



September 13, 2013

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File Reference: No. 2013-270 *Leases (Topic 842): A Revision of the 2010 Proposed FASB Accounting Standards Update, Leases (Topic 840)*

Dear Board Members and Staff:

The PNC Financial Services Group, Inc. ("PNC") appreciates the opportunity to comment on the *Proposed Accounting Standards Update (Revised), Leases- Topic 842* (the Proposed ASU). As the fourth largest U.S. bank-owned leasing company and in our roles as a lessor, a lessee and a user of financial statements, we have a significant interest in the Proposed ASU. We support the Boards' goals of increasing transparency, reducing complexity and creating international convergence in lease accounting. We thank the Boards for listening to stakeholder feedback on the previously issued proposal and for continuing to work towards developing a lease standard.

We are concerned that the Proposed ASU is complex and, as a result, does not achieve the objective of improved financial reporting. We agree that many lease arrangements represent the financing of an asset. When a lease financing arrangement exists, the lessor and the lessee should each record a lease asset and liability. However, the Proposed ASU increases accounting complexity by requiring the lessor and lessee to classify and account for a lease based on whether the lease is Type A or Type B. We believe the Proposed ASU does not align with the Boards' objective of a single lease model and recommend that the Boards work toward this goal.

We discuss this concern more fully below and also provide additional recommendations which are intended to decrease the complexity of the Proposed ASU and to ease the burden of adoption and ongoing operations.

In summary, we recommend:

1. A single lease model in which all leases are accounted for as finance leases.
2. The proposed scope exception should be modified.
3. The elimination of an ongoing reassessment requirement.

4. Clarification that Right of Use assets are property, plant and equipment.
5. Simplifying requirements for determining the effective interest rate for the lease receivable and residual asset.
6. Limited retrospective application with transition provisions that grandfather:
  - a) Legacy leveraged leases;
  - b) Leases that have been terminated or expired as of the date of adoption; and
  - c) Sale and leaseback transactions.
7. A sufficient amount of time should be allotted for implementation.

## **1. All Leases Should Be Classified as Finance Leases**

We believe that all leases inherently have two components, the use of the asset, and the financing element associated with it. If the underlying principle for lease capitalization is that the asset consumed by the lessee is financed by the lessor; the nature of the underlying asset is irrelevant. Therefore, we find no conceptual basis for classifying leases based on the type of underlying asset. Furthermore, the level of asset consumption is irrelevant as all consumption is financed through the lease. The current finance lease model (i.e. Type A lease model under the proposed ASU) appropriately reflects asset consumption and the financing thereof. We propose that a single lease finance model be applied to all leases.

Consistent with our view that capitalized leases are equivalent to financing arrangements, we agree that lease receivables should be subject to the same impairment analysis as applied to loans. Under this approach, an allowance would be recorded against lease receivable balances to account for any losses and balances would be written down when it is determined that it is not probable that all contractual cash flows will be collected.

Applying a single model to all leases alleviates a need to interpret the proposed "insignificant", "major part", and "substantially all" classification criteria. We strongly believe these proposed criteria will not remain principles-based as, inevitably, entities, regulators and auditors will define "bright lines" to interpret these terms. Furthermore, these bright lines will vary resulting in inconsistent accounting treatment and lack of comparability among financial statements. Therefore, if the Boards continue with the two classification model we recommend the final lease standard specifically state the threshold for insignificant. We recommend that when a lease term for a non-property asset is less than 20 percent of the economic life of the asset, the lease would be classified as a Type B.

We are in favor of a single model approach as we believe accounting for leases as financing instruments is consistent with the principle that a lease is the purchase of an asset financed by a lessor. Furthermore, because loan accounting is understood by investors, applying the financing and impairment concepts to leases may be more acceptable to investors and provide more useable financial statement information.

## **2. The Proposed Scope Exception Should be Modified**

The proposed requirement to apply lease accounting at an asset level will require preparers to separately identify and individually account for many homogenous assets under master contracts. In general, our master contracts cover back-office equipment such as copiers. In addition to tracking each of these assets individually, individual accounting will also apply to the servicing elements in these contracts. We do not believe there is any reporting benefit for applying this treatment, in particular, to contracts which are primarily entered into for the purpose of obtaining a service. We believe investors are interested in understanding an entity's leasing business, not its back-office equipment contracts.

We strongly believe the final leasing standard must include a scope exception that alleviates the burden of applying the accounting to contracts which are entered into for the purpose of providing services to our business. The proposed scope exception does not provide relief as the large majority of our contracts for copiers, etc. have terms longer than 12 months. We understand the concern with allowing entities to apply judgment in determining which contracts qualify as services contracts. However, we believe it is possible to develop a principles-based standard which allows for judgment but requires a robust disclosure of an entity's policy and process related to identifying scope exceptions. If the Boards remain opposed to a principles-based standard, we strongly recommend the proposed scope exception be modified to allow for a longer term, such as 24 months.

