Letter of Comment No: 101
File Reference: 1204-001

PNC

October 28, 2005

Ms. Suzanne Bielstein
Director, Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

VIA EMAIL (director@fasb.org)

File Reference No. 1204-001, Business Combinations
Re: FASB Exposure Draft, Proposed Statement of Financial Accounting Standards, *Business Combinations, a replacement of FASB Statement No. 141*

Dear Ms. Bielstein,

The PNC Financial Services Group, Inc. (PNC) is one of the nation's largest financial services companies with over $90 billion in assets as of September 30, 2005. PNC has a diversified business mix including consumer banking, institutional banking, asset management and global fund processing services. The company's stock is traded on the New York Stock Exchange.

We appreciate the opportunity to comment on the FASB Exposure Draft on Business Combinations ("the Business Combinations ED"). While we agree in concept that the use of fair value for accounting for business combinations improves the relevance and reliability of financial information, we believe certain proposed changes may cause anomalies in practice and compromise comparability especially for financial institutions. We also believe the provision to measure any contingent consideration at the acquisition date and the valuation of goodwill for less than 100 percent acquisitions should be reconsidered. Our comments on these issues are detailed below.

Loans and Receivables Recorded at Fair Value

Paragraph 34 of the Business Combinations ED indicates that an acquirer would no longer recognize a separate valuation allowance as of the acquisition date for any assets required to be recognized at fair value. For example, an acquirer would recognize receivables (including loans) acquired in a business combination at fair value as of the acquisition date and would not recognize a separate valuation allowance for uncollectible receivables at that date. Under this concept, any discount related to credit quality would be reflected in the fair value measure of the loans along with any adjustments due to interest rates.

While this supports the consistent measurement of all acquired assets and liabilities at fair value, it creates both comparability and operational issues for financial institutions who would be most affected by this change.

Comparability Issues

Asset quality ratios are key performance measures for a financial institution both from period to period and across its peer group. Nonperforming loans to total loans, net charge-offs to total loans, and the allowance for loan losses to total loans are just three of the asset quality ratios that investors, analysts and banking regulators use to assess an institution's performance.

Currently, loans acquired in a business combination are recorded at the acquisition date at book value net of any applicable discounts or premiums resulting from interest rate changes. The contra account, allowance for loan losses, is carried from the predecessor with no purchase accounting adjustment permitted in accordance with Staff Accounting Bulletin No. 61. Any additional allowance that the acquirer or its banking regulator deems necessary above the amount initially recorded is charged to earnings of the acquirer. This method allows the acquirer to reflect the loans on their balance sheet at fair value. And, more importantly, it provides for the consistent measurement of asset quality before and after the acquisition for the affected institution and among financial institutions – both those who were active in the merger and acquisitions market and those who were not. By contrast, the recognition of loans acquired on a "net basis" as proposed would adversely impact these asset quality ratios and create less comparable and transparent results both for the institution and among its peers. For example, the allowance for loan losses to total loans ratio would decline for an institution that recognized acquired loans at fair value under the proposal even though the actual credit discount inherent in the fair value may have been greater than the percentage in the existing portfolio. Asset quality measures would be distorted from one period to the next due to the inconsistency between acquired and existing loans. In turn, comparisons across the peer groups would be distorted depending on the acquisition activity of the individual institutions. These distortions would likely create confusion among investors, analysts and banking regulators who depend on the consistency and comparability of these measures to assess performance and safety and soundness.

Operational Issues

From an operational perspective, the recording of acquired loans at their fair value may create hurdles from a systems infrastructure perspective. Currently, the balance for these accounts, as recorded by the acquiring institution in its loan system, is the actual dollar amount of the customer balance that the acquirer is entitled to collect under the loan agreement. Any discounts and premiums are recognized separately and amortized to earnings on an effective yield method. The allowance for these loans is recognized separately and adjusted in the future for charge-offs or any changes in credit quality. To record these accounts individually on a net fair value basis (net of any discounts/premiums and allowance for loan loss) would ultimately result in a difference between the amount collected from the customer and the amount recorded in the loan system. This gives rise to the open question of how the acquirer should account for the resultant difference – since cash has been received and must be accounted for. While using an effective yield method appears appropriate for any interest discounts or premiums, it does not appear appropriate for any discounts associated with credit quality. And while one may propose to maintain records to track both the historical balance of the loan for collection purposes and the recorded fair value, this appears problematic from a control standpoint given the emphasis of Sarbanes-Oxley to maintain controls over subsystems that support the financial statements.

Contingent Consideration

Paragraph 25 of the Business Combinations ED indicates that the acquirer should measure and recognize the fair value of contingent consideration as of the acquisition date.

Contingent consideration results from the negotiation between the parties as to their individual views of the fair value of the business in question. The seller generally desires to maximize the value received while the acquirer may attempt to minimize the initial purchase price due to the inherent risks in the estimates used to value the business. Contingent consideration plays a vital role in providing an upside to the seller and comfort to the buyer as to confirmation of assumptions inherent in its initial valuation. The current accounting rules recognize the additional consideration based on a liability model.

Contingent consideration is used to bridge the gap between the views of the seller and buyer on future performance and, therefore, recording at the acquisition date is extremely subjective. Consequently, we believe there would be a tendency toward conservatism resulting in the recognition of the entire amount at the time of the acquisition. Otherwise, the company would risk taking a charge to future earnings if the contingent consideration paid exceeded the amount recognized at acquisition. While this practice would result in higher recorded goodwill, the downside risk would be a future goodwill impairment charge. If the contingent consideration were not paid, the excess liability would be recognized in earnings. While we believe that this outcome is not consistent with the Board's stated intent in recording acquired assets and liabilities at their acquisition date fair value, we believe the requirement to make a decision at the time of acquisition would drive this result. We believe that the better alternative would be to continue the current practice of adjusting goodwill when the contingent consideration issue is resolved rather than at acquisition.

Goodwill

Paragraph 49 indicates that an acquirer should calculate goodwill as of the acquisition date as the excess of the fair value of the acquiree, taken as a whole, over the net amount of the recognized identifiable assets acquired and liabilities assumed. This requirement applies even if the buyer acquires less than 100 percent of the equity interests in the acquiree at the acquisition date (that is, even if a no controlling interest in the acquiree exists at the acquisition date).

As an example, an acquirer who acquires 70 percent of an entity will now recognize 100 percent of the goodwill. This raises practical issues as to the required goodwill impairment tests since the acquirer will only be entitled to 70 percent of the entity's revenue and earnings.

PNC appreciates your consideration of our views in this matter. If you have any questions or would like to discuss any points in this letter in more detail, please contact me at 412-762-3900.

Sincerely,

/s/Samuel Patterson
Samuel Patterson
Controller
The PNC Financial Services Group

/s/ Thomas F. Garbe
Thomas F. Garbe
Assistant Controller and
Director of Accounting Policy
The PNC Financial Services Group

m: wpdata\michele\SFAS141RComment.doc