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December 13, 2010

Via email

Technical Director
File Reference No. 1850-100
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1850-100, *Leases (Topic 840)*

Dear Sirs:

Wells Fargo & Company (Wells Fargo) is a \$1.2 trillion diversified financial services company providing banking, insurance, trust and investments, mortgage banking, investment banking, retail banking, brokerage and consumer finance. We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Leases (Topic 840)* (the “Proposed ASU”) as we are engaged in various leasing activities, both as a lessor and lessee, which will be significantly impacted by the proposed guidance. We lease out over 250,000 non-real estate assets to our customers under approximately 85,000 finance leases and 6,000 operating leases. We structure complex transactions on behalf of customers, including over 450 leveraged lease transactions. We also lease in real estate assets in connection with our business activities, including approximately 6,000 stores under operating leases. In addition, as a lender and investor, we evaluate our customer’s leasing transactions included in their financial statements. Our comments are made considering these perspectives.

Executive Summary

We acknowledge that the existing model for leases may not provide users with sufficient transparency related to the assets obtained and obligations assumed under certain leasing arrangements and thus support the effort to develop a comprehensive framework to address the accounting for leases. However, the Proposed ASU employs a “kitchen-sink” approach in the measurement of lease assets and liabilities which we believe is overly complex, operationally challenging, disconnected from the economic and practical realities of leasing and ultimately may discourage entities from engaging in leasing transactions.

Our conceptual and operational concerns with the Proposed ASU are expressed below.

Overall Concerns with the Proposed ASU

- Standard setting should not be used to temper perceived structuring abuses: We acknowledge the concern of the FASB and some users that leases are sometimes structured to achieve off balance sheet

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accounting treatment. However, we believe that such concerns are not sufficient rationale for the inclusion of contingent amounts (e.g., term renewal options, rent escalations and contingent rentals) in the determination and measurement of expected lease payments. The decision to lease an asset is driven by the economic realities of an entity's business model and the environment in which it operates, not by the desire to mitigate financial statement disclosures. Such economic realities will ultimately prevail in leasing arrangements regardless of the accounting treatment. Given the valid economic benefits and business flexibility that leasing offers, we do not think standard setting should be used to moderate perceived accounting abuses that may be present in a small percentage of transactions. We are therefore concerned that the Proposed ASU may unduly penalize the vast majority of leasing transactions.

- The inclusion of contingent amounts in the measurement of expected lease payments represents a new accounting measurement basis that is not supported by fundamental accounting principles: We do not agree that contingent amounts should be included in the measurement of a lease asset and liability because such amounts do not meet the definition of assets or liabilities under GAAP. A contingent liability should not be recognized, until it is both probable and estimable, and contingent assets should not be recognized until such contingencies are resolved. Lessees are not obligated to pay and lessors are not entitled to receive contingent amounts at lease inception. Rather, such amounts are only payable or receivable when the event that triggers the rent adjustment occurs, whether related to the usage of the leased asset, a change in an index or exercise of the renewal option. It is questionable that contingent amounts can be considered estimable with any degree of reliability, due to the inherent uncertainty and period of time between the lease inception and the contingent event triggering date. As such, the recognition of contingent amounts should not be required until an obligation to pay/ perform has been created.

The proposed guidance is most troubling from the lessor perspective as lessors typically do not have sufficient information regarding the contingent triggering events on which to base their estimates resulting in the arbitrary recognition of revenue. The uncertainty of these estimates will also produce inconsistent accounting results for parties engaged in the same leasing transaction. This proposed guidance will also have many non-economic consequences, including the potential to produce a right of use asset that exceeds the fair value of the underlying leased asset, and the exacerbation of gains or losses upon modification or termination of a leasing arrangement.

For these reasons, if the FASB continues to support the inclusion of contingent amounts in the determination of expected lease payments, we encourage a change to the measurement threshold to "assured beyond a reasonable doubt" from "more-likely-than-not".

