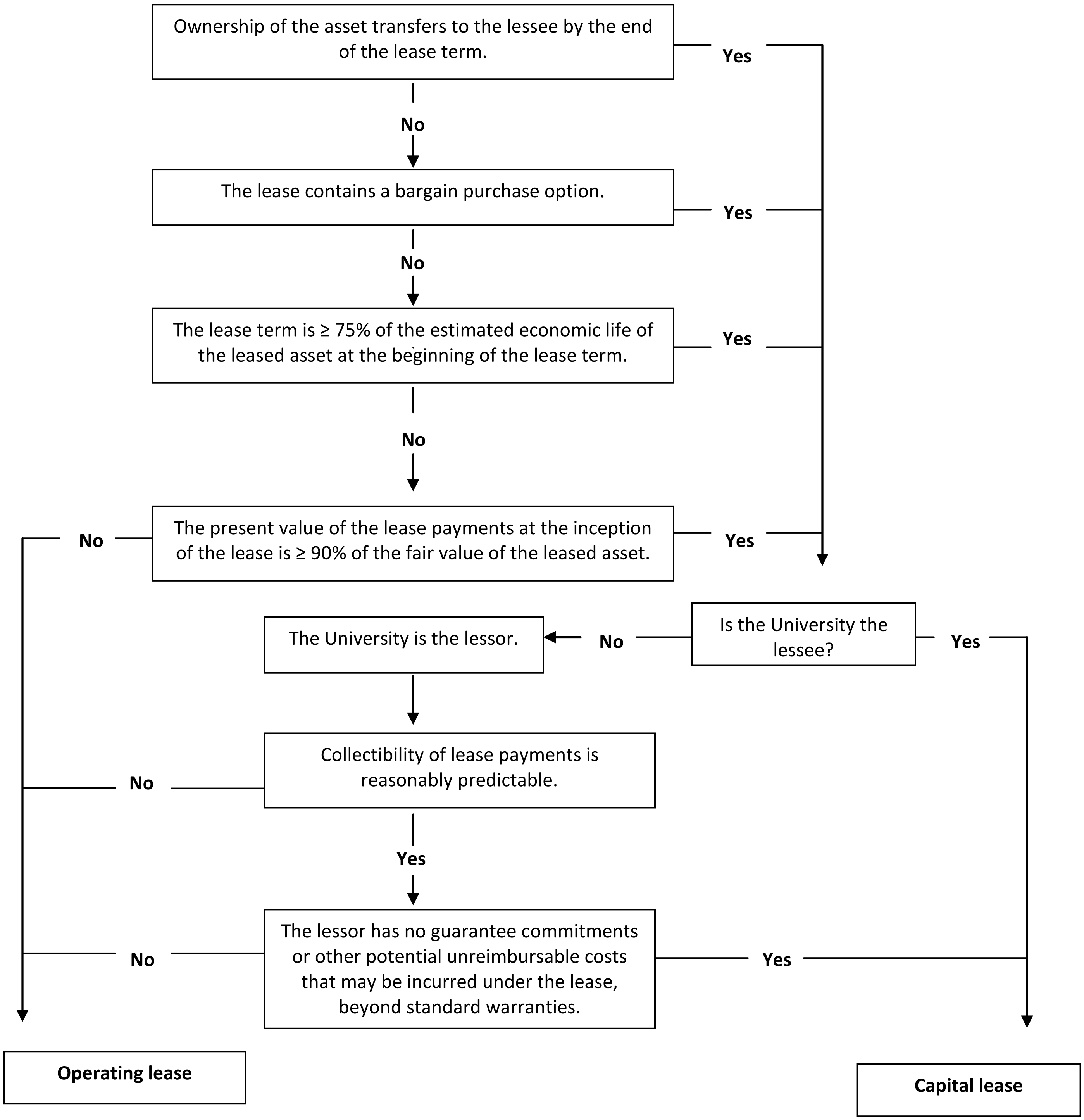
Appendix A: Capital vs. Operating Leases

Decision Tree*

Note: This decision tree only applies to external leases that satisfy the cash payment and lease term thresholds outlined in the main Lease Accounting Policy. Intertub leases may only be accounted for as operating leases; consult the University's Internal Billing Transactions Policy and the Internal Transfer Policy for the appropriate accounting treatment.



* Decision tree assumes an equipment or facilities lease <u>not</u> involving land.

Guidelines for Applying Criteria 3 and 4

Lease term (criterion 3) - The lease term is the original fixed period covered by the agreement plus any additional period included as an option (i.e., right to extend the term) that, at the inception of the lease, appears to be reasonably assured of being exercised. Generally, reasonably assured options are those that have penalties if not exercised, result in a lower rental payment if exercised, and/or may be exercised solely at the lessor's discretion.

Estimated economic life of the asset (criterion 3) - The estimated economic life is the remaining period during which the leased asset is expected to be economically usable, with normal repairs and maintenance, at the inception of the lease. To determine the estimated economic life of an asset, use the University's depreciable useful lives as stated in the University's Capitalization and Depreciation Procedures. If there is a compelling reason not to use the University's depreciable life, the tub must consult with and provide support to Financial Accounting and Reporting, within the Office of the Controller.

Present value (criterion 4) - The discount rate to be used to compute the present value of the lease payments is the incremental borrowing rate. This is the interest rate the lessee would pay in the lending market to purchase the asset using debt financing. The University's incremental borrowing rate is calculated centrally by the Office of Treasury Management (OTM). Tubs must contact OTM directly to obtain the incremental borrowing rate as of the lease inception date. The *Lease Classification Form,* which can be found online at (http://able.harvard.edu/forms/lease_class.pdf), offers guidance for calculating the present value of the lease payments. Contact Financial Accounting and Reporting (FAR) for additional assistance.

Fair value (criterion 4) - The fair value of the leased asset at the inception of the lease is generally the amount that would be paid to acquire the asset in the open market. The age of the asset, as well as the value of other similar facilities or equipment, are factors in determining the fair value.