HARVARD

UNIVERSITY POLICY

Lease Accounting Policy

(Previously called Accounting for Leases)

Originally Issued: 07/01/2014
Last Revised: 07/01/2022
Responsible Office: Financial Accounting and Reporting

Policy Statement

This policy establishes accounting treatment for lease agreements and agreements that contain lease components entered into by the University, both as a lessee and as a lessor. The lessee is the party granted use rights of an asset as part of an agreement. The lessor is the owner of the assets identified in the agreement.

There are two types of lease classifications for a lessee: finance and operating. There are three types of leases for a lessor: direct financing, sales-type, and operating leases. The proper lease classification is important because it determines the University's accounting and reporting requirements.

A lease exists when there is a contract, or part of a contract, which conveys the right to control the use of an identified asset (property, plant, or equipment – PP&E) for a period of time in exchange for consideration (i.e., payment). The lessee is determined to have control of the use of an asset if it has the ability to determine how the asset is used and the right to substantially all of the economic benefits arising from the asset.

Contracts that convey the right to use an asset other than PP&E are not covered by this policy. Please reach out to Financial Accounting and Reporting (FAR) for agreements not covered by this or the Software Accounting Policy.

Reason for Policy

Generally accepted accounting principles requires both lessees and lessors to recognize the effect of a leasing contract on the balance sheet. This policy provides guidance on determining the classification of an identified lease arrangement (i.e., for lessees: finance or operating; for lessors: direct financing, sales-type or operating) and establishes uniform thresholds and procedures when recording a lease.

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 7/1/2022; note that addenda to and extensions of existing leases may qualify as new leases for purposes of this policy.

If a University Policy conflicts with any other University Policy, term, external regulation, or law, the more restrictive provision will apply.

Harvard University schools, tubs and local units may have related local policies as long as they are consistent with and meet the minimum standards set by University Policies

Responsibilities

School/unit finance offices (Tubs) are responsible for ensuring that local units abide by this policy and the accompanying procedures.

- For lessee arrangements, Tubs must notify FAR of leases that meet the thresholds noted under Section I below as they arise throughout the year, no later than quarter end, and must disclose finance and operating lease commitments for which the University is a lessee 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.
- For lessor arrangements, those Tubs that are lessors must notify FAR of leases that meet the thresholds noted under Section III and work with FAR to determine the appropriate accounting treatment, including necessary journal entries.

Financial Accounting and Reporting (FAR) maintains this policy and provides guidance regarding the policy.

- For lessee arrangements, FAR has the following responsibilities: With information supplied by the tubs at lease commencement, FAR records the initial setup of finance lease assets and liabilities, for providing the amortization schedule for the lease liability, and for recording depreciation of the finance lease asset. With information supplied by the tubs at year-end, FAR records the operating lease assets and liabilities on the tub balance sheet each year end and disclosing all other supplementary required information pertaining to leases. At year end, FAR collects and analyzes information from tubs regarding all lease costs and commitments (both operating and finance) and supplies this information to external auditors.
- For lessor arrangements, FAR has the following responsibilities: Work with the responsible school/unit to determine the appropriate accounting treatment for leases over the identified thresholds below, including necessary journal entries.

Contact: Associate Director of Financial Reporting or your Tub Analyst

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. See find your OSP Contact.

Procedures

A lease exists when there is a contract, or part of a contract, which conveys the right to control the use of an identified asset (property, plant, or equipment) for a period of time in exchange for consideration (i.e., payment). To qualify as a lease, the lessee must obtain substantially all the economic benefits from using the asset and have the right to direct the use of the asset. The economic benefits from using an asset include the asset's primary output and by-products. Examples include: the economic benefits from the University using a solar farm include the power generated by the solar panels and renewable energy credits obtained from using the assets to generate power; leased lab space used to generate specific research, leased office space used, held or subleased, or physical receipt of material produced by machinery.

The determination of whether a contract is a lease, or contains a lease, is made at the lease inception date.

Note: any lease of property, plant or equipment that is held outside of the state of Massachusetts or the United States of America must be reviewed by the Office of the General Counsel and Tax Compliance Office for potential tax or regulatory implications in those locations.