- It is not necessary to have different patterns of amortization for each lease component: Conceptually, the right-of-use ("ROU") approach introduced in the Proposed ASU addresses the perceived shortfalls in the existing model through the recognition of assets and liabilities that arise from lease contracts. However, the proposed measurement of such assets and liabilities will distort important performance metrics and reduce the overall usefulness of the income statement of both lessors and lessees. In substance, the unit of account for a lease transaction is the lease agreement rather than its components as the lease asset and liability are economically and inextricably linked. For example, when an asset is acquired in a non-lease financing transaction, the asset remains in use by the buyer after the financing is repaid. That is generally not the case with a lease. In addition, the lease income recognition pattern in the Proposed ASU may result in the recognition of potentially significant gains or losses when leases are modified or terminated early due solely to the difference in how lease assets and liabilities are

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amortized. Linking the amortization of lease assets and liabilities will better facilitate users understanding of the value of a leasing arrangement and the related impact on the financial statements. If the objective of the Proposed ASU is to record previously unrecognized assets and liabilities on the balance sheet, we think this can be accomplished without producing the unnecessary income statement impacts that the proposed guidance will create.

- The derecognition model should be the default model provides for lessors: We support the existing lessor accounting framework in Topic 840¹ because it sufficiently reflects the underlying economic substance of the lessor's transactions. The current lessor framework is well understood by preparers, users and auditors and can be supplemented with incremental financial statement disclosure to increase transparency related to the risks of the lessor. However, if the FASB believes that a change in lessor accounting is necessary in order to incrementally reflect the risks of operating and capital leases, we believe the derecognition model provides the most economically faithful representation of the lessor's risks associated with the leased asset. Notwithstanding our advocacy of the derecognition model, we recognize the model may not be practicable for certain short term leases or leases of certain real estate assets. Accordingly, we encourage the designation of the derecognition model as the default model with an option to use the performance obligation approach when it is more practicable based on the business model of the lessor or characteristics of the leased asset.
- The derecognition model provides better symmetry with the lessee ROU model: The performance obligation approach ignores the fact that the lessor has unconditionally transferred all or a portion of the utility of the leased asset to the lessee during the ROU period. The lessee accounting model acknowledges this transfer of control through the lessee's recognition of the ROU asset. Accordingly, the assessment of whether the lessor has maintained effective control of a leased asset should give primacy to the lessee's right to use the leased asset. The reference to constraints on the ability to direct the use of and derive benefits from an asset in the newly issued Revenue Recognition ED² as a measure of control are misguided because this analysis assumes leased assets are analogous to financial instruments. We do not believe such an analogy is appropriate because the lessee does not plan to pledge or sell leased assets to derive economic benefits and more importantly, the fact that such assets may revert back to the lessor does not prevent the lessee from directing the use of and deriving economic benefits from the leased asset during the ROU period. In addition, the notion that control has not passed to the lessee because the lessor has an ongoing performance obligation to make the leased asset available to the lessee is also misguided. The lessor's performance obligation is satisfied upon delivery of the leased asset to the lessee. For these reasons, we believe derecognition of the leased asset by the lessor is consistent with the transfer of the ROU to and recognition of the ROU asset by the lessee.
- Expected lease payments should be calculated using a single best estimate: The proposal to calculate expected lease payments using probability-weighted expected outcomes, including the periodic reassessment, is not operational. In order for such an approach to produce meaningful results, it will be necessary to use multiple scenario modeling techniques. Leases are not fungible and cannot be combined into homogenous pools. Accordingly, multiple scenario modeling is simply not feasible for entities with significant leasing activities given the large number of leases that would be subject to this approach, particularly when coupled with the ongoing quarterly remeasurement requirements. The FASB acknowledged this by suggesting the use of a "reasonable number" of scenarios in the

¹ FASB Accounting Standards Codification Topic 840, *Leases*

² Proposed Accounting Standards Update, *Revenue Recognition (Topic 605)*, issued June 24, 2010

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calculation. However, such an approach results in a false sense of precision that will not produce better results than a single best estimate. If the FASB proceeds with an approach that requires inclusion of contingent amounts in the determination of expected lease payments, we encourage the use of a single best estimate as it would be more operational, practical to implement and more readily understood by financial statement users.

