PREMISES AND EQUIPMENT

DEFINITIONS....................2
FIXED ASSETS ACCOUNTING....................2
Fixed Assets - Owned....................2
Fixed Assets - Leased....................2
Sale-Leaseback Transactions....................3
ANALYSIS OF FIXED ASSETS....................3
Depreciation Costs....................3
Overinvestment....................4
Fixed Asset Investments....................4
FIXED ASSET INSURANCE....................4
EXAMINATION PROCEDURES....................4

DEFINITIONS

Banks 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. Bank 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 bank, its branches, and consolidated subsidiaries. This includes vaults, fixed machinery, equipment, parking lots, and real estate acquired for future expansion. Interest costs associated with the construction of a building should be capitalized as part of the cost of the building. Bank premises also include leasehold improvements. Leasehold improvements comprise two types of accounts:

- Buildings constructed on leased property, and
- Capitalized disbursements directly related to leased quarters such as vaults, renovations, or fixed equipment.

Equipment includes all movable furniture, fixtures, and equipment of the bank, its branches, and consolidated subsidiaries, including automobiles and other vehicles, and any liens on the above. The institution's ownership interest in premises or equipment of non-majority-owned corporations is also included.

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 a period of time to be brought to the condition and location necessary for their intended use. FASB Accounting Standards Codification (ASC) 835-20, Capitalization of Interest (formerly Statement of Financial Accounting Standards (FAS) 34, *Capitalization of Interest Cost*), 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

Premises and equipment are often leased. Lease obligations can represent commitments that have or will have a significant effect on bank earnings. ASC 840, Leases (formerly FAS 13, *Accounting for Leases*), establishes generally accepted accounting principles regarding lease transactions. Any lease entered into by a Lessee bank, which at its inception meets one or more of the four following criteria must be accounted for as a property acquisition financed with a debt obligation (i.e., as 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.
- 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 date, less any related investment tax credit retained by or expected to be realized by the lessor.

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

Capitalized leases are to be reported in the Premises and Fixed Assets category in the Call Report. The amount capitalized equals the present value of the minimum required payments over the noncancellable term as defined by the lease plus the present value of the payment required under the bargain purchase option, if any, less any portion of the payments representing administrative expenses such as insurance, maintenance, and taxes to be paid by the lessor. The property shall be amortized according to the bank's normal depreciation policy (except, if appropriate, the amortization period shall be the lease term) unless the lease involves land only.

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. Decisions on how to report a lease should be fully supported and documented.

Sale-Leaseback Transactions

Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. If a bank 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 criteria above for capitalization. Otherwise, the lease shall be accounted for as an operating lease. ASC 840-40, Leases – Sale-Leaseback Transactions (formerly FAS 28, *Accounting for Sales with Leasebacks*) 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 a 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.

Banks may provide seller-financing to the purchaser in conjunction with a sale-leaseback transaction, ASC 360-20, Property, Plant, and Equipment - Real Estate Sales (formerly FAS 66, *Accounting for Sales of Real Estate*, as amended by FAS 98, *Accounting for Leases*), applies to all transactions in which the seller provides financing to the buyer of the real estate.

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

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 bank 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.

Banks 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 a bank 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 overcommitment in equipment and facilities can adversely impact earnings. A review of pertinent Uniform Bank Performance Report (UBPR) schedules will reveal how an institution compares to its peers in terms of total assets invested in premises and equipment, and percent of operating income absorbed by occupancy expense. This information, though not in itself conclusive, can be a useful starting point in the analysis. 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 bank business. However, overinvestment in facilities or equipment may weaken depositor protection, encumber capital, and burden earnings. Consequently, many states impose limits on fixed asset investments. Reluctance on the part of banks to keep their investments within statutory limits has resulted 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 bank 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.

Lease-purchase contracts or sale-leaseback arrangements should enable a bank, at its option, to acquire title to the fixed assets either during, or at the expiration of, the lease period.

Examiners should determine whether any arrangements or transactions concerning fixed assets involve "insiders" and, if so, that the transactions are made 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 bank. In addition, examiners should consider whether insiders' use of bank owned/leased facilities and equipment (including vehicles) is prudent and in accordance with banking laws and employment agreements.

FIXED ASSET INSURANCE

Historically, banks purchased property insurance to cover damage caused by fire or lightning. Coverage to protect against other risks, such as windstorms, hail, explosions, riots or civil commotion, aircraft damage, vehicle damage, etc., was obtained by purchasing extended coverage policies or endorsements.

Modern property insurance is generally designated as providing basic, broad, or special (a.k.a. all-risk) coverage. The primary difference between these types of policies is that basic and broad coverage policies only provide coverage for items specifically included in a policy. Special coverage policies provide coverage for other risks not specifically excluded by a policy.

Basic policies 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. As mentioned above, special coverage policies provide protection against all risks not specifically identified in a policy. Special coverage policies normally 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, management must thoroughly understand, periodically review, and document their analysis of the adequacy of their institution's insurance coverage.

EXAMINATION PROCEDURES

The Examination Documentation Modules include examination procedures regarding the evaluation of the reasonableness of investment in premises and equipment.