



Lease Accounting

Policy Statement

This policy establishes accounting treatment of lease agreements entered into by the University, both as a lessee and as a lessor. There are two types of lease classifications: capital and operating. The proper lease classification is important because it determines the University's accounting and reporting requirements.

Reason for Policy

When the risks and rewards of ownership have been passed on to the lessee, generally accepted accounting principles require the lessee to record the lease as an asset. This policy establishes uniform thresholds and procedures for all parts of the University when recording both operating and capital leases.

Who Must Comply

All Harvard University schools, tubs, local units, Affiliate Institutions, Allied Institutions and University-wide Initiatives must comply. This policy applies to all new leases entered into as of 7/1/2014; note that addenda to and extensions of existing leases qualify as new leases for purposes of this policy.

Procedures

1. **Understand rules for lease accounting.** Leases that meet certain criteria must be recorded as assets to the lessor; these leases are called capital leases. Capital leases are recorded on the balance sheet and depreciated over time. Leases that don't meet these criteria are called operating leases; operating lease payments are recorded as rental expense. The criteria that qualify a lease as a capital lease or an operating lease are described below.
2. **Apply lease term threshold.** Any item with a lease term of less than 3 years cannot be capitalized. Treat all leases with terms of less than three years as operating leases.
3. **Apply cash payment thresholds.** Apply the following thresholds when determining when to capitalize an equipment or facility lease. Note that thresholds should be applied by lease schedule; lease agreements can be for a building, an individual asset, a group of assets, and can fall under the terms of a University-wide master lease agreement.
 - A. A lease with annual lease year cash payments greater than **\$1,000,000 per year** or with cumulative spending over the life of the lease greater than \$10 million must be capitalized if it meets the criteria outlined in Procedure 4 below.
 - B. A lease with annual lease year cash payments between **\$250,000 and \$999,999** that meets the capital lease criteria outlined in Procedure 4 below may be capitalized at the discretion of the tub.
 - C. A lease with annual lease year cash payments below \$250,000 **must not** be capitalized; it must be treated as an operating lease.



- 4. Assess leases that meet cash and term thresholds for capitalization.** An equipment or facilities lease that meets the lease term and cash payment criteria above must be capitalized if it meets any one of the four criteria listed below. If the lease meets none of these criteria, treat it as an operating lease.
- A.** A lease only needs to meet one of the below criteria in order to be classified as a capital lease. (See Appendix A for additional guidance.)
 - a. Transfer of ownership:** Ownership of the asset transfers to the lessee by the end of the lease term.
 - b. Bargain purchase option:** The lease contains a bargain purchase option (BPO). A bargain purchase option is a lease clause that allows the lessee to obtain title to the leased facilities and/or equipment for less than its fair market value, for example a nominal amount such as \$1.
 - c. Lease term:** The lease term is equal to 75% or more of the estimated economic life of the leased **asset at the beginning of the lease term**.
 - d. Minimum lease payments:** The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased asset. This amount excludes the portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon.
 - B.** For all leases that tubs intend to capitalize, tubs must send a copy of the lease agreement and support for the capital lease classification to the Associate Director for Accounting Operations in Financial Accounting and Reporting (FAR).
- 5. Record capital leases properly.**
- A.** Initial setup: the tub must calculate the amounts and prepare the initial journal entry. However, given the complexity of accounting for capital leases and the fact that it requires central-only object codes, FAR will review the tub's calculations and upload the journal. FAR records the entry to establish the capital lease asset and the related liability at the inception of the lease. The capital lease asset and liability are recorded at an amount equal to either the fair value of the leased property at the lease inception date, or the present value of the lease payments using the incremental borrowing rate, whichever is lower. (Contact FAR for the current incremental borrowing rate). This is an important step to ensure all of the University's financial obligations are consistently valued. The Lease Classification Form (Appendix D) provides guidance on how to calculate the present value of the lease payments. Tubs should submit this form to FAR along with the journal entry in order to set up the lease.
 - B.** Making lease payments: lease payments are the responsibility of the tub. Ideally, tubs should establish annual purchase orders for their lease obligations. These payments should follow local payment policies and guidelines for processing and approving payments and are initially coded to expense object codes.
 - C.** Amortization of the lease liability: The lease liability is reduced throughout the life of the lease using the effective interest method. On a quarterly basis, tubs are responsible for creating journal entries (for each lease) which reverse the payment coding and reclassify it to the appropriate amortization and interest object codes, as well as reducing the liability. Each lease payment is allocated between the calculated lease liability amortization and interest expense. Under this method, interest expense decreases and the liability amortization amount increases over time. **Tubs must send these journal entries to FAR for uploading because they require the use of central-only object codes.** See the example that illustrates the amortization of a lease liability in the "Examples" section of this document.