Lessee Specific Comments

We have the following additional concerns with the proposed accounting model for lessees:

- **Executory costs should not be included in determination of expected lease payments:** Certain types of executory costs, which are typically not separately disclosed, are frequently paid by and reimbursed to the lessor through the gross rental payments. For example, executory costs prevalent in leases of real estate include common area maintenance, landlord property taxes and other similar costs. Unless these services are separately stated in the lease agreement, the proposed guidance requires the utilization of gross rentals in the measurement of the lease asset and liability. As result, amortization of the ROU asset will result in the expense of executory costs before they are incurred by the lessee. This proposed guidance represents a change from the Discussion Paper³ that proposed the exclusion of executory costs from expected lease payments. We encourage the FASB to revert the proposed treatment of executory costs in the Discussion Paper.
- **Additional guidance on the treatment of lease incentives is necessary:** The Proposed ASU does not provide sufficient guidance related to the accounting for lease incentives. Lease payments are defined broadly in the Proposed ASU as “payments arising under a lease”. The proposed guidance includes contingent rentals, residual value guarantees and term option penalties as examples of lease payments, all of which are payments made by a lessee. However, lease incentives, such as tenant improvements, are frequently paid by the lessor. Accordingly, it is not clear how such amounts should be accounted for. For example, it is not clear whether incentive lease payments should be accounted for as negative rental payments in the measurement of the ROU asset or treated as a reduction of the ROU asset when paid by the lessor. We recommend that the clarification of this guidance.

Lessor Specific Comments

We have the following additional concerns with the proposed accounting model for lessors:

- **The lease residual should be accreted to expected value:** Under the Proposed ASU, the lease residual is accounted for as a non-earning asset and periodically assessed for impairment. Accordingly, the subsequent measurement of the residual asset is analogous to an indefinite lived intangible asset. However, we do not believe this proposed treatment is consistent with the economic substance of the leasing transaction. The lease residual represents the right to the cash flows the lessor expects to receive at the end of the ROU period that will ultimately be realized through sale, residual value guarantee or re-lease of the leased asset. Accordingly, the value of the lease residual is inextricably linked to the lease receivable and the value of the leased asset at the end of the ROU period. We encourage the FASB to permit accretion of the residual asset to its expected value at the end of the ROU period.

³ Discussion Paper, *Leases: Preliminary Views*, March 2009

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- Depreciation of underlying leased asset: Under the performance obligation approach, the Proposed ASU appears to require depreciation of the leased asset over its useful life to a residual value irrespective of the leasing arrangement. However, because the economic and useful lives of the leased asset are not necessarily the same, the useful life of a leased asset should be coterminous with the ROU period, which may be shorter than the economic life of the asset. This accounting has two important benefits. Most importantly, it recognizes that the underlying leased asset is integrally related to the leasing arrangement and the associated ROU period. Secondly, the use of a longer depreciation period may result in immediate impairment issues relative to the book value of the asset subject to the lease since a single cash flow stream must support both the leased asset and the lease receivable for purposes of impairment analysis. For these reasons, we believe that the underlying leased asset should be depreciated over the lease term to the expected residual value at the end of the ROU period.
- The accounting model for leveraged leases should be retained: The existing accounting model for leveraged leases provides the most accurate reflection of the economics of the lessor. The return on investment for the lessor is a function of both before and after tax cash flows. For the lessee, lessor tax savings are often passed on to the lessee in the form of pricing concessions which is often an integral component of the lease versus buy decision. In addition to these general leasing characteristics, leveraged leases are specifically differentiated from other leasing transactions because the non-recourse debt allows the lessor to recoup a substantial portion of its investment in the leased asset very early in the lease. This allows the lessor to redeploy capital more quickly and efficiently. The proposed guidance will no longer integrate the impacts of tax benefits of the lessor or leverage in the accounting model. As a result, a transaction that yields positive life of lease economic returns will reflect negative yielding returns during the early years of a lease.

In addition, investment decisions are often made at the transaction level based on a required minimum return on investment, i.e., the “hurdle rate”. The hurdle rate considers the cost of capital of the lessor which may be adversely affected by the proposed guidance. Accordingly, many common leasing transactions may no longer be feasible. We acknowledge that the existing leveraged lease accounting is complex. However, we do not believe any of the specific concerns raised about the lease accounting model revolve around leveraged leasing. Leveraged leasing is a longstanding financing tool in the United States that is well understood by industry participants and the benefits of the existing reporting model outweigh any concerns about its complexity. For these reasons, we do not believe the proposed elimination of leveraged lease accounting represents an improvement in financial reporting.

