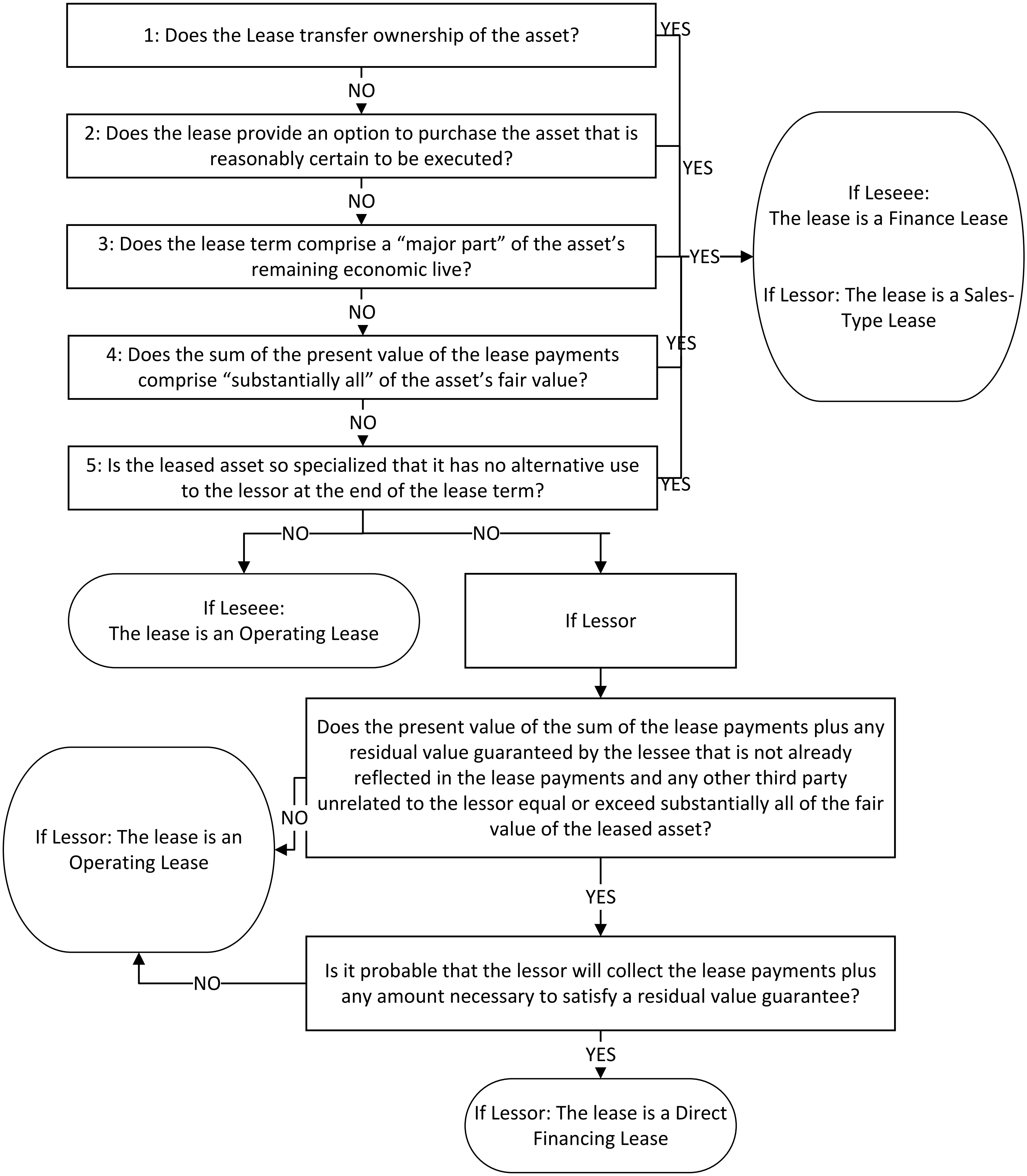
Appendix A: Lease Classification Decision Tree

Note: This decision tree only applies to an equipment or facilities lease, not involving land and are external leases that satisfy the cash payment and lease term thresholds outlined in the 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.



Guidelines for Applying Criteria 3 and 4

STEP 3:

Lease term - The lease term is the original fixed period covered by the agreement including any additional period included as an option (i.e., right to extend the term, termination options) that, at lease commencement, appears to be reasonably certain of being exercised. Generally, reasonably certain 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. The assessment of whether it is reasonably certain that a lessee will exercise an option should be based on the facts and circumstances at lease commencement and not be based solely on the lessee's intentions, past practices, or estimates.

Remaining economic life of the asset - The economic life is the remaining period during which the leased asset is expected to be economically usable, with normal repairs and maintenance, at the commencement 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 Financial Management of Property, Plant, and Equipment Policy. 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. For purposes of determining whether this criterion applies, it would be reasonable to conclude that 75% or more of an asset's remaining economic life comprises a "major part" of its remaining economic life. It would also be reasonable to conclude that an asset for which 25% or less of its economic life remains at lease commencement is "near the end" of its useful life.

Step 4

Present value - The discount rate to be used to compute the present value of the lease payments (including any residual value guarantee) is the rate implicit in the lease. In the case the lease implicit rate is not readily available, tubs must use the incremental borrowing rate. The incremental borrowing rate 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 FAR directly to obtain the incremental borrowing rate as of the lease commencement date. The *Lease Classification Form,* which can be found online at (https://policies.fad.harvard.edu/accounting-leases), offers guidance for calculating the present value of the lease payments. Contact Financial Accounting and Reporting (FAR) for additional assistance.

Fair value - 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. For purposes of determining whether this criterion applies, it is reasonable to conclude that an amount equal to 90% or more of an asset's fair value is "substantially all" of that asset's fair value.

Residual Value Guarantee (Lessor) – Lessors are exposed to the risk that the leased asset will have little or no value at the end of the lease term. As such, a contract for a leased asset may contain a residual value guarantee which is a guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount. The lease payments are the same under the lessee and lessor accounting model except for the treatment of a residual value guarantee. This amount, if any, applies only to a lessee as it is included in the measurement of lease payments. Lessors do not include such amounts in their lease payment calculation, but it is part of the additional lessor criterions to determine if a lessor lease is potentially a direct finance lease.