- D. Depreciation of the capital lease asset: the depreciation method used depends on which of the four possible capitalization criteria the lease asset meets:

Table with 2 columns: Capitalization Criteria Met, Depreciation Method. It details how different capitalization criteria (Criterion 1, 2, 3, 4) determine the depreciation method (over its useful life vs. over the lease term).

- E. The tub is responsible for the reconciliation of object codes 2793 (Capital Lease Equipment Liability) and 2794 (Capital Lease Building Liability). If the balances in these accounts are greater than the reconciliation threshold of \$1M, the quarterly reconciliations should be kept on file in accordance with the quarterly financial close checklist.

6. Special treatment for leases involving land and land with buildings.

- A. Leases involving land only: If a lease involves land alone, use only capitalization criteria 1 and 2 to determine the proper classification of the lease.
B. Leases involving land and building(s): When the lease involves land and buildings, tubs must first calculate each asset's relative fair value (i.e., using recent sales, appraisals or tax statements) and then answer a series of questions to determine the proper treatment.

7. Record operating leases properly. An operating lease is treated as a true rental of property, which is not recorded on the balance sheet, but as an expense.

- A. Actual vs. straight-line: operating leases must be recorded on a straight line basis even if the payments vary in amount over the lease term, if the impact of the deferral equals the following annual thresholds.
B. Escalating rent payments: lease payments that are not of equal amounts but that escalate during the life of the lease should be recognized on a straight line basis, unless another systematic and rational basis is more representative of the time pattern in which the leased property is physically employed.
C. Rent expense adjustments: If the actual rent expense is higher or lower than the straight-line basis rent expense, the tub must record adjusting entries for the difference.
D. Initial direct costs incurred by the lessee: any initial direct costs related to the lease are expensed as incurred (e.g., commissions, legal fees, costs of preparing documents, etc.).



8. Account for all leases timely.

- A. Capital leases: the accounting for capital leases **should** be recorded at the lease inception date and **must** be recorded no later than quarter end. FAR makes adjustments to plant and equipment equity concurrently with the periodic lease payments.
- B. Operating leases: the lessee records rent expense as payments are made according to the lease specifications. If payments vary over the course of the lease and meet the thresholds outlined in Procedure 7 above, tubs must record an adjustment to properly record the rental expense on a straight-line basis no later than quarter end.

9. Treat intertub leasing properly. When assets are leased between tubs, they may only be accounted for as operating leases, and no gain or sale may be recognized on the transaction. Consult the University's Internal Billing Transactions Policy and Internal Transfer Policy for the appropriate accounting treatment.

10. Account for leasehold improvements:

Capital projects involving externally leased property (or leased property between two tubs) should be treated as leasehold improvements and recorded as a "Capital Leasehold Improvement" on the lessee's balance sheet because leasehold improvements result in a true asset addition. The leasehold improvement should be recorded and amortized over the shorter of the useful life or the lease term.

11. Account for executory costs correctly: Executory costs include utilities, repairs, maintenance, insurance, common area expenses, and taxes paid for the leased asset during its economic life. They are considered period costs and therefore must be expensed as incurred. These expenditures may be the responsibility of either the lessee or lessor, depending on the lease terms.

12. Maintain supporting documentation. For any lease that has been capitalized or operating lease greater than the threshold, keep the following documentation on file for the life of the leased asset plus an additional seven years:

- A. The master lease agreement
- B. A copy of the completed "Lease Classification Form"
- C. Supporting documentation for any additional assumptions used in determining whether the lease is capital or operating
- D. For capital leases, tubs must also maintain a schedule of payments showing amortization of the lease-related liability.

13. Make required disclosures for year-end lease reporting: the University is required to disclose the total gross assets under capital leases as well as both capital and operating lease commitments for each of the next five years and thereafter in its annual financial report. FAR coordinates the process of obtaining this information from the tubs each fiscal year-end using a reporting materiality threshold of \$500,000 per lease.

14. Account for leases where Harvard is the lessor. Accounting for leases where Harvard is the lessor follows the same rules outlined above, except that Harvard is on the other side of the transactions. If you have questions about this accounting, please contact Financial Accounting and Reporting.



Responsibilities and Contacts

School/tub finance offices are responsible for ensuring that local units abide by this policy and the accompanying procedures. Tubs must notify FAR of capital leases as they arise throughout the year and no later than quarter end and must disclose capital and operating lease commitments as part of the year-end financial reporting process. Schools and Tubs are responsible for making all payments and journal entries. Tubs are also responsible for processing journal entries to adjust operating lease payments to a straight line basis where required.

