1850-100 Comment Letter No. 514

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Leslie Seidman, Acting Chairman Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

Sir David Tweedie, Chairman International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

Submitted via electronic mail to director@fasb.org

Re: File Reference: No. 1850-100, Exposure Draft: Leases

Dear Madam and Sir:

We appreciate the opportunity to provide our views on the Proposed Accounting Standards Update, *Leases* (the "ED"). While we have provided responses directly related to some of your questions, our comments include additional issues that we believe the FASB and the IASB (the "Boards") should consider in deliberating a final standard.

Southern Company is a leading U.S. producer of electricity, and owns retail regulated electric utilities in four states, a growing competitive wholesale generation company, as well as fiber optics and wireless communications. Southern Company has 4.4 million customers and more than 42,000 megawatts of generating capacity.

### Overall

We support the convergence of U.S. GAAP and IFRS related to lease accounting and we commend the Boards on proposing a simplified leasing model that we believe is fundamentally sound. While there are always compromises from not having a detailed complex model, we believe that the benefits of the model proposed far outweigh any added value that could be obtained from further precision.

### Responses to Questions in the ED

### Question 1:

(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We agree with the Boards' proposal to reflect essentially all leasing transactions on the statement of financial position through the recognition of a right-of-use asset and a lease obligation.

# (b) Do you agree that the lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

While we agree that the lessee should recognize amortization of the right-of-use asset, we do not believe that the use of the effective interest method to recognize interest expense and the resulting front-loading of total expense accurately portrays the economics of many leasing transactions. We instead believe that the recognition of interest expense on a straight-line basis, resulting in ratable recognition of the total expense, more accurately presents the economics of most leasing transactions. While we do not disagree that some leases have the characteristics of financing transactions, absent a bright-line or dual approach to lease accounting (such as with the current lease accounting), it becomes difficult to distinguish between those leases that mirror a financing transaction/acquisition of an asset and those that do not. Therefore, we believe that the use of a straight-line expense approach for all leases is the best solution.

# Question 3: Do you agree that the lessee and the lessor should account for short-term leases in this way? Why or why not? If not what alternative approach would you propose and why?

We believe the treatment of short-term leases by lessees and lessors should be consistent, whereby lessees are given the option, on a lease-by-lease basis, to not recognize assets and liabilities for short-term leases. Any benefit gained by the inclusion of short-term lease assets and liabilities within a year is outweighed by the significant costs to record and track short-term leases.

### Question 4:

### (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 agree with the Boards' definition of a lease contained in paragraph B1. However, we believe that the guidance for distinguishing leases from service contracts should be modified (see our response to (c) below).

## (b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

We agree with the Boards' conclusion related to the distinction between a lease and a sale. We would suggest that the Boards consider clarifying the term "all but a trivial amount of the risks and benefits" as it is unclear what would be considered "trivial". Additionally, it is unclear to us how this term relates to the term "significant risks and benefits" used in determining which accounting approach a lessor should use (per paragraph 8a). We would ask that the Boards consider providing greater clarity on how these two terms relate.

# (c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

In general, we do not believe that the guidance providing for distinguishing between leases and service contracts is sufficient. We believe the Boards should reconsider how to determine when the contract conveys the right to control the use of a specified asset for a period of time. In the years since the issuance of EITF 01-8, *Determining Whether an Arrangement Contains a Lease*, or ASC 840-10-15, we have found it difficult to apply that guidance to various transactions,

primarily with respect to purchase power agreements (PPAs) and fuel supply agreements. In light of the significant accounting changes proposed for leases, we believe the Boards should take this opportunity to reassess the existing guidance in this area and make the changes necessary to ensure consistent application across industries and between companies. As currently worded, we believe the guidance will result in entities accounting for similar transactions in significantly different ways, due to the on-balance sheet treatment required for all agreements considered to be leases.

