PREMISES AND EQUIPMENT

INTRODUCTION

Institutions have historically relied on a reasonable investment in premises and equipment to successfully conduct business. A financial institution's physical presence in a community can bolster its public image and competitive position, and enhance convenience for customers. Institution offices can provide a platform for gathering deposits, originating credit, and serving the financial needs of its community. However, overinvestment in facilities may tie up capital and hinder earnings. Therefore, similar to other balance sheet assets, premises and equipment can pose risks to the institution and present a range of accounting issues that require appropriate oversight.

Premises include the cost, less accumulated depreciation, of land and buildings actually owned and occupied (or to be occupied) by the institution, its branches, and consolidated subsidiaries. This includes vaults, *fixed* machinery and equipment, parking lots, and real estate acquired for future expansion. Interest costs associated with the construction of a building are capitalized as part of the cost of the building. Institution premises also include leasehold improvements. Leasehold improvements comprise two types of accounts:

- Buildings constructed on leased property, and
- Capitalized disbursements directly related to leased properties, such as vault, renovation, and fixed machinery and equipment expenses.

Non-fixed equipment includes all *movable* furniture, fixtures, and equipment of the bank, its branches, and consolidated subsidiaries, including automobiles and other vehicles used in the conduct of business.

Premises and equipment are reported in the Call Report schedule RC-Balance Sheet, Item 6, *Premises and Fixed Assets*. The institution's ownership interest in premises and equipment of non-majority-owned corporations is also included in schedule RC, Item 6.

FIXED ASSETS ACCOUNTING

Fixed Assets - Owned

Fixed assets are reported at original cost and are depreciated over their estimated useful life, except for land which is not a depreciable asset.

Interest may be capitalized as part of the historical cost of acquiring assets that need time to be brought to the condition and location necessary for their intended use. The FASB Accounting Standards Codification (ASC) 835-20, *Capitalization of Interest*, calls for capitalization of interest costs associated with the construction of a building, if material. Such interest costs include both the actual interest incurred when the construction funds are borrowed and the interest costs imputed to internal financing of a construction project. The rate used to capitalize interest on internally financed projects in a reporting period shall be the rate(s) applicable to the bank's borrowings outstanding during the period. For this purpose, a bank's borrowings include interest-bearing deposits and other interest-bearing liabilities. The interest capitalized shall not exceed the total amount of interest cost incurred by the bank during the reporting period.

Fixed Assets - Leased

Institutions often lease premises and equipment. Lease obligations, which essentially reflect an extension of credit between the lessee and lessor may reflect material investments and can significantly, affect a bank's earnings.

ASC 840, *Leases*, is the current lease accounting standard for non-public entities and entities that have not adopted ASC 842, *Leases*. ASC 842 is effective for public business entities (as defined in U.S. GAAP) and will become effective for banks that are not public business entities, for fiscal years beginning after December 15, 2020, and interim reporting periods within fiscal years beginning after December 15, 2021. As such, a calendar year end non-public entity's first reporting period will be December 31, 2021. Early adoption is permitted.

In general, under ASC 840, a *capital lease* is recorded on the balance sheet (with interest and depreciation expensed on the income statement). An *operating lease*, on the other hand, is not reported on the balance sheet (it is disclosed in the footnotes of financial statements). Under ASC 840, operating leases are expensed using the straight-lined method on the income statement.

Under ASC 842, lessees are required to classify a lease as either a *finance lease* or an operating lease and, in most cases, identify and report them on the balance sheet. Although the term finance lease replaced the term capital lease that was previously used in ASC 840, the substance of recording and reporting the transactions remains the same.

Lease Accounting – ASC 840

In accordance with ASC 840, any lease entered into by a lessee institution, which at its inception meets <u>one or more</u> of the following four criteria must be accounted for as a property acquisition financed with a debt obligation, i.e., a capitalized lease. The criteria are:

- Ownership of the property is transferred to the lessee at the end of the lease term;
- The lease contains a bargain purchase option;
- The lease term represents at least 75 percent of the estimated economic life of the leased property; and
- The present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the fair value of the leased property to the lessor at the inception of the lease, less any related investment tax credit retained by or expected to be realized by the lessor.