Financial Accounting and Reporting (FAR) maintains this policy and provides guidance regarding the policy. With information supplied by the tubs, FAR is responsible for recording the initial setup of the capital lease asset and liabilities, for amortizing the lease liability, and for recording depreciation of the capital lease asset. At year end, FAR collects information from tubs regarding all lease commitments (both operating and capital) and supplies this information to external auditors. **Contact: Associate Director for Accounting Operations at (617) 495-3766**

Office for Sponsored Programs (OSP) advises units on compliance with the terms of federal and nonfederal awards. Contact OSP with questions regarding sponsored compliance on leases charged on awards. **Contact: Manager of Reporting, Cost Analysis and Compliance at (617) 496-4771**

Definitions

Capital lease: a lease considered to have the economic characteristics of asset ownership. A capital lease is treated as a purchased asset for accounting purposes, meaning it is recorded as an asset on the balance sheet and depreciated over time.

Bargain purchase option (BPO): A bargain purchase option is a lease clause that allows the lessee to obtain title to the leased facilities and/or equipment for less than its fair market value, for example a nominal amount such as \$1.

Effective interest rate: the interest rate on a loan or financial product restated from the nominal interest rate as an interest rate with annual compound interest payable in arrears. It is used to compare the annual interest between loans with different compounding terms (daily, monthly, annually, or other).

Executory cost: costs of an ongoing lease agreement. Executory costs include utilities, repairs, maintenance, insurance, common area expenses, and taxes paid for the leased asset during its economic life. They are considered period costs and therefore must be expensed as incurred.

Fair market value: Probable price at which a willing buyer will buy from a willing seller when (1) both are unrelated, (2) know the relevant facts, (3) neither is under any compulsion to buy or sell, and (4) all rights and benefit inherent in (or attributable to) the item must have been included in the transfer.

Incremental borrowing rate: Interest rate a lessee would have to pay if, instead of leasing, he or she finances the purchase of the same asset.

Large schools: for purposes of this policy, FAS, HMS, HBS

Lease bonus: An amount paid by a lessee to a lessor as consideration for granting a lease, usually as a lump sum; this payment is in addition to any rental or royalty payments.

New leases: for purposes of this policy, new leases are leases entered into after 7/1/2014, including addenda to or extensions of existing leases.

Operating lease: a lease treated as a true rental for accounting purposes. Operating lease payments are recorded as rental expense.



HARVARD UNIVERSITY FINANCIAL POLICY

Responsible Office: Financial Accounting and Reporting
Date First Effective: 7/1/2014
Revision Date: N/A

Small schools: for purposes of this policy, all other schools and units other than FAS, HMS, HBS

Related Resources

Facilities and Equipment Accounting policy: <http://policies.fad.harvard.edu/pages/facilities-and-equipment>

Internal Billing Transactions Policy: <http://policies.fad.harvard.edu/pages/internal-billing-transactions>

Internal Transfers Policy: <http://policies.fad.harvard.edu/pages/internal-transfers>

Revision History

N/A

Appendices

Appendix A: Decision Tree for Classifying Operating vs. Capital Leases

Appendix B: Decision Tree for Treatment of Leases Involving Land and Buildings

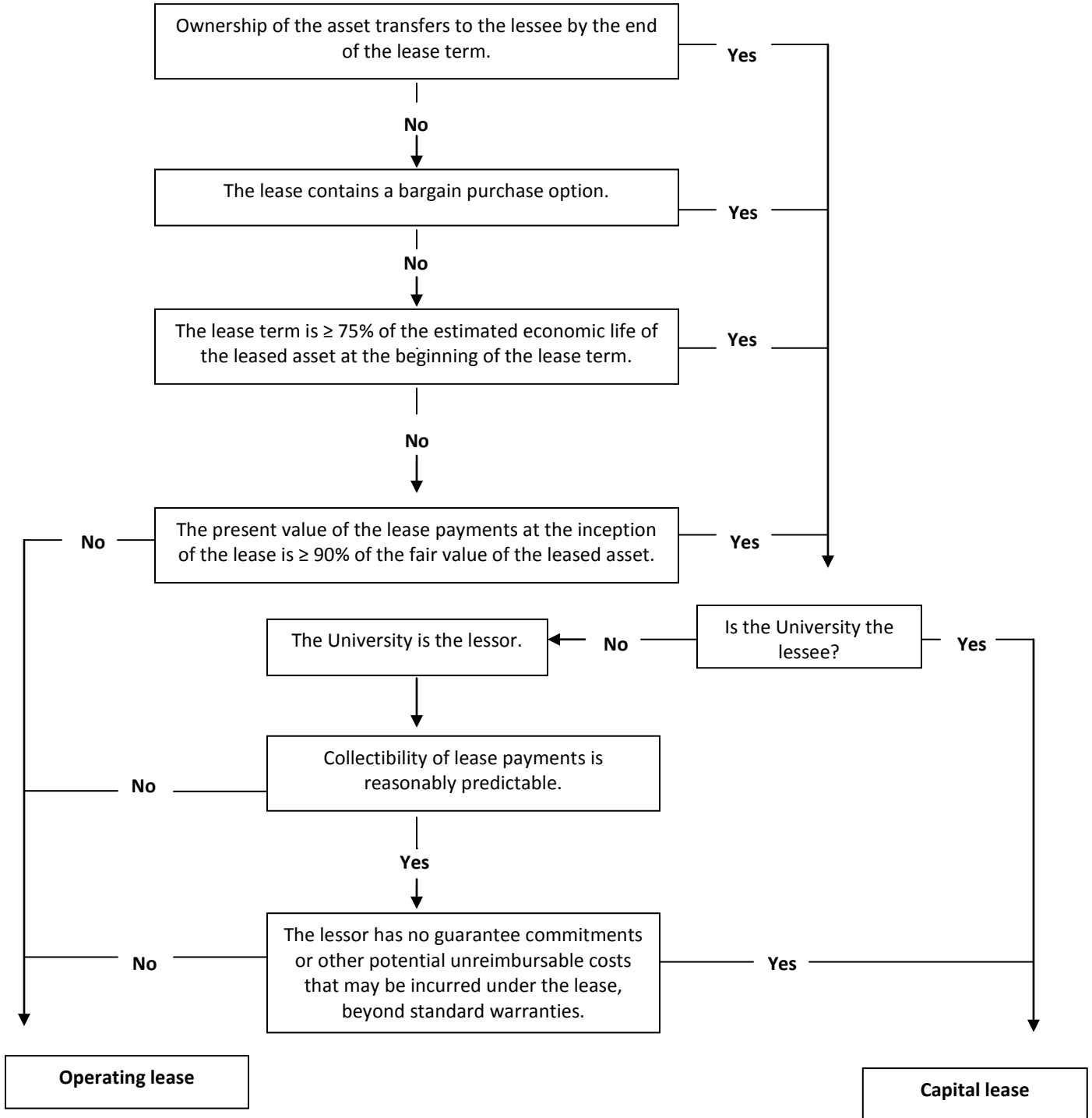
Appendix C: Examples of Proper Accounting for Leases