We recommend that the Boards revisit the discussion related to this area in the development of EITF 01-8, specifically the Working Group reports and issue summaries. We believe that a "risk and rewards" model for determining when a contract conveys the right to use a specific asset would be most appropriate and would be consistent with the "risks or benefits" concept used throughout the Exposure Draft. Under that model, an agreement would be considered a lease when the risks or benefits of operating the specific asset are transferred to the purchaser based on the terms of the agreement, while obtaining all but an insignificant amount of output or other utility of the asset during the term of the arrangement. We believe this risks and rewards model can be best accomplished by providing two sets of indicators: a list of factors that indicate that the *purchaser* has obtained the right to control the asset (representing a lease) and a list of factors that indicate that the *owner* has retained the right to control the asset. Such a list of factors could include:

- Does the purchaser control when the underlying asset is producing outputs?
- Does the purchaser have the right of first refusal to purchase excess outputs in addition to the quantities identified in the contract?
- Does the purchaser have first priority for its requirements, or are they ranked pari-passu with other purchasers?

If, however, the "risk and rewards" model is not considered, and the guidance proposed in the Exposure Draft is retained, we believe the criterion detailed in paragraph B4(e) should be revised to clarify what is meant by the term "contractually fixed price per unit of output". Presently, we believe there is considerable diversity in practice in how this key element is defined in the application of ASC 840. Without additional guidance, we believe this diversity in practice will continue upon adoption of the final standard resulting in pronounced differences in accounting and financial reporting for essentially similar transactions.

When considering what represents a "contractually fixed price per unit of output" today, we are aware that some companies and accounting firms hold to a strict definition whereby the price is considered fixed only if it is established at the inception of the contract and does not change over the life of the contract. Other companies and accounting firms have a more liberal interpretation of what "fixed" is, allowing the price to change over time but only in a manner prescribed in the contract. At present, this difference in interpretation often results in economically similar contracts being accounted for in different ways. However, the current accounting for leases makes this a moot issue in most cases given the similar accounting afforded to operating leases and executory contracts.

Common examples of pricing mechanisms that can be considered "contractually fixed" include: (i) contracts that specify a different fixed price per unit for each year of the contract; (ii) contracts where the pricing of the output is based on a fixed formula that incorporates the future costs to produce the output (e.g., commodity indexes); (iii) contracts that specify different fixed prices based on the timing of the delivery of the output (e.g., seasonal, off-peak, and on-peak pricing); and (iv) contracts where the price is initially fixed with an annual adjustment for inflation. We believe under current practice some entities and some accounting firms would conclude that one or more of these pricing mechanisms do not meet the definition of "contractually fixed". At the same time, we believe all of these pricing mechanisms, in isolation, meet the spirit of ASC 840-10-15 in that a contract that contains one of these pricing conventions does not, by virtue of the pricing mechanism, convey the right to use the underlying asset. We therefore encourage the

Boards to consider these examples and clarify what is meant by "contractually fixed price per unit of output" to eliminate the current diversity in practice.

Question 8: 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 option 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?

We do not agree that the lessee or the 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 options to extend or terminate the lease. We believe that the lease term should include only the term to which the lessee is contractually obligated to make lease payments. We believe that options to extend or terminate a lease are not contractual obligations of the lessee until the lessee commits to such options at a future date. Similarly, a lessor does not have the contractual right to receive lease payments related to a lease renewal until such time as the lease renewal is exercised. When the lease term used to measure expected lease payments for both lessees and lessors includes consideration for options to extend or terminate the lease term, an unacceptable level of uncertainty is introduced to the amounts presented in the statement of financial position and the income statement. When a renewal option to extend a lease agreement is exercised, we believe new rights and obligations are created at that time and should only be accounted for and measured at the exercise date. Similarly, early lease terminations should be accounted for only when notice is given to the lessor that the lessee is terminating the lease.

If the Boards choose to proceed with an approach requiring the inclusion of renewal options in the lease asset and liability, we ask the Boards to strongly consider increasing the measurement threshold from "more likely than not" to "reasonably assured".