### **3. Lessors and Lessees Should Not Be Required To Perform Ongoing Assessments of Lease Options**

We do not agree with the proposed requirement for lessors and lessees to assess the likelihood of the exercise of a lease option at the inception of a contract. In addition, we do not believe lessors and lessees should perform ongoing assessments of lease options.

Lessors cannot anticipate all facts and circumstances that a lessee considers in making a lease option decision, and lessors do not have the ability to evaluate all factors from a lessee's perspective. For example, it is impractical for a lessor to predict the importance to a lessee of current market rates versus contractual rates when determining whether a lessee is economically incented to exercise a lease option (Proposed ASU 842-10-55-4(a)). Aside from rate considerations, other economic incentives may exist for a lessee to continue or terminate the lease, such as changes in demand for the lessee's services or products. However, these factors may not be known by the lessor. Likewise, a lessor cannot track all of a lessee's leasehold improvements for the purpose of assessing whether such improvements create an economic incentive for the lessee to exercise an option (Proposed ASU 842-10-55-4(b)).

From a lessee's perspective, a lessee often makes a decision regarding the exercise of a lease option near the time at which the contract requires that the decision be made or at the time business strategy changes. There may be few determinative leading indicators that a lessee would identify as impacting its decision, which a lessee could evaluate on a continuing basis. Therefore, lessees would have difficulty in applying a continuous reassessment requirement. For example, PNC generally does not reassess extension options for branch leases unless these are close to the end of their lease terms or under an initiative or strategy for expansion or consolidation of branches.

We understand the Boards' intent in drafting the "significant economic incentive" evaluation was to establish a threshold higher than "more likely than not" (BC171) and that the Boards expect lease terms to change infrequently (BC127). We agree that subsequent to the origination of a lease, changes to a lease term should be infrequent. However, we are concerned that the use of the term "significant economic incentive" implies a lower hurdle for evaluation as we believe the term could be construed as a requirement to change a lease term based on a change in market conditions. We propose that the Boards retain the "reasonably assured" threshold specified in ASC 840, which still meets the Boards' intent.

Subsequent to the origination of a lease, we believe reasonable assurance regarding the exercise of a lease option is only achieved when a lessor receives notification from the lessee of the lessee's intent to exercise the lease option. From a lessee's perspective, reasonable assurance is only achieved when management makes a firm decision to exercise the option. Absent this firm decision and notification, lease accounting would be subject to unnecessary volatility when lease related assets and liabilities are constantly remeasured to reflect changing economic conditions.

We agree with the Boards and investors that it is important to report information related to existence of and the terms of lease options. We believe the proposed disclosures along with our recommended accounting treatment would achieve the goal of providing financial statement users with useful lease information and would avoid confusing and unnecessary financial statement volatility.

**4. The Boards Should Clarify That Right Of Use Assets Are Property, Plant And Equipment**

We agree that the Right of Use asset should be tested for impairment under Topic ASC 360-10 - Property, Plant and Equipment. Consistent with this treatment, we recommend that the Boards clarify that Right of Use assets be accounted for under the recognition and measurement guidance of Topic ASC 360-10 as Property, Plant and Equipment. If the Boards retain the Type B lease model, specialized subsequent measurement of Right of Use assets under Type B leases<sup>1</sup> should be included within Topic 360-10 along with implementation examples for guidance. We believe these clarifications are important in order to ensure that Right of Use assets receive treatment for regulatory purposes consistent with similar long-lived assets.

**5. The Requirements for Determining the Lease Receivable, the Residual Asset and Their Applicable Effective Interest Rate Should Be Simplified**

We believe additional complexity results from the proposed treatment of initial direct costs with respect to the lease receivable and the residual asset. As noted in paragraphs 842-30-55-7 to 55-15 of the Proposed ASU, including initial direct costs in the lease receivable balance results in different effective interest rates for the lease receivable versus the residual asset. Under the principle that a lease is a financing of the underlying asset, we propose that a single effective interest rate be assigned to the lease receivable and the residual asset. This approach would be in line with existing ASC 840 guidance, where the residual asset is treated as a lease cash flow at the end of the lease term in order to determine a single effective interest rate. We propose this existing guidance should be incorporated in a new lease standard.

In addition, under the Proposed ASU, residual values are only included in the lease receivable if the lease payment is structured as a residual value guarantee which excludes residual value shortfall guarantees. This would result in asymmetrical measurement of lessors' lease receivables as compared to lessees' lease liabilities. This is counterintuitive as pricing for lease agreements considers whether or not the residual value is guaranteed, regardless of how the guarantee is structured. Therefore, we request the Boards allow all guaranteed payments to be included in the lease receivable.