I. Lessee Accounting

A. Understand Rules for Lessee Accounting

Leases must be evaluated to determine if they are finance leases or operating leases, which, in turn, determine the appropriate accounting processes. All leases are recognized and initially measured on the lease commencement date by recording a right-of-use asset and a lease liability on the balance sheet.

A lease is a finance lease if it meets certain criteria; if not, it is an operating lease. Lease classification must be evaluated at the lease inception date.

Both finance and operating leases are recorded to the Balance Sheet as a Right-of-use asset and Lease liability, however, the methodology differs depending on lease classification. Financial Accounting and Reporting (FAR) manages the balance sheet for both operating and finance leases.

For operating leases, FAR records/updates the ROU asset and Lease liability based on information reported annually in Commitments and Contingencies by schools and units. For finance leases, FAR records the initial transaction to the balance sheet, and the schools/units are responsible for the quarterly entry to amortize the Lease liability (the finance lease asset is systematically depreciated via Oracle Fixed Assets).

B. Finance Leases

Finance leases are recorded as a Finance Lease Liability and Property, Plant and Equipment asset, using Oracle Fixed Assets, based on the present value of lease payments. The asset is depreciated, and the liability is amortized with interest expense incurred over the life of the lease.

1. A lease must be evaluated for proper classification as either a finance lease or operating lease when the following lease term and cash payment thresholds are met[1]. Leases that don't meet these thresholds must be treated as operating leases.
   - Lease term must be ≥ 3 years, **and**
   - Annual lease cash payment must be ≥ $1,000,000 per year, OR
   - Cumulative spending over the lifetime of the contract must be >$10,000,000.
2. If the above thresholds are met, a lease must be capitalized as a finance lease **<u>if it meets any one</u>** of the criteria listed below (See Appendix A for additional guidance.) **Reach out to FAR for assistance with this analysis when these thresholds in Step 1 are met.**
   a. Transfer of ownership: Ownership of the asset transfers to the lessee by the end of the lease, OR
   b. Purchase option: The lease contains a purchase option that the lessee is reasonably certain to exercise. For example, a lease may contain a bargain purchase option (BPO), 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, OR
   c. Lease term: The lease term covers a majority (i.e., ≥75%) of the estimated economic life of the leased asset. OR
   d. Lease payments[1]: The present value of the sum of lease payments and any lessee residual value guarantee not reflected in lease payments, equal or exceed substantially (i.e., ≥90%) all of the underlying asset's value (further guidance provided in Appendix A). Lease payments include fixed payments, amounts paid before the lease commencement date, less any lease allowances (e.g., tenant improvement allowances) or incentives, plus qualifying initial direct costs. This amount excludes variable payments and executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, unless such executory costs are determinable at lease commencement in which case they should be included. The present value of lease payments should be discounted using the rate implicit in the lease (or if that rate cannot be readily determined, contact FAR for the incremental borrowing rate). OR

[1] Please note that this threshold applies to all University schools and units that are NOT subject to a standalone audit. For any units with a standalone audit requirement, locally materiality levels will need to be considered. Reach out to FAR for assistance.

e. Customized Asset: The leased asset is so customized that is has no alternative use to the lessor at the end of the lease term.

*The Lease Classification Quick Guide (Appendix C) provides guidance on how to calculate the present value of the lease payments. Tubs should submit this form along with a copy of the lease agreement and support for the lease classification assessment to their Tub Analyst in Financial Accounting and Reporting (FAR) for all new leases that meet the materiality threshold in I.B.1 above.

3. Record Finance Leases Properly

   a. Initial Set-Up

   The University is required to record a right-of-use ("ROU") asset and a lease liability for finance leases at the lease commencement date. Given the complexity of accounting rules for finance leases and the fact that it requires central-only object codes, FAR will prepare and upload the initial journal, establishing the finance lease asset and liability.

   (1.) All ROU assets related to finance leases will be recorded as fixed assets in Oracle Fixed Assets with subsequent depreciation being recorded to the GL monthly by Oracle.

   (2.) All liabilities related to finance leases will be recorded as Finance Lease Equipment Liability (object code 2793) or Finance Lease Building Liability (object code 2794).

   (3.) Lease prepayments and incentives: If lease payments are made, or lease incentives received, prior to the lease commencement, such as the lease inception date, they should be recorded as prepaid rent. This prepaid amount will be reclassified to the lease asset on lease commencement date.