Question 9: Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

We do not agree with the inclusion of contingent rentals in the measurement of the lease obligation for lessees or the right to receive lease payments for lessors. As in the case of rentals related to renewal option periods, we do not believe that contingent rentals meet the definition of a liability from the lessee's perspective or an asset from the lessor's perspective. Such amounts should not be recognized in the financial statements until a liability has been incurred by the lessee and a receivable has been earned by the lessor. Similarly, the expected payments related to term option penalties and residual value guarantees should only be included in the lease payment measurement in the event of a triggering event when the expected payments can be reliably estimated.

Question 10: 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 the 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?

If the Boards conclude that a lease obligation or a lease receivable should include contingent rentals and rentals for periods beyond the original term of the lease when they are more likely than not to occur, we agree that changes in the lease term or in the estimated amount of contingent rentals should be reflected in the lease obligation when significant. However, we believe companies should be required to perform reassessments only when a triggering event has occurred and not on a specified periodic basis. We believe that the time and effort necessary to periodically review and assess a large portfolio of leases far outweighs any benefits to investors.

Question 14: Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

We agree with the Boards' conclusion that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows. However, from the lessee's perspective, we believe only the portion of the lease payments representing "repayment" of the lease obligation should be presented as a financing activity. The portion of the lease payments related to the payment of interest should be presented as operating cash flows.

Question 15: 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; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?

### Why or why not? If not, how would you amend the objectives and why?

We agree with the Boards' decision to allow an entity to aggregate or disaggregate disclosures in order to provide useful information that is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics. However, given the substantial variations of lease terms even within similar lease categories, we believe complying with the disclosure requirements as currently proposed will not provide investors with meaningful information.

We also believe the proposed disclosure requirements are inconsistent with the Board's overall approach in treating all leases as financing arrangements. While we acknowledge that some additional information may be warranted when a company's leased assets are significant to its operations, we note that the nature and amount of the disclosures required go well beyond the disclosures currently required for property, plant and equipment and for long-term debt. As an example, we do not believe that a reconciliation of the beginning and ending balances for the lease assets and liabilities should be required when it is not required for property, plant and equipment that is owned outright. In general, we do not believe that the leasing activity of the vast majority of companies would warrant the level of disclosures proposed by the Exposure Draft.

If the disclosure requirements in the Exposure Draft are retained, we recommend that the Boards limit the disclosure requirements to the significant details of lease arrangements that were actually used in determining the amounts recorded on the statement of financial position and not require disclosure and discussion of other factors that were not used in determining the balance sheet amounts, as is currently proposed.

As proposed, paragraph 84 would require an entity to disclose information in accordance with the proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic

825) and Derivatives and Hedging (Topic 815). The lease obligations are not financial instruments, and the Boards rejected the need to carry them at fair value, and thus we seek clarification that the lease obligations will be scoped out of the requirements of ASC 825-10-40-10 through 19.

#### **Question 18**

### Do you have any other comments on the proposals?

ASC Subtopic 980-840 relates to lease accounting for rate-regulated entities. The paragraphs in that section originated from FAS 71, *Accounting for the Effects of Certain Types of Regulation*, but are currently included in this Codification cross section of Topic 980 (*Regulated Operations*) and Topic 840 (*Leases*). Since the proposed exposure draft is intended to replace all current GAAP related to leasing, there is concern within our industry that this section may be eliminated.

We believe the guidance in Topic 980 should be retained when that topic is modified to incorporate the guidance of the final standard on leasing. We believe, as is presently permitted under section 980-840-45-3, the timing of expense recognition for leases should be allowed to conform with rate treatment. Recording expense for leases in an amount equal to the amount allowed for rate-making purposes and included in revenues appropriately reflects the effects of the regulator's actions and the cause-and-effect relationship between a regulated utility's costs and revenues, resulting in a proper matching of the utility's revenues and expenses.

### Conclusion

We believe the accounting outlined in the Exposure Draft is a significant improvement over the current accounting for leases. However, as we have noted in our comments, we believe that there are several important issues that need to be considered and addressed in the final standard.

Sincerely,

W. Ron Hinson

Chief Accounting Officer and Corporate Comptroller