- A linked presentation should be permitted for leveraged lease transactions: If the FASB proceeds with the elimination of current leveraged lease accounting, we propose a linked presentation for leasing arrangements that otherwise would be accounted for as leveraged leases under existing guidance. A linked presentation would allow both the lease receivable and the liability for the non-recourse debt to be presented on the same side of the balance sheet. As such, it more appropriately reflects the underlying economics of the leasing arrangement (as described above) and gives recognition to the fact that the non-recourse debt is contractually linked to the leased asset. Complete elimination of leveraged lease accounting will result in the double counting of assets as the both the lessor and the non-recourse lender will report essentially the same receivable directly related to the leased asset. An asset should only be recognized by the entity that directly enjoys the economic benefits. In the case of a leveraged lease, that is the non-recourse lender because the non-recourse lender controls the right to receive the payments (i.e., the lessor has effectively transferred the right to receive the lease payments related to the nonrecourse debt to the lender). We acknowledge that there is no legal right of offset in a leveraged lease; however, the linked presentation approach is consistent with paragraph 42 of the

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Proposed ASU, which allows offset of the lease liability against the related asset under the performance obligation approach for a lessor.

Other Conceptual and Operational Weaknesses of the Proposed ASU

We have the following additional concerns with the Proposed ASU:

- Additional implementation guidance is necessary for several areas:
 - Incremental borrowing rate of the lessee: The proposed guidance offers the lessee the option of utilizing its incremental borrowing rate to initially measure the lease asset and liability if the rate implicit in the leasing arrangement cannot readily be determined. It is unclear in the proposed guidance whether the incremental borrowing rate should be the lessee's incremental borrowing rate for general corporate purposes or a non-recourse (i.e., asset specific) rate. If a non-recourse rate is permitted, we recommend that the FASB provide additional implementation guidance as such a rate will be difficult to reliably estimate.
 - Deferred gains related to sale leaseback transactions: The proposed transition guidance does not address the accounting for deferred gains related to sale leaseback transactions. Under current accounting standards, the amortization of such deferred gains are recognized as a reduction of rent expense, similar to the amortization of prepaid or accrued lease payments resulting from uneven rents. Under the proposed guidance, deferred rent balances due to straight-lining rent, described in paragraph 91 of the proposed guidance as "any recognized prepaid or accrued lease payments", are reversed against the right of use asset at the initial application date. Given the similar accounting treatment for these items as adjustments of rent expense, we believe that a deferred gain arising from a sale leaseback transaction should also be treated as a reduction in the right of use asset at the implementation date.
 - Vacant space accruals: The Proposed ASU does not address vacant space accruals currently accounted for under ASC 420⁴. Under ASC 420, the liability recognized for these transactions is measured net of sublease rentals, whether or not the lessee has successfully negotiated a new sublease. It is not clear whether the ability to account for the vacant space liability, net of actual or expected sublease rentals, should continue when the lessee enters into a sublease, or whether, thereafter, the new sublease should be accounted for differently under the Proposed ASU. We encourage the FASB to provide further guidance on the interaction between ASC 420 and the proposed guidance for vacant space accruals that exist at initial adoption as well as vacant space accruals that arise subsequent to initial adoption.
- Lessee lease payments should be classified as operating cash flows: The Proposed ASU requires that the lessee's lease payments would be financing outflows in the statement of cash flows. Regardless of the accounting model decided upon for leases, we believe that lease payments made by a lessee represent operating activities related to rental expense since they relate directly to the right to use the asset under lease. We therefore recommend that these payments continue to be classified as operating cash flows in the statement of cash flows.

⁴ Accounting Standards Codification 420, *Exit or Disposal Cost Obligations*

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- Full retrospective transition should be permitted: We support some form of simplified application and appreciate the FASB's recognition that full retrospective application would be very difficult. The proposed guidance to treat each lease as a new lease as of the date of initial application by discounting the remaining payment obligations over the remaining lease term (rather than as of inception of each lease) appears to be a reasonable accommodation. However, we are concerned that this approach will result in frontloading income and expenses for lessors and lessees, respectively. Accordingly, we encourage the FASB to permit a full retrospective approach as a transition date alternative. Also, in an effort to reduce the operational burden of implementation, we recommend the exclusion from the proposed guidance any lease arrangements that have terminated in the period prior to the effective date of the Proposed ASU.
- Certain short term leases should be excluded from the requirements of the Proposed ASU: We encourage the FASB to provide a scope exception for leases with a remaining term of 24 months or less. Given the limited time period of these leases, the income statement recognition under the Proposed ASU would not be significantly different when compared to the cash recognition under the lease terms. Excluding these leases from this complex accounting in the proposed guidance would still capture the material amounts for the longer term leases, while providing operational and practical efficiencies to preparers. We believe that additional quantitative or qualitative disclosures for these shorter term leases could provide adequate information to users of financial statements.

