Honeywell

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VIA E:MAIL: director@fasb.org

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No.: 1850-100 – Exposure Draft – Proposed Accounting Standards Update – Leases (Topic 840)

Dear Technical Director:

Honeywell International is a 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 comment on the proposed Accounting Standards Update, Leases (Topic 840) (the "Proposal").

We support the FASB's objective of developing a model that increases the usefulness of the information reported regarding leases. We generally support the model in the proposed update. However, we believe certain aspects of the Proposal should be clarified or modified in order to achieve the Boards' objective to provide useful information to the investors. We respectfully request that the FASB consider these concerns.

We have provided responses to several of the specific questions raised by the Boards in the proposed update as follows, and have limited our responses to those questions that most significantly impact our processes and operations.

Question 3: Short-term leases

This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at

the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65). (See also paragraphs BC41-BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

While we are supportive of the option to record short-term leases using a simplified method, we propose the Board modify the guidance to allow a company to utilize its historical experience with similar leased assets instead of utilizing "maximum possible" lease term in determining the eligibility of short-term lease accounting treatment to meet the Boards' simplification objective.

Example 1: A company leases vehicles from a rental car company for outof-town employees on a temporary basis. The rental rate is established on a weekly basis but the company has the option to renew up to 13 months. The rental car company has the discretion to adjust the rental rate according to its pricing policy at each renewal rate. Historically, the company has an average lease term of less than 6 months.

<u>Example 2</u>: A company rents a boiler, equipment that is integral to a production line for 1 year. The company has the option to renew up to 5 years. The boiler owner has the discretion to adjust the rental rate at each renewal date. Historically, the company has renewed every year and the average lease term is between 3 to 5 years.

In Example 1, one may interpret the "maximum possible" lease term as more than one year as the company has the right to renew up to 13 months. Therefore, the current proposed guidance would prohibit the company from applying the simplified accounting. However, given the company's average lease term of less than 6 months, this type of leasing arrangement would seem to be one that should be eligible for the simplified accounting treatment.

In contrast, under Example 2, given the company's average lease term of the boiler is between 3 to 5 years, the company should not be eligible for the simplified accounting treatment under the Proposal.

Ouestion 4: Definition of a lease

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

We recommend that the Board further clarify what constitutes a specified asset. The current lease definition indicates a lease exists when the underlying asset is "specified," but paragraph B3 of the Proposal also states that a contract that permits substitution of similar assets after the lease commencement date does not constitute a lease because the underlying asset is not specified, even if the contract explicitly identifies a specified asset. At the same time, the Proposal states that a lease may exist when a contract permits or requires the supplier to substitute other assets only when the specified asset is not operating properly.

Under the Proposal, it is unclear whether the below examples would fall within the scope of the Proposal.

<u>Example 1</u>: A company rents vehicles from a rental car company for outof-town employees. The company will specify types of vehicles (e.g. midsize sedans, SUVs, etc.) but does not dictate a specific brand or model. The vehicles are identifiable by VIN but they are not customized. The rental car company will substitute other vehicles if the original ones are not functioning properly.

<u>Example 2</u>: A company rents forklifts from an equipment supplier. The forklifts are identifiable by VIN but they are not customized. The company does not dictate a specific brand or model and only focuses on capacity and fork heights. The supplier has the right to substitute for other forklifts with equal or higher capacity and fork heights at its discretion.

<u>Example 3:</u> A company rents scaffolding for a renovation and construction project that is expected to be completed in 9 months. The rental agreement is written month to month with the rate guaranteed for one year; however, after 12 months the rate can be adjusted at the lessor's discretion.

The scaffolding is delivered unassembled as a set of 500 metal bars and 25 platform boards. The scaffolding is identifiable generically by its components. The agreement provides for replacement of any pieces that are not in working order, such as bent bars and broken platforms, but requires return of all pieces at the end of the term.

Further, in relation to Example 3, we believe that arrangements such as the scaffolding rental arrangement should not be scoped into the leasing guidance given the fungible nature of the leased assets. For instance, the company may determine that it needs only half of the scaffolding based on the progress of the project, so 250 bars and 12

platforms are returned to the rental company. Any half of the bars and platforms could be returned because the rental company doesn't differentiate the pieces.