Appendix D: Lease Classification Form

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 not involving land.

Guidelines for Applying Criteria 3 and 4

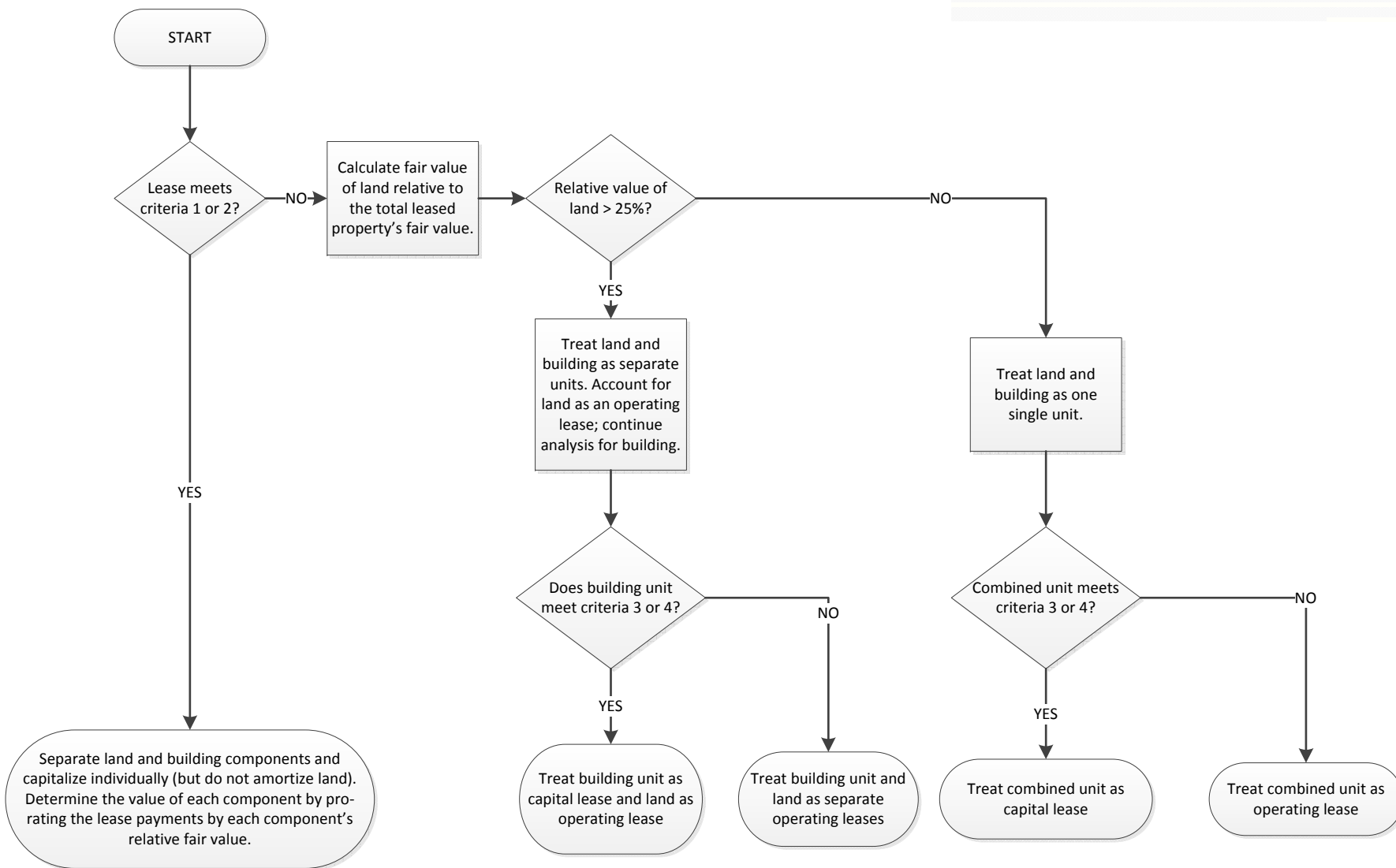
Lease term (criterion 3) - The lease term is the original fixed period covered by the agreement plus any additional period included as an option (i.e., right to extend the term) that, at the inception of the lease, appears to be reasonably assured of being exercised. Generally, reasonably assured options 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.