**6. Limited Retrospective Adoption Should Apply**

The Proposed ASU would require retroactive application for all leases; however, we believe certain transactions should be grandfathered due to the complexity of retroactively applying the Proposed ASU. Specifically, we recommend leveraged leases existing as of the issuance date of the final standard should continue to be accounted for under current leveraged lease accounting guidance. In addition, there is no benefit to retroactively apply the final standard to leases which were terminated or expired prior to the period of adoption. Finally, we believe that sale and leaseback transactions should not be reevaluated under the proposed revenue recognition guidance.

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<sup>1</sup> Proposed ASU – 842-20-35-2(b)

a) Leveraged leases

Presenting the gross leased asset and the related debt in a leveraged lease arrangement on the lessor's balance sheet does not appropriately reflect the substance of the leveraged lease transaction. The position of a lessor in a leverage lease transaction is akin to a subordinate lender, as the majority of the leased asset is funded by and secured to the senior lender and the lessee controls the operations of the leased property. The lessor has no obligation for the performance of the senior loan and therefore should not present the debt as a liability. Similarly, since the lessor does not receive all of the economic benefits from the underlying asset, it should not be required to account for the entire receivable.

In addition, we believe that the income statement impact of leveraged lease transactions should not be unwound. The current guidance for leveraged leases incorporates the tax benefits as cash flows within the lease to reflect the underlying economics of the transaction. These leases are generally entered into at lower than market interest rates due to tax benefits and separating the tax benefits from lease cash flows will produce counter-intuitive income statement results.

Determining the financial statement impact of leveraged lease transactions for prior periods will be complex. In addition, leveraged lease transactions have declined significantly. We urge the FASB to consider grandfathering existing leveraged lease transactions under existing ASC 840-30 guidance.

b) Limit Retrospective Application for Prior Period Presentations

Although we understand that the Boards are concerned about ensuring comparability between periods reported, we believe that restating financial information for lease contracts that have expired or have been terminated as of the date of adoption does not provide a benefit that exceeds the cost of performing the retrospective application. We urge the Boards to consider a limited retrospective approach, where leases that do not exist at the end of the first reporting period after adoption date are not retrospectively restated.

c) Sale and leaseback transactions

We believe that the Proposed ASU's requirement to retrospectively reassess whether or not sale accounting was achieved per the new revenue recognition guidance<sup>2</sup> would be operationally difficult to apply to previously originated sale and leaseback transactions and we do not believe retrospective assessment of sale accounting provides useful financial statement information. We suggest the Boards reconsider the requirement for retrospective reassessment of historic sale and leaseback conclusions and, instead, require early adoption of the new revenue recognition guidance for any prospective sale and leaseback transactions after the Proposed ASU is issued in final form.

## **7. A Sufficient Amount of Time Should be Allotted for Implementation**

Implementation of the standard, as proposed, would require significant effort and costs. Lessors' lease software will require extensive modification or replacement. Business processes and internal systems related to data collection and warehousing, accounting and reporting will also require modification. These modifications will need to occur sequentially and well in advance of the implementation date to ensure appropriate testing and adequate controls. We recommend the date of adoption be no less than three years from the issue of the final standard.

In conclusion, we believe the accounting complexity and operational burden introduced by the Proposed ASU exceeds the financial reporting benefit. We urge the Boards to work with investors to understand their lease financial reporting needs; however, the Boards should also equally consider preparers views. We believe that changes to lease accounting and reporting should not

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<sup>2</sup> Proposed ASU to be issued during the third quarter of 2013 per FASB's website

be made unless there is general agreement among the Boards, investors and financial statement preparers that such changes are a meaningful improvement over current lease accounting standards. Therefore, before moving forward with lease changes, we recommend the Boards re-expose the proposed lease accounting standard allowing investors and preparers to provide feedback and to ensure the standard accomplishes the Boards' goal of improving financial reporting in the most cost effective manner.

We appreciate the opportunity to share our views with the Boards. We welcome any questions or comments you may have on this letter. Please contact me (412.762.7546) with any questions about PNC's comments.

Sincerely,

A handwritten signature in black ink that reads "John (JJ) Matthews". The signature is written in a cursive, flowing style.

Mr. John (JJ) Matthews  
Director of Accounting Policy  
The PNC Financial Services Group, Inc.

cc: Gregory H. Kozich  
Senior Vice President and Corporate Controller  
The PNC Financial Services Group, Inc.

Mr. Robert Q. Reilly  
Executive Vice President and Chief Financial Officer  
The PNC Financial Services Group, Inc.