Measurement

Ouestion 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

More likely than not criterion

We recommend that the Board use a higher threshold in defining the lease term, for example, the longest possible term that is "probable" or "reasonably assured" instead of "more likely than not". We believe a higher threshold would lower the uncertainty of cash flow assumptions in calculating the present value of lease payments and provide a more accurate depiction of the lessee's or lessor's intention and, hence, would improve the quality of financial data and provide more decision-useful information to the investor community.

Renewal Options and Discount rate

The Board defines the lessee's incremental borrowing rate as the "rate of interest that, at the date of inception of the lease, the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar underlying asset."

The above definition seems to focus on the legal counterparty of the lease contract which may create significant implementation challenges for global companies with foreign operations and at the same time may not reflect the underlying economics. For example, a key source of liquidity of many global companies is from within the US even though those companies may have significant foreign operations worldwide. The local subsidiaries are often the legal counterparties of the leases for statutory reasons. The current definition seems to indicate that companies would be required to estimate the borrowing rates of their local subsidiaries under the Proposal when often those local subsidiaries have minimal external borrowing and rely on inter-company borrowing.

We believe a more flexible definition of lessee's incremental borrowing rate would help to mitigate implementation issues and at the same time will not sacrifice decision-useful information.

Example 1: Subsidiary A in India does not have external borrowings. It relies on inter-company borrowings. Over 90% of the external borrowings at the consolidated level were raised in the US by ultimate parent B.

Example 2: Subsidiary C in Brazil has some external borrowings through a line of credit with the local bank. However, any significant capital

expenditures would be funded through inter-company borrowings. Over 90% of the external borrowings at the consolidated level were raised in the US by ultimate parent D.

In Example 1, any capital expenditure made by Subsidiary A would be funded through inter-company borrowing. In this scenario, it seems that ultimate parent B's incremental borrowing rate may be a reasonable proxy for the lessee incremental borrowing rate.

Alternatively, it is less clear in Example 2 whether ultimate parent D's incremental borrowing rate, Subsidiary C's borrowing rate in the local region or some combination of both should be used as the lessee' incremental borrowing rate.

We recommend that rather than a definition of incremental borrowing rate based on legal form, the Board considers providing a list of factors for preparers to consider in determining the appropriate lessee's incremental borrowing rate. Given the numerous liquidity vehicles in the marketplace and currencies variations, we recommend the Board provide some flexibility in the guidance to help preparers conclude on an interest rate that meets the Board's objective and at the same time minimizes operational burdens.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

We agree conceptually that reassessment is warranted when there is a significant change in the lease obligation or lease receivable due to changes in the lease term or contingent payment. However, it is unclear to us how substantial lease modification would be accounted for under the new model.

Example 1: Company A (Lessee) enters into an agreement with Company B (Lessor) on 1/1/20x1 to lease office space for \$100,000/month over a lease term of 10 years. Company A has the option to renew the lease for an additional 10 year renewal option at the then prevailing market rate. At the end of the 10 years, Company A agreed to renew the lease for an additional 10 years at \$160,000/month, which represents the prevailing market rate.

Under the Proposal, Company A in Example 1 would be required to incorporate its intention to renew in assessing the lease term at the inception of the lease even though the fair market value renewal option is akin to the beginning of a brand new lease.

Additionally, since the Proposal does not allow revision of the discount rate, Company A would be required to use the same discount rate for 20 years in measuring the lease obligation which could potentially be not representative of the underlying economics.

We believe fair market value renewal option or renewal option with substantial terms undefined is akin to a new lease and therefore such renewal option should not be included in assessing the "more likely than not" lease term at the inception of the contract. If such option is exercised, we believe the renewal period should be treated as a brand new lease and a new discount rate at the date of renewal should be used in measuring the lease obligation.