4. Ongoing Measurement and Journals for Finance Leases

   a. Quarterly Journals: **FAR will assist in the initial journal entry set-up and template that will be used for the recurring journal entry going forward.** On a quarterly basis, the lease liability is reduced using the effective interest method. 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. As part of the quarterly entry, tubs are responsible for updating the payment coding on finance leases to recognize interest expense and to reduce the liability. When preparing the quarterly entry, tubs must utilize the lease amortization schedule provided by FAR at initial setup to determine the quarterly interest expense and liability reduction amounts. **Tubs are responsible for preparing and sending these journal entries to FAR for upload because they require the use of central-only object codes.** See **Appendix B** for an example that illustrates the amortization of a lease liability.

   b. Depreciation of the finance lease asset: The ROU asset is depreciated on a straight-line basis over the lease term, inclusive of extensions, within OFA. If the lease term is greater than the asset's useful life, it will be amortized over the asset's useful life. No manual entries are necessary.

   c. Making lease payments: lease payments are the responsibility of the tub. Ideally, tubs should establish annual purchase orders for their lease obligations and code these payments as "rent expense" in the General Ledger. These payments should follow local payment policies and guidelines for processing and approving payments. Tubs should check that "rent expense" nets to zero for finance leases on an annual basis (after the impact of the quarterly journal entry).

   d. 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 must be kept on file in accordance with the quarterly financial close checklist.

C. Operating Leases

Operating leases are recorded as a ROU Asset and a Lease Liability, equal to the present value of the remaining lease payments, discounted using the rate implicit in the lease (or if that rate cannot be readily determined, the lessee's incremental borrowing rate), and are adjusted annually by FAR (for units with a standalone audit, the unit is responsible for amortizing the ROU asset and annually reducing the lease liability) for all leases with a remaining lease obligation of $100k or more and a remaining term greater than 1 year. Rent expense is recorded on a straight line or cash basis (see thresholds below for distinction) throughout the year without an impact to the asset or liability. Although operating expenses are treated as rental expense by the tub during the year it is important for the tub to retain information on operating leases for its year-end submission to FAR.

Operating leases are recognized on the balance sheet as their own financial statement line items (separate from finance leases) and are remeasured annually, with expenses recognized as rent/lease expense by the tub. This differs from finance leases, which result in depreciation and interest expense once all monthly and quarterly recurring entries are processed. Any lease that does not meet the Finance Lease criteria above is an operating lease.

1. Record Operating Leases Properly

   Generally accepted accounting principles require operating leases to be recorded on the balance sheet as a ROU asset and Lease liability. In practice, tubs should record operating leases as rent expense as described above however operating lease details including lease term, escalating rent payments, rent expense adjustments, initial direct costs, prepayments, lease improvements, and lease incentive information must be included in the tub's annual submission to FAR as part of the commitment and contingency request at year-end. FAR will use the information provided to record operating leases on the balance sheet to comply with accounting standards.

2. 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 is greater than or equal to a threshold of $500,000 or more annually in one or more of the lease years. Include in the deferred payment calculation are the basic rent amounts plus any other payments required under the lease terms (e.g., a lease non-renewal penalty or other likely payment required by the lessee). For operating leases with straight-line impact under the $500,000 threshold, rent expense recorded may equal the actual amounts paid.

   a. 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, based on the above threshold. The time value of money and anticipated inflation should not be considered in allocating scheduled rent increases.

   b. 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. See Example #3 in Appendix B for an example of the accounting.

   c. Initial Direct Costs: The sum of lease payments must include commissions paid upon executing the lease, and therefore must be included in the Commitments and Contingencies annual FAR request. All other initial direct costs are expensed as incurred.

D. Special Treatment for Leases Involving Land and Land with Buildings

For leases that include a land element (e.g. a lease of land and a building, or land and integral equipment), the land may be considered a separate lease if separating the land component would have an impact on lease classification. If you believe that land is a significant component of your lease, please contact FAR.