Lease Accounting – Appendix B, Leases Involving Land and Buildings



Criteria Key

- **Criterion 1:** Ownership of the asset transfers to the lessee by the end of the lease term.
- **Criterion 2:** The lease contains a bargain purchase option (BPO). A bargain purchase option is a lease clause that allows the lessee to obtain title to the leased facilities and/or equipment for less than its fair market value, for example, a nominal amount such as \$1.
- **Criterion 3:** The lease term is equal to 75% or more of the estimated economic life of the leased asset at the beginning of the lease term.
- **Criterion 4:** The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased asset. This amount excludes the portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon.

Lease Accounting Appendix C – Examples of Proper Lease Accounting

Example #1 - Operating vs. Capital Lease

On July 1, HRES entered into an agreement with an external party to lease a building (an asset with a 35-year useful life) for 20 years. The following details are available:

- Annual lease payments total \$520,000 (paid at the end of each year).
- Lease bonus of \$200,000 to be paid at the lease inception.
- Included in the annual lease payments are \$15,000 of maintenance costs.
- The building was newly acquired by the lessor. By obtaining prices from several realtors, HRES determines that the building's fair value is \$8,000,000.
- The University's incremental borrowing rate on July 1 is 6% (the rate that the University would have incurred to borrow same amount).

Since annual rental payments are above \$250,000, HRES can elect to assess it for capitalization. If annual rental payments were less than \$250,000, the lease would have to be treated as an operating lease.

	Criteria	Answer	Comments										
1.	Does ownership of the asset transfer to the University by the end of the lease term?	No	There is no provision in the lease agreement stating that the asset will be transferred to the University at the end of the lease.										
2.	Does the lease contain a bargain purchase option?	No	The lease agreement does not contain a bargain purchase option (e.g., that the building can be purchased for \$1 at the end of the lease term).										
3.	Is the lease term equal to 75% or more of the estimated economic life of the asset at the beginning of the lease term?	No	The lease term equals 57% of the economic useful life. (20 years/35 years), which is less than 75%.										
4.	Is the present value of the lease payments at the inception of the lease at least 90% of the fair value of the leased asset?	No	<p>Present value of the lease payments calculation:</p> <table style="margin-left: 40px; border-collapse: collapse;"> <tr> <td style="padding-right: 20px;">Annual lease payment</td> <td style="text-align: right;">\$520,000</td> </tr> <tr> <td style="padding-right: 20px;">Amortization of lease bonus (\$200,000/20 years)</td> <td style="text-align: right;"><u>\$ 10,000</u></td> </tr> <tr> <td></td> <td style="text-align: right;">\$ 530,000</td> </tr> <tr> <td style="padding-right: 20px;">Maintenance costs</td> <td style="text-align: right;"><u>(\$ 15,000)</u></td> </tr> <tr> <td style="padding-right: 20px;">Actual lease expense</td> <td style="text-align: right;">\$515,000</td> </tr> </table> <p>The present value of a twenty-year annuity with annual lease expense of \$515,000 and an incremental borrowing rate of 6% are calculated using the criterion 4 section of the "Lease classification form." This amount is \$5,990,000. Therefore, the present value of the lease equals 75% (\$5,990,000/\$8,000,000) of the fair value of the lease asset, which is less than 90%.</p>	Annual lease payment	\$520,000	Amortization of lease bonus (\$200,000/20 years)	<u>\$ 10,000</u>		\$ 530,000	Maintenance costs	<u>(\$ 15,000)</u>	Actual lease expense	\$515,000
Annual lease payment	\$520,000												
Amortization of lease bonus (\$200,000/20 years)	<u>\$ 10,000</u>												
	\$ 530,000												
Maintenance costs	<u>(\$ 15,000)</u>												
Actual lease expense	\$515,000												

Example # 1 conclusion: This is an operating lease, because it does not meet any of the four capitalization criteria.