If none of the criteria listed above is met, the lease should be accounted for as an operating lease. Normally, rental payments should be charged to expense as they become payable over the term of the operating lease.

Capitalized leases are to be reported in the Premises and Fixed Assets category of the Call Report. The amount capitalized equals the present value of the minimum required payments over the non-cancellable term as defined by the lease (plus the present value of payments required under a bargain purchase option, if any) less any portion of payments representing administrative expenses (such as insurance, maintenance, and taxes to be paid by the lessor). The property should be amortized according to the institution's normal depreciation policy (except, if appropriate, the amortization period should be the lease term) unless the lease involves land only, which is not a depreciable asset.

Lease Accounting – ASC 842

The core principle of ASC 842 is that a lessee should recognize the assets and liabilities that arise from leases. Under ASC 842, institutions are required to report a right-of-use (ROU) asset and a lease liability for most finance and operating leases. The ROU asset reflects the lessee's control over the leased item's economic benefits during the lease term. The measurement of the ROU asset includes the initial present value of lease payments plus certain third party, initial direct costs minus any lease incentives. The lessee records a related lease liability equal to the present value of the unpaid future lease payments.

The discount rate used to estimate the present value should be the rate implicit in the lease, or if that rate cannot be readily determined, the lessee's incremental borrowing rate (IBR). Many times a lessee may not have the necessary information, (such as the residual value estimate of the lessor or the initial direct cost incurred by the lessor) to determine the rate implicit in the lease. In such cases, the lessee may use its IBR.

While most leases will be reported on the balance sheet, ASC 842 permits a lessee to make an accounting-policy election to exempt leases with a term of one year or less (at the commencement date) from on-balance sheet recognition. The lease term generally includes the non-cancellable period of a lease as well as purchase options and renewal options that are reasonably certain to be exercised by the lessee, renewal options controlled by the lessor, and any other economic incentive for the lessee to extend the lease, which may include a related-party commitment.

Classification of Leases by the Lessee

ASC 842 requires a lessee to classify a lease (at the commencement date) as either a finance lease or an operating lease. When lease terms effectively transfer control of the underlying asset, the substance of the transaction is reflective of a sale, and the lease is classified as a finance lease by the lessee. Leases between related parties, such as a holding company and its financial institution are classified in the same manner as a lease with unrelated parties, i.e., the classification is based on the terms of the contract without considering the related party relationship. ASC 842 has five criteria for determining if a lease is a finance lease or an operating lease for the lessee.

A lessee is required to classify a lease as a finance lease when <u>one or more</u> of five criteria are met:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise;
- The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion is not used for purposes of classifying the lease;
- The present value of the sum of the lease payments and any residual guarantee by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset; or
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

If none of the five criteria are met and the lease is not a short-term lease in which the institution has elected the short-term lease policy election, the lessee is to classify the lease as an operating lease.

While the initial reporting of the ROU asset and lease liability will be the same regardless how the lease is classified (i.e., finance or operating lease), the reporting in the income statement differs. For a finance lease, a lessee is required to report interest expense on the lease liability using the effective interest method separately from the amortization expense on the ROU asset, typically on a straight-line basis. For an operating lease, a lessee is required to report a single lease cost. The lease expense is recorded on a straight-line basis over the lease term by adding the interest expense on the lease liability to the amortization of the ROU asset.

If a lease is not being correctly reported, appropriate comments should be included in the Report of Examination. The comments should remind management of the responsibility for accurate reporting and include the recommendation that competent outside assistance be obtained if the bank lacks satisfactory accounting expertise. In addition, if the amount incorrectly reported is significant, amended Call Reports may be necessary. Examiners are to verify whether bank decisions on how to report a lease are be fully supported and documented.