Example 2: Company C (Lessee) enters into an agreement with Company D (Lessor) to lease warehouse space for \$150,000/month over a lease term of 10 years. The lease has no specified renewal option. At the end of year 8, Company C and D agreed to renew the lease for an additional 10 years (a total lease term of 20 years). The rental rate for year 11 through 20 is readjusted to \$200,000/month, which represents the prevailing market rate. For convenience, Company C and D executed an amended agreement which stipulates a monthly lease payment of \$191,667/month over the next 12 remaining years (i.e. average monthly rate based on the sum of \$150,000 over the next 24 months and \$200,000 over year 11 through 20).

It is unclear to us how the amended lease agreement would be accounted for under the Proposal. The current Proposal may lead Company C to account for the amendment as a reassessment which would again require Company C to use the old discount rate in measuring the remaining 12 years of lease obligation.

If Company C would have executed the new lease agreement independent of the original lease contract, Company C would be required to recognize a right of use asset and lease obligation based on a new discount rate at the end of year 8 (since the Proposal defines the discount rate as the rate at the date of the inception of the lease).

We are concerned that transactions with similar economics seem to be accounted for differently depending on the legal forms. Therefore, we recommend that the Board address substantial lease modification in this project.

We noted that the Boards have provided substantial modification guidance in other topical areas, such as debt modification (ASC 470-50) and may be able to leverage the work that has already been done in that area. Given the inherent difference between financial instruments and lease accounting, the Board may want to re-define the substantial modification threshold to balance simplicity and economics.

Question 15: Disclosure

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognized in the financial statements arising from leases

Given the significant assumptions and judgments involved, we are supportive of the Boards' proposal to provide expanded quantitative and qualitative information on the amount, timing and uncertainty of cash flows arising from leases. However, adoption of the requirements of this proposal will likely require significant system modification or new system implementation. Therefore, we have significant concerns regarding the implementation timeline given the significant number of leases and leasing entities involved and the lack of a readily-available data management and accounting solution.

Question 16: Transition

(a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

The update in its proposed form would require significant implementation effort and time, especially with regard to systems implementations and modifications. Currently, while it is possible to identify and track the inventory of leases in a manner similar to Property, Plant and Equipment, we have not identified an available integrated systems solution with functionality to track assumptions and inputs and perform the complex measurement requirements as required under the Proposal.

Honeywell has potentially 80,000+ contracts which could be subject to this Proposal. In addition to tracking leases for GAAP and statutory reporting purposes, companies with foreign operations will need to consider tracking these items in sufficient detail to enable correct tax reporting across multiple tax jurisdictions. An integrated software solution combined with an organizational change in lease contracting would be essential to successful implementation of this Proposal.

The amount of transition time needed depends heavily on the Boards' permitted adoption approach. If the Board maintains the simplified retrospective approach to only require presentation of the most two recent comparative years, we believe an effective date no earlier than 2015 would be necessary to adequately prepare for the adoption of this significant standard.

Question 18: Other comments

Do you have any other comments on the proposal?

We recommend that the Board review the impact of its proposal on industry specific regulations, particularly in those cases where industry specific rules and regulations may reference current US GAAP guidance. We recommend that the Board communicate with the industry specific regulatory authorities to ensure sufficient time for the regulators to assess the proposed accounting changes and potential impact to those affected by their regulatory promulgations.

For example, U.S. government contracting regulations (i.e., the Federal Acquisition Regulation, or FAR) does not permit cost recovery, under U.S. government contracts, of explicit interest cost. Under the Board's proposal, the interest component of lease expense would not be a reimbursable contract cost under the FAR. This change alters the economics of doing business with the U.S. government.

In summary, our most significant observations concerning the Proposal are as follows:

- We recommend the Board to consider establishing a higher threshold in defining the lease term, for example, the longest possible term that is "probable" or "reasonably assured" instead of "more likely than not".
- We recommend the Board consider how substantial lease modification could be accounted for under the new model in a manner that will balance simplicity and properly reflect economics.
- Given the far reaching impact of the Proposal to companies' operational and financial processes and IT systems, it is crucial for the Board to provide an effective date that will give sufficient implementation time.

We appreciate the opportunity to express our views on this Proposal, and thank you for your consideration of the comments presented in this letter.

Sincerely,

Kathleen A. Winters

Vice President and Corporate Controller

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Honeywell International