paper offers two proposed approaches to accounting for goods sold with the right of return.

- Failed sale – The discussion paper presents the possibility of using a failed sale approach to account for goods sold with a right of return. Under this approach, a company would not recognize any revenue until the right of return expires, as the customer has not accepted the company's proposed terms of sale because it has the ability to unwind the transaction without consequence (that is, put themselves in the position they were in before entering into the contract).

We disagree with the methodology of the failed sale approach as it would require companies to significantly enhance their systems to capture and account for the necessary data. If, however, the Boards elect to adopt this approach, further guidance would be required as to the granularity of information that would be needed to be maintained. For example, if a company could not track financial information on an individual product unit basis, would you then require to tracking such information by product by period of time (i.e., day, week, monthly, etc)? In addition to the complexity in tracking this information and the significant incremental cost, we question the overall benefit that the user of the financial statements would obtain through the use of this approach, as it would be confusing and not aligned with likely outcomes.

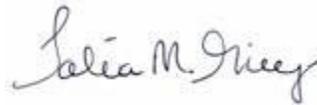
- Performance obligation – The discussion paper proposes a second approach in that preparers segregate goods sold with a right of return into separate performance obligations. Under this scenario, a company would not recognize all of the revenue when a good is transferred to a customer at the point of sale, but would be required to attribute some of the revenue to the return service, only recognizing this revenue component when the return right expires.

We support this performance obligation approach, as this methodology is consistent with the overall model proposed; however, we are concerned that there is the potential that revenue could be recognized more than once for the same product.

In closing, we believe that the Boards' proposed model will materially impact our current revenue recognition practices and provide less financial insight to our investors. The Discussion Paper seeks more precise and speculative disclosure, at the cost of alignment of accounting practices with economic reality. The cost of providing any required data will be significant, from both a systems and implementation perspective. We recommend that a long term contract model such as that prescribed by SOP 81-1, coupled with a separate model for all other contracts, would provide users of public company financial statements the most beneficial information, considering the economics of the respective transactions. If, however, the Boards elect to move forward with the proposed model, we respectfully request that further review and possible clarification be provided with respect to the points addressed above.

We appreciate the opportunity to submit these comments. If you have questions, or need additional information, please contact me at 973-455-4014.

Sincerely,



Talia M. Griep  
Vice President and Corporate Controller