Sale-Leaseback Transactions

Sale-leaseback transactions occur when the owner of a property sells the property and subsequently leases it back from the buyer. The seller-leasee transfers legal ownership of the property to the buyer-lessor in exchange for consideration and then makes periodic rental payments to the buyer-lessor to retain use of the property.

Sale-Leaseback Accounting - ASC 840-40

If an institution sells premises or fixed assets and leases back the property, the lease shall be treated as a capital lease if it meets any one of the four capitalization criteria in ASC 840. Otherwise, the lease shall be accounted for as an operating lease. ASC 840-40, *Leases – Sale-Leaseback Transactions* provides guidance on the treatment of any gain or loss. A loss must be recognized immediately for any excess of net book value over fair value at the time of sale. In the event a bank sells a property for an amount less than its fair value, (for example, in order to obtain more favorable lease terms), the difference between the sale proceeds and fair value represents an additional loss that must be deferred and amortized over the life of the lease. Any gain resulting from a sale-leaseback transaction is generally deferred and amortized over the life of the lease. Accordingly, the general rule on deferral does not permit the recognition of all or part of the gain in income at the time of sale. Exceptions to the general rule do permit full or partial recognition of a gain at the time of the sale if the leaseback covers less than substantially all of the property that was sold or if the total gain exceeds the minimum lease payments.

Sale-Leaseback Accounting – ASC 842-40

For a sale-leaseback transaction to qualify for sales treatment under ASC 842, the transfer of the asset must meet the requirements for a sale in ASC 606, *Revenue from Contracts with Customers*. If the transaction qualifies as a sale in accordance with ASC 606 and the transaction would not be considered a failed sales-leaseback (as described below), any gain or loss on the sale is recognized immediately. However, an option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale unless both of the following criteria are met:

- The exercise price of the option is the fair value of the asset at the time the option is exercised, and
- There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

The classification of a lease can affect whether a sale has occurred. In the event a leaseback is classified as a finance lease by the seller-lessee, or a sales-type lease by the buyer-lessor, then a sale has not occurred since a finance lease is essentially the purchase of an asset and a sales-type lease is essentially a sale of an asset. As such, the transaction would be considered a failed sales-leaseback.

If the transaction would not meet the conditions for a sale under ASC 606, or when the leaseback would not be classified as an operating lease (i.e., a failed sales-leaseback), the transaction would be accounted for as a financing arrangement. The transferor would not derecognize the asset and will continue to depreciate the asset as the legal owner. Any sales proceeds received would be reported as a liability.

For sale and leaseback transactions accounted for under ASC 840, the transition guidance does not require an entity to reassess whether the transaction would have qualified as a sale and a leaseback under ASC 842.

The accounting requirements for leases and sales of real estate are complex; and examiners who have questions on lease accounting or sale-leaseback transactions should refer to appropriate accounting resources or contact their regional accounting specialist.

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ANALYSIS OF FIXED ASSETS

From an accounting standpoint, an investment in fixed assets is an essential cost of doing business. Attention should be focused on the adequacy of depreciation, the reasonableness of the overall commitment, and the current and prospective utilization of fixed assets in serving the present and future anticipated banking needs. Only under exceptional circumstances, such as the contemplated abandonment of institution premises, gross under-utilization due to obsolescence, closed bank situations, or other extreme circumstances, do market value considerations assume any significance in the analysis of fixed assets.

Depreciation Costs

Depreciation is an overhead cost of doing business as the item being depreciated will have to be replaced when it ceases to have utility. An acceptable depreciation program allocates the original cost of the fixed asset over its estimated useful life. Failure to follow a realistic schedule of fixed asset depreciation distorts both the balance sheet and income statement.