II. Account for Leasehold Improvements - Lessee

A. Capital projects involving leased property (both for external leases and inter tub leases) are 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 accounting is the same regardless of whether the lease is a finance or operating lease. The leasehold improvement must be depreciated over the shorter of the standard useful life or the lease term plus extensions. Refer to the Fixed Assets Policy for additional information.
B. If the lease contains a tenant improvement allowance, this will not impact the value of the leasehold improvement (follow the PPE Policy for costs to capitalize). The tenant improvement allowance will be used as the funding source of the project.Please reach out to FAR for assistance with related journal entries.
C. If the lease contains language on leasehold improvements that will be owned by the lessor, please consult with FAR for accounting implications, as it could impact lease classification or trigger a lease modification.

III. Lessor Accounting

A. Understand the Rules for Lessor Accounting

Harvard is the lessor in a lease transaction when leasing property, plant, or equipment to a third party. Leases must be evaluated to determine if they are operating leases, direct financing leases or sales-type leases, which, in turn, determine the appropriate accounting processes. Leases that do not meet the requirements to be a direct financing or sales-type lease are, by default, classified as operating leases.

A lease must be assessed for direct financing or sales-type lease treatment if the following thresholds are met. If these thresholds are NOT met, the lease must be treated as an operating lease:

1. Cumulative receipts over the life of the lease are >$10M, OR
2. Annual lease year cash receipts are >$1M

If the above thresholds are met, the tub must consult with FAR to determine if the lease is a sales-type or direct financing lease.

B. Record Sales-Type and Direct Financing Leases Correctly

A Sales Type Lease exists when it meets the above cash threshold **and** one of the criterions in section I.B.2 (lessee accounting) is met. If a lease doesn't meet any of those five criteria (I.B.2.a-e) then two additional criterion below must be evaluated. If both of the additional criterions are met, then the lease is classified as a Direct Financing Lease. If only one or none of the additional two criterions are met, then the lease is classified an operating lease. The two additional criteria are:

1. Whether the sum of the present values of (a) the lease payments, (b) any residual value guarantee not included in the lease payments, and (c) any residual value guaranteed by third parties, either substantially equals or exceeds all of the fair value of the leased asset.
2. Whether it is probable that the lessor will collect the lease payments and the residual value guarantee(s).

This evaluation includes performing the assessment of lease payments described in Section I.B.2.d. For this criterion assessment, the lessor should compare the fair value of the asset against the present value of the total fixed and optional payments that are reasonably certain to be paid under the lease.

Please contact Financial Accounting and Reporting for assistance with the lease evaluation, initial setup and ongoing accounting guidance for a lease determined to be a Sales-type or Direct finance lease, or if you have questions about lessor lease classification.

C. Record Lessor Operating Leases Properly

An operating lease where Harvard is the lessor is treated as rental income by the tub.

1. Cash vs. straight-line basis: operating leases must be recorded on a straight-line basis even if the receipts vary in amount over the lease term if the impact of the deferral is $500,000 or more on an annual basis. Tubs may elect to apply straight-line accounting for leases below this threshold. Include in rental income the basic rent amounts required under the lease terms plus any other reasonably certain amounts to be collected from the lessee. For operating leases with straight-line impact under these thresholds, rental income recorded may equal the actual amounts received.
    a. Escalating rent receipts: lease receipts that are not of equal amounts but that escalate during the life of the lease should be recognized on a straight line basis based on the threshold above, unless another systematic and rational basis is more representative of the time pattern in which the leased property is physically employed.
    b. Rent income adjustments: If the actual rent income is higher or lower than the straight-line basis rent income, the tub must record adjusting entries for the difference. Reach out to FAR with questions on proper accounting entries.
    c. Initial direct costs: These costs are generally limited to commissions paid upon executing the lease and costs paid to existing tenants as an incentive to vacate the leased premises. All other Initial direct costs are expensed as incurred.
    d. Generally accepted accounting principles do not require lessor operating leases to be recorded on the balance sheet. Tubs should continue to depreciate the leased asset over its useful life and amortize any deferred initial direct costs. If lease payments were received up front, for example at least inception, record as a deposit liability.
    e. Tenant improvement allowances: Where a school/unit provides a tenant improvement allowance to a lessee, the capital improvement must be evaluated to determine if the University owns the leasehold improvement. If the school/unit retains ownership of the improvement, the improvement has a useful life beyond the