Summary of amounts to be used in the journal entries below:

Lease bonus payment made by the tub at the beginning of the lease: \$200,000

Portion of lease bonus to be recognized over the life of the lease term: $\$200,000/20\text{years} = \$10,000$ per year

Annual lease payments: \$520,000

Maintenance costs included in the lease payments: \$15,000

Entries by HRES (lessee)

The tub processes a payment request in HCOM to record the prepaid lease bonus at the inception of the lease:

Dr - O/C 0540, "Prepaid+Accrued Items"	\$200,000
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*	\$200,000

At the end of the year, the tub makes the following adjusting entry to expense a portion of the prepaid lease bonus (on a straight-line basis):

Dr - O/C 7230, "Rentals+Leases of Space, GENERAL"	\$ 10,000
Cr - O/C 0540, "Prepaid+Accrued Items"	\$ 10,000

The tub processes a payment request in HCOM to record the lease payment and maintenance cost:

Dr - O/C 7230, "Rentals+Leases of Space, GENERAL"	\$505,000
Dr - O/C 7120, "Improvements+Alterations to Space, Not Capitalized, GENERAL"	\$ 15,000
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*	\$520,000

* "Due to/from Consolidated Tub" is automatically credited to the tub in place of cash when payments are made, since cash is held centrally.

Example #2 - Operating vs. Capital Lease

On January 1, HMS entered into an agreement with an external party to lease scientific equipment (an asset with an 8-year useful life) for a 4-year period. The following details are available:

- A one-year renewal option exists for the lessee and is subject to a termination penalty.
- Annual lease payments total \$515,000 (paid at the end of each year).
- Included in the annual lease payments are \$15,000 of maintenance costs.
- The scientific equipment was newly acquired by the lessor. By obtaining prices from several external vendors, HMS determines that the equipment's fair value is \$2,500,000.
- The University's incremental borrowing rate on January 1 is 7% (the rate that the University would have incurred to borrow the same amount).
- HMS will make payments out of their unrestricted undesignated fund (000001).
- HMS has the right to obtain title to the building at the end of the lease term for the bargain price of \$1.

Since annual rental payments are above \$250,000, HMS can elect to assess the lease for capitalization. If annual rental payments were less than \$250,000, the lease would have to be treated as an operating lease.

	Criteria	Answer	Comments						
1.	Does ownership of the asset transfer to the University by the end of the lease term?	No	There is no provision in the lease agreement stating that the asset will be transferred to the University at the end of the lease.						
2.	Does the lease contain a bargain purchase option?	Yes	Since HMS can buy the equipment at the end of the lease for a bargain price of \$1, the lease agreement contains a bargain purchase option.						
3.	Is the lease term equal to 75% or more of the estimated economic life of the asset at the beginning of the lease term?	No*	<table style="width: 100%; border: none;"> <tr> <td style="width: 60%;">Original term</td> <td style="text-align: right;">4 years</td> </tr> <tr> <td>One-year termination penalty**</td> <td style="text-align: right;"><u>1 year</u></td> </tr> <tr> <td>Total lease term</td> <td style="text-align: right;">5 years</td> </tr> </table> <p>**The additional one-year renewal period is included as part of the lease term because it is assumed that HMS will renew the lease due to the termination penalty associated with not renewing for another year.</p> <p>The lease term equals 63% (5 years/8 years) of the economic useful life, which is less than 75%.</p>	Original term	4 years	One-year termination penalty**	<u>1 year</u>	Total lease term	5 years
Original term	4 years								
One-year termination penalty**	<u>1 year</u>								
Total lease term	5 years								
4.	Is the present value of the lease payments at the inception of the lease at least 90% of the fair value of the leased asset?	No*	<p>Present value of the lease payments calculation:</p> <table style="width: 100%; border: none;"> <tr> <td style="width: 60%;">Annual lease payments</td> <td style="text-align: right;">\$515,000</td> </tr> <tr> <td>Maintenance costs</td> <td style="text-align: right;"><u>(\$ 15,000)</u></td> </tr> <tr> <td>Actual lease expense</td> <td style="text-align: right;">\$500,000</td> </tr> </table> <p>The present value of a 5-year annuity with annual lease expense of \$500,000 and an incremental borrowing rate of 7% is calculated using the criterion 4 section of the "Lease classification form." This amount is \$2,050,100. Therefore, the present value of the lease is 82% (\$2,050,100/\$2,500,000) of the fair value of the lease asset, which is less than 90%.</p>	Annual lease payments	\$515,000	Maintenance costs	<u>(\$ 15,000)</u>	Actual lease expense	\$500,000
Annual lease payments	\$515,000								
Maintenance costs	<u>(\$ 15,000)</u>								
Actual lease expense	\$500,000								

* Note that since the response to criterion 2 is yes, criteria 3 and 4 are not required to be tested, but are shown here for informational purposes.