In addition to the above, we may become a temporary lessor as a result of a foreclosure on collateral subject to a lease. There are regulatory restrictions that limit a financial institution from owning and operating this type of collateral and we have no on-going expectation of retaining these properties. As such, we generally do not hold these assets longer than 12 months. If the FASB proceeds with the proposed guidance, we encourage the FASB to provide a scope exception to exclude leases that are expected to be retained for only a short period of time.

- Existing leveraged leases should be grandfathered: Due to the complexity associated with leveraged leases, if the FASB proceeds with the elimination of the leveraged lease accounting model, we suggest that new guidance be applied prospectively and existing leveraged leases could continue under current accounting until the end of their term. Any restatement of existing leveraged leases will require substantial implementation guidance.
- A long transition period is necessary to properly implement the proposed guidance: The FASB has acknowledged that implementation of the proposed guidance will require significant time and effort to develop and implement systems, processes and internal controls. However, the proposed guidance will be very difficult to operationalize and the costs of maintaining the models will be significant, particularly related to contingent rentals, estimated lease terms and the ongoing need to reassess, update and recalculate the amounts recognized related to these assumptions. Moreover, these issues are further exacerbated for entities engaged in significant leasing activities as such entities will need to evaluate and continuously monitor a considerable volume of individual leases and leased assets. Accordingly, it may be necessary to address any proposed accounting and reporting deficiencies with manually-intensive processes, utilizing simple databases or spreadsheet tools, to augment existing accounting systems. By increasing the usage of manual processes and spreadsheets to support accounting, the control environment will be put under unnecessary stress. This type of stress on accounting operations and systems makes it difficult to meet Sarbanes-Oxley requirements and could cause financial institutions to be more susceptible to financial statements errors.

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To facilitate comparability between periods, public companies will need to provide required financial disclosures for a three to five year period. Companies in regulated industries, like financial institutions, will need adequate time to assess the impacts of the proposed guidance on their regulatory performance metrics, such as capital and leverage ratios. Companies will also need to evaluate and cope with the impact of the proposed guidance on non-lease contracts, such as debt covenants, and implement any necessary changes to those arrangements. Given the operational significance of the proposed guidance and its impact on historical disclosures and existing business arrangements, we recommend a long transition period of at least five years.

Conclusion

We support the efforts by the FASB to better reflect the risks associated with leasing on the balance sheet, but only if certain of the complex requirements in the proposed guidance are simplified. However there are many provisions included in the Proposed ASU which require additional thought and consideration, particularly related to the inclusion of contingent amounts and terms in the measurement of the lease asset and liability. These requirements will reduce the reliability of financial reporting and introduce significant operational complexities for preparers. In addition, we are concerned with the income recognition pattern that the proposed guidance produces and believe that the amortization of the components of a lease arrangement should be linked to minimize this inconsistency. We also believe that the existing leveraged lease accounting model should be retained. We believe that simplifying the proposed accounting, especially in the areas noted above, will significantly reduce the costs to preparers while rectifying the perceived problems with the current accounting model as the lease assets and liabilities will be reflected on the balance sheet. We encourage the FASB to revise the Proposed ASU to address the concerns we have raised above.

Given the substantial changes proposed, the complexity of existing lease accounting and the application of these changes to a broad group of preparers, we encourage the inclusion of additional examples for transition and ongoing implementation. We also request that the FASB continue its efforts of outreach and potentially provide opportunities for field testing these significant changes to lease accounting.

We appreciate the opportunity to comment on the issues contained in the FASB's invitation. If you have any questions, please contact me at (415) 222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy
Executive Vice President & Controller

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cc: International Accounting Standards Board Members
Kathy Murphy – Office of the Comptroller of the Currency
Art Lindo – Federal Reserve Board
Robert Storch – Federal Deposit Insurance Corporation
Donna Fisher – American Bankers Association
Gail Haas – New York Clearing House Association