Institutions carry premises and equipment at cost less accumulated depreciation, and adjust the carrying amount for permanent impairments of value. Any method of depreciation or amortization conforming to accounting principles that are generally acceptable for financial reporting purposes may be used. However, depreciation for premises and fixed assets may be based on a method used for federal income tax purposes if the results would not be materially different from depreciation based on the asset's estimated useful life. Under normal circumstances, examiners should not need to prepare detailed depreciation schedules in accordance with the generally accepted accounting principles. In instances where tax depreciation and book depreciation are the same, and depreciation is accelerated for tax purposes only, detailed analysis of book values may be necessary to determine whether fixed assets are being appropriately depreciated.

Depreciation can result in a taxable, temporary difference if an institution uses the straight-line method to determine the amount of depreciation expense to be reported for book purposes but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this period, a taxable, temporary difference originates. Tax depreciation will be less than book depreciation in the later years when the temporary difference reverses. Therefore, in any given year, the depreciation reported on the books will differ from that reported in the bank's tax returns. However, total depreciation taken over the useful life of the asset will be the same under either method.

Overinvestment

An over commitment in equipment and facilities can adversely affect earnings. A review of pertinent Uniform Bank Performance Report schedules will reveal how an institution compares to its peers in terms of total assets invested in premises and equipment, and the percent of operating income absorbed by occupancy expense. This information, though not in itself conclusive, can be a useful starting point in the analysis. Other considerations include the bank’s business model and strategy. However, as long as commitments conform to state banking regulations and aggregate direct and indirect investments, including lease obligations, appear reasonable in relation to the institution's earnings performance and capacity, the decision as to what constitutes an appropriate fixed asset commitment should generally be left to management's discretion.

Fixed Asset Investments

A reasonable investment in premises and equipment is essential to conducting institution business. However, overinvestment in facilities or equipment may encumber capital and burden earnings. Consequently, many states impose limits on fixed asset investments. In order to keep their investments within statutory limits, some institutions have engaged in a variety of alternative arrangements, such as the organization of subsidiary or affiliate realty corporations, sale-leaseback transactions, and lease-purchase contracts. These arrangements are most common in connection with institution buildings, but in some instances are also used in connection with equipment.

The realty corporation arrangement typically calls for investment in a subsidiary corporation and capitalization by the bank of an amount within state limitations, with the subsidiary corporation financing the additional cost of banking facilities in the mortgage market. The facilities are then leased to the bank by the subsidiary corporation at a rent rate that usually coincides with the mortgage payments. In one type of affiliate setup, a group of the bank's directors may form a corporation to hold title to the property and lease it to the bank.

Examiners should determine whether any arrangements or transactions concerning fixed assets involve insiders and, if so, that such transactions are on substantially the same terms as those prevailing at the time for comparable transactions with non-insiders and do not involve more than normal risk or present other unfavorable features to the institution. In addition, examiners should consider whether insiders’ use of institution owned/leased facilities and equipment (including vehicles) is prudent and in accordance with banking laws and employment agreements.

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FIXED ASSET INSURANCE

Basic insurance policies and extended coverage endorsements typically provide coverage of risks caused by fire, lightning, explosion, windstorm, hail, civil unrest, aircraft or vehicle damage, etc. Broad form property insurance includes coverage for the risks identified in basic policies and adds additional coverage for falling objects, weight of ice, sleet, or snow, and accidental water damage.

The most common form of property insurance is special coverage, or *all risk* insurance. Special coverage policies may provide the best overall risk protection; however, the number and type of items excluded from coverage can be numerous. Typical exclusions include damage caused by government action, nuclear hazard, wars, floods, fungus, and pollution.

Regardless of the type of property insurance policies a bank carries, examiners should assess whether management thoroughly understands, periodically reviews, and documents their analysis of the adequacy of their institution's insurance coverage.

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EXAMINATION PROCEDURES

The Other Assets and Liabilities Examination Documentation Module includes examination procedures regarding the evaluation of the reasonableness of investment in premises and equipment.