Example #2 conclusion: The lease is a capital lease, because it meets at least one of the four capitalization criteria (criterion 2 above).

Summary of amounts to be used in the entries below:

Annual lease payments: \$515,000

Maintenance costs included in the lease payments: \$15,000

Net present value of annual lease payments: \$2,050,100

Liability amortization is calculated using the effective interest method - See schedule 1 on the next page

Leased asset depreciation calculation: \$256,262 ($\$2,050,100 \div 8$ years)

Entries:

At the inception of the lease, FAR records the following entry to establish the capital lease asset and the related liability:

Dr - O/C 1003, "CO^Equip, Scientific, Nonsponsored"	\$2,050,100
Cr - O/C 2793, "CO^Capital Lease Equipment Liability"	\$2,050,100

HMS processes a payment request in HCOM to record the lease payment, maintenance cost, and interest expense. Amounts are derived from the liability amortization table included in schedule 1:

Dr - O/C 7131, "Appliance Repair+Supplies^Mechanical Repairs+Maint. of Space"	\$ 15,000
Dr - O/C 7230, "Rentals+Leases of Space, GENERAL"	\$500,000
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"	\$515,000

On a quarterly basis, HMS is responsible for creating journal entries (for each lease) which reverse the payment coding and reclassify it to the appropriate amortization and interest object codes, as well as reducing the liability. As the lease liability is reduced, equipment equity must be increased to balance the equipment equity equation. Included in HMS's supporting documentation is the funding source they have chosen for the payments, designated as 000001. Therefore, FAR records the following equipment equity journal entry:

Dr - O/C 2793 "CO^Capital Lease Equipment Liability"	\$356,493
Dr - O/C 7621 "Other External Interest Expense"	\$143,507
Cr - O/C 7230, "Rentals+Leases of Space, GENERAL"	\$500,000
Dr - O/C 9330, "Transfers to/from Funds Invested in Equipment - PIS" Fund 000001	\$356,493
Cr - O/C 9301, "Transfers to/from Unrestricted Undesignated Balances" Fund 724001	\$356,493

After this entry is made, the new equipment equity amounts continue to balance as follows:

Equipment asset = \$2,050,100

Equipment debt = \$1,693,607 ($\$2,050,100$ less \$356,493 of lease obligation amortization)

Equipment net assets = \$356,493

Schedule 1: Obligation amortization

Date	Lease payment	7% Interest Expense	Obligation amortization	Balance of lease obligation
				\$ 2,050,100
Year 1	\$ 500,000	\$143,507	\$ 356,493	\$ 1,693,607
Year 2	\$ 500,000	\$118,552	\$ 381,448	\$ 1,312,159
Year 3	\$ 500,000	\$ 91,851	\$ 408,149	\$ 904,010
Year 4	\$ 500,000	\$ 63,281	\$ 436,719	\$ 467,291
Year 5	\$ 500,000	\$ 32,709	\$ 467,291	\$ 0

FAR records the following depreciation entry to amortize the capitalized lease asset balance on a straight-line basis over the asset's useful life (since criterion number 2 was met):

Dr - O/C 7571, "Nonsponsored Equipment, Fixtures, Furniture Depreciation"	\$256,262
Cr - O/C 1181, "CO^Equip, Scientific, Nonsponsored, Acc Depr"	\$256,262

Example # 3 - Straight-line rent calculation

On July 1, FAS leased a piece of equipment from an outside vendor. The lease agreement states that the equipment will be leased for three years for a total amount of \$1,800,000. FAS will make a \$375,000 payment at the end of year one, a \$600,000 payment at the end of year two, and an \$825,000 payment in the last year. The lease is classified as an operating lease. On a straight-line basis, the lease expense is \$600,000 per year (\$1,800,000/3 years). Since the per-unit annual rent payments are above \$250,000, FAS must make adjusting entries to charge rent expense on a straight-line basis.

Year 1

FAS processes a payment request through HCOM to record the lease payment:

Dr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	\$375,000
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*	\$375,000

The following adjusting entry must be made at the end of year 1:

Dr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	\$225,000
Cr - O/C 2751, "Misc Deposits+Other Liabilities"	\$225,000

By recording this entry, FAS is recording \$225,000 of additional rent expense, bringing the total to \$600,000 rather than just the \$375,000 paid. The net effect to the CINA is the \$600,000 straight-line rent expense amount.

Equipment asset – equipment debt = equipment equity (net assets)

* "Due to/from Consolidated Tub" is automatically credited to the tub in place of cash when payments are made, since cash is held centrally.

Year 2

FAS processes a payment request through HCOM to record the lease payment:

Dr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	\$600,000
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*	\$600,000

The lease payment equals the calculated straight-line basis rent; therefore, no adjustment is necessary at fiscal year-end. The net effect to the CINA is the \$600,000 straight-line rent expense amount.

Year 3

FAS processes a payment request through HCOM to record the lease payment:

Dr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	\$825,000
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*	\$825,000

The following adjusting entry must be made at the end of year 3:

Dr - O/C 2751, "Misc Deposits+Other Liabilities"	\$225,000
Cr - O/C 6770, "Rentals of Equipment, Furniture+Fixtures, GENERAL"	\$225,000

By recording this entry, FAS is ensuring that the recognized rent expense for the period is \$600,000 rather than the \$825,000 paid. FAS is also offsetting the \$225,000 liability established in year 1. The net effect to the CINA is the \$600,000 straight-line rent expense amount.

Note: In the example above the lease term and the University's fiscal year-end coincide. This might not always be the case. If these dates differ then the adjustment calculation will be different.

* "Due to/from Consolidated Tub" is automatically credited to the tub in place of cash when payments are made, since cash is held centrally.

LEASE CLASSIFICATION FORM (to determine if the lease is operating or capital)

This form must be completed by any tub or department leasing property from an outside party (i.e., not from another Harvard department) where annual payments are more than \$1,000,000 per unit and the term of the lease is at least 3 years.

Leases with annual cash payments between \$250,000 and \$999,999 and a lease term of at least 3 years may be assessed for capitalization at the tubs' discretion.

Leases with less than \$250,000 in per unit annual payments or terms of less than 3 years must be classified as operating leases.

Tub or department: _____

Lease inception date: _____

Instructions on how to fill the form:

- All boxes highlighted in yellow are required fields (i.e., information must be input in these boxes).
- All boxes highlighted in grey are updated automatically (i.e., no input is necessary).
- For the first and second criteria below, respond "Yes" or "No" directly in the "Status" column (highlighted in yellow).
- For the third and fourth criteria below, answer the questionnaire included at the bottom of this document.
The status column (highlighted in grey) will be automatically updated with a "Yes" or "No" answer, based on the information provided.
- Further information regarding these criteria may be found in the Facilities and Equipment Lease Procedures.

Capital versus Operating lease conclusion:

- If at least one of the four capitalization criteria is met (i.e., if at least one of the status boxes below says "Yes"), the lease is considered a capital lease. The "CONCLUSION BOX", at the bottom of the capitalization criterion, will automatically indicate the classification of the lease.
- This form must be maintained for the life of the asset or lease.

Capitalization Criteria	Status	
1. The lease transfers ownership of the facilities or equipment to the lessee by the end of the lease term.		REQUIRED: ENTER Yes or No
2. The lease contains a bargain purchase option.		REQUIRED: ENTER Yes or No

If the answer to criterion 1 or 2 above is "Yes," then conditions 3 and 4 are not required to be tested, since the lease is classified as capital.

If the answer to both criteria 1 and 2 is "No," then, continue to answer criteria 3 and 4.

3. The lease term is equal to 75 percent or more of the estimated economic life of the leased property. (Need to complete criterion #3 questionnaire included below.)	No
4. The present value of the minimum lease payments at the beginning of the lease term equals or exceeds 90 percent of the fair value of the leased property. (Need to complete criterion #4 questionnaire included below.)	No

<p>Based on the information included in above this lease is classified as a/an:</p> <div style="border: 1px solid black; background-color: grey; padding: 5px; text-align: center; margin: 5px auto; width: 50%;"> <p>OPERATING LEASE</p> </div>	<p>CONCLUSION BOX</p>
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Criterion #3 questionnaire:

a. Provide the lease term in years

not required
not required

b. Provide the lease asset economic life

c. Provide a brief description on how the term of the lease was calculated (e.g., indicate whether there are additional periods covered by options):

not required

d. Provide a brief description on how the economic life of the asset was calculated (e.g., University's useful life for equipment)

not required

Lease term percentage of the economic life of the asset

Criterion #4 questionnaire:

a. Average lease payment per month

not required

b. Incremental borrowing rate (from OTM)

not required

c. Lease term in years (in accordance with the number of lease payments, including options to renew)

not required

d. Indicate when are the lease payments due:

-Type "0" if lease payments are due at the end of each period

-Type "1" if lease payments are due in advance (i.e., at the beginning of each period)

not required

Total present value of the minimum lease payments

e. Provide the fair value of the lease asset.

not required

f. Include a description of the methodology used to determine the fair value of the lease asset:

not required

Present value of the lease payment percentage of the fair value of the lease asset