December 15, 2010

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-05116

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

Dear Sir/Madam:

The PNC Financial Services Group, Inc. ("PNC"), one of the nation’s largest diversified financial services organizations, appreciates the opportunity to comment on the Proposed Accounting Standards Update, Leases (Topic 840) ("ED" or "proposed ASU"). The ED states the FASB’s objective is to “develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position.”¹ While PNC supports this objective, we believe that the ED as currently drafted creates many implementation risks and costs and may not ultimately achieve an accounting result that more accurately reflects the economics of lease transactions than that which is captured in the current lease accounting guidance.

Our concerns with the proposed ASU are summarized as follows:

- We do not agree with the proposed lessor accounting guidance and recommend that the FASB should not change the current lessor accounting guidance.
- While we generally agree with the proposed lessee accounting model, we disagree with the proposal as written to include optional lease periods and contingent lease payments in the measurement of the lease payment liability. Further, we recommend that the lease asset and liability be amortized to get a constant rate of expense as they are clearly linked.
- We recommend that the Proposed ASU be revised to establish guidance that would define core and non-core leasing activities for both lessees and lessors, and permit non-core leases to be accounted for as operating leases under existing lease accounting guidance. We believe this would reduce the complexity of the ED and emphasize activities that directly contribute to operating results.

¹ p. 1, Proposed Accounting Standards Update, Leases (Topic 840).
- Revision to the lease of leases that qualify as sales should be consistent with the revenue recognition guidance contained in the exposure draft, *Revenue from Contracts with Customers* ("Revenue ED).
- Implementation of this standard could be more efficiently and effectively accomplished if the FASB adopted a prospective transition approach for existing leases, with a cumulative effect adjustment recorded in retained earnings.

The proposed lessor accounting guidance does not provide meaningful improvements in comparison with the current guidance

We are not supportive of the proposed ASU's approach to lessor accounting. We believe that the current accounting guidance is not viewed by users and investors as a model that is overly complex or flawed. In our opinion, the significant changes proposed by the ED introduce new complex accounting that will ultimately not lead to greater transparency or consistency in its application.

We are not supportive of the Performance Obligation approach because we believe that it is overly complex and does not result in symmetrical accounting between the lessor and lessee. The Performance Obligation approach essentially requires the lessor to record two assets regardless of whether or not one of those assets can be netted against a performance obligation. If the lessee records a right to use asset reflective of the leased asset, then that asset should not continue to be recorded by the lessor too. In other words, we do not view recording a single leased asset multiple times as an improvement to financial reporting, and we are unclear what benefits are derived from this accounting that exceed the continuing operational costs of this accounting.

Additionally, while we acknowledge that there is merit in the derecognition methodology, we believe that more time is necessary to develop it into a workable model for all lease arrangements. Until that time, we recommend that the direct financing lease accounting model be used by lessors. Direct financing lease accounting is a well understood model that is more reflective of the underlying economics of these transactions. For example, leasing businesses generally provide lessees the right to use assets through a financing arrangement while retaining the economic risks related to the credit of the lessee and the residual value of the leased asset. We believe this arrangement is appropriately reflected in a direct financing lease model. Adopting this approach would also simplify the implementation for many financial statement preparers as existing lease accounting systems could be utilized with fewer modification required.

We generally support the lessee right of use model; however, certain revisions are necessary

We support the basic premise that lessees enter into arrangements that create a right of use asset and an obligation to pay for that use that should be measured and recorded on the balance sheet. However, due to the provisions discussed below, we believe the measurement requirements proposed in the ED create a complex and costly approach to recognition that substantially exceeds the benefits that would be derived.
Term extension options and contingent rents, as well as the effect of any options to terminate the lease should not be included in the measurement of the lease asset and liability as proposed in the ED. In addition, we do not support continual adjustments to the right-of-use asset by estimating the expected payments under residual value guarantees. When considering the accounting for the aforementioned items, we agree with the dissent of Mr. Stephen Cooper\(^2\) as follows:

- "Optional lease periods should be reflected in the measurement of recognised assets and liabilities only when the arrangement includes an incentive to extend the lease period such as penalties payable on cancellation or reduced rentals in the optional period, or where costs of customisation or installation make renewal likely. However, if the exercise of options to extend merely depends on future business conditions it is inappropriate to reflect this in the measurement, even if extension or renewal of the lease is likely" (Par AV 2),
- "Including all optional lease periods in the recognition and measurement of the lessor’s receivable (under both the performance obligation and derecognition models) is that investors may underestimate the business risk of the lessor. In his view the overstatement of the receivable implies exposure to credit risk when the reality is an exposure to underlying asset risk" (Par AV4), and he
- "Questions whether lease payments which an entity has no contractual or constructive obligation to pay meet the definition of a liability" (Par AV7).

In consideration of the above comments, we recommend the ED be revised as follows:

- For both lessors and lessees, incorporate definitions of lease term and minimum lease payments that require renewal options to be included in the accounting lease term only if they are "probable" of being exercised by the lessee because of a contractual or noncontractual penalty for nonrenewal.
- If the renewal options are not "probable" of being exercised at inception of the lease, then the renewal options should only be recognized when they are exercised.
- Contingent rents should be recognized when the contingency is satisfied.

We believe the above recommendations would provide a more reasonable approach to recognizing lease assets and liabilities enabling greater symmetry for lessors and lessees in the accounting for a lease arrangement. Lessors would have a greater ability to measure lease transactions consistent with the lessee using our recommended changes as a "probable" recognition principal would be more readily determined by both parties. We have approximately 30,000 lease arrangements where we act as a lessor. Under the proposed ED we would have to reassess each lease quarterly to adjust the lease asset and liability based on changes of our assessment of whether the respective lease option is more likely than not to be acted on by the lessee. We believe the cost of the measurement process and the necessary disclosure that would be required to explain this activity would be unduly burdensome. However, if our proposals were

\(^2\) Paragraphs referenced are from the IASB Exposure Draft.
accepted, we believe they would reduce the extremely subjective requirements and the corresponding continual monitoring costs that are currently proposed.

We believe that supplemental disclosures of renewal options and contingent rents could address the opportunities/risks created by these types of provisions providing the necessary transparency for those items that were not factored into the amount recognized on the balance sheet while leaving more objective measurement and recognition guidance in place. This approach would promote comparability and accounting symmetry for lessors and lessees for lease transactions. Further, this approach would satisfy the Proposed ASU’s objective of recording the lessee’s obligation on the face of the balance sheet without the added complexity of factoring in renewal options and contingent rents on a continual basis as the ED currently requires.

We understand that the FASB has concerns over the opportunity for structuring as it pertains to optional lease periods and contingent rentals; however, the concern should not outweigh the goal of providing relevant and reliable information to investors. We believe structuring opportunities could be avoided by establishing principles for identifying where optional lease periods and contingent rental arrangements lack economic substance and represent disguised minimum rental payments and through adequate disclosure of how one evaluates those principles.

**The asset and liability recognized by the lessee should be amortized using a method that yields a constant rate of expense**

As we believe the assets and liabilities that arise in lease transactions are unique and linked, we believe the amortization of the assets and liabilities recorded for these arrangements would be better reflected in the income statement by amortizing the right of use asset and the liability to make lease payments using a method the equates to a constant rate of expense. If a lease is cancelled, the lessee’s obligation is not represented by the lease payment liability in isolation; it is a linked consideration of impairment of the right of use asset in tandem with the release of the obligation to make lease payments. The proposed ASU would result in the front end loading of expenses which may require users to adjust reporting income to reflect the rental nature of the transaction. If the related asset and liability was linked as recommended, the sum result would provide a clearer view of the cash rental payments throughout the duration of the lease.

**Reduce complex accounting implementation by allowing non-core leases to be accounted for as operating leases**

We believe that the FASB should consider separating lease arrangements whereby leases are distinguished between core and non-core leases. Results of core leasing arrangements typically are those that provide users of our financial statements with key data to analyze the operating performance of our organization. A simple distinguishing characteristic that could be provided is that core leases are direct client-facing assets used in the generation of income (e.g. a retail branch); non-core leases (e.g. copiers) would be defined as those costs that are indirectly related to the generation of income.
for a company. Providing a scope exception for non-core leases would eliminate a substantial cost of evaluating thousands of small ticket leases that are peripheral to core business results. Therefore, while we believe that core leasing arrangements should follow the guidance in the ED with our recommended changes, non-core leasing arrangements should follow a simplified lease accounting approach consistent with the current operating lease model. Moreover, non-core leases should be accounted for as operating leases as accounting for the significant volume of small dollar leases under the ED would be overly complex resulting in prohibitive costs from a contract evaluation and internal control monitoring perspective. We believe disclosure of minimum rentals currently addressed in the existing guidance capture the financial exposure to shorter term non-core lease arrangements.

As drafted the Proposed ASU eliminates the income statement caption “rent expense” for lessees replacing it with amortization and interest expense for the right of use asset and the lease performance obligation, respectively. As we have recommended revising the ED to establish separate accounting guidance for core and non-core leases, the results of core leasing activities should be presented in net interest margin. Non-core leasing activities should be accounted for as operating expense outside of net interest margin. For financial institutions, we believe this would permit key financial metrics to better isolate those activities that contribute directly to primary operating results from those lease activities that are essentially general and administrative types of activities.

**Lease Definition - Purchase or Sale of the Underlying Asset**

We do not agree with the FASB’s decision to exclude from the ED certain lease type contracts that would meet the ED’s definition of a purchase or a sale of the underlying asset. Certain aspects of our core business provide leasing options to customers that contain bargain purchase options of the underlying asset which we believe are appropriately reflected as a lease transaction. These lease arrangements may be excluded from the lease accounting guidance as they meet the definition of a sale under the ED’s “risk and rewards” model, but may fail the sale criteria under the proposed Revenue ED. Therefore, in regard to accounting for the purchase or sale of the underlying asset, we recommend that the lease ED be revised to be consistent with the “control” principles of the proposed Revenue ED.

**Transition**

We disagree with the transition approach in the ED as the operational burden and costs would be significant. Therefore, we recommend the FASB adopt a prospective transition approach with a cumulative effect adjustment recorded in retained earnings in the year of adoption. A prospective transition approach would reduce the implementation issues and would be consistent with adoption methods applied to other significant recent accounting standards issued (e.g. SFAS 166 and 167). A prospective transition approach would further reduce the complexity of considering the accounting ramifications of historical lease transactions (e.g. sales-type leases and terminated leases) that do not remain in place today.
Considering the implementation effort required to adopt this ED, we strongly recommend that the FASB provide a significant extended timeframe before requiring adoption of this leasing guidance to ensure that companies can properly evaluate and effectively execute implementation. As an example of the effort that would be required, a significant change made to our core lease accounting and servicing system would require extensive modification of 1) the front-end application that interfaces the core lease system, 2) the data warehouse configuration, 3) data extracts and interfaces, 4) approximately twenty “backend” reporting systems and 5) business processes supporting these systems. The resources required in implementing the wholesale changes proposed by this ED would be significant and would require an extended planning and implementation timetable. In addition, most of the modification work required at our institution could not even begin until the core leasing system vendor completed or substantially completed enhancement of their system consistent with the ED. Furthermore, the ramifications of adopting this Proposed ASU are broad and diverse and will require substantial costs to revise contracts and covenants within certain financial contracts, and to educate the entire financial system.

**Conclusion - Benefits and costs**

While we fundamentally agree that current lease standards should be revised to better reflect the economics of these transactions, we have serious concerns as to what the impact of adopting this ED will have on businesses and the financial markets at a time when so much economic and regulatory pressure is being placed on the financial system. More specifically, the lessor accounting model should be given more time and consideration to permit parties to evaluate and comment on the operational costs and complexities of adoption and to put forth thoughtful comments as to the accounting changes that most appropriately reflect the economics of the various lease transactions. Further, the lessor and lessee model may be unduly burdensome for leases that are considered non-core activities of a company. In our opinion, these considerations and those involving the scope of this guidance should be revisited before issuing a final standard.

While we appreciate the level of effort provided by the FASB on this standard, we believe more assessment and evaluation is necessary to ensure that the final standard issued best addresses the economics of these transactions in a way that is beneficial to all impacted entities.

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We appreciate the opportunity to share our views with the Board and staff and welcome any questions or comments you may have. Please contact me with any questions about these comments at 412.762.3900.

Sincerely,

Samuel R. Patterson
Senior Vice President and Controller
The PNC Financial Services Group, Inc.

cc  Mr. Richard Johnson
    Executive Vice President and Chief Financial Officer
    The PNC Financial Services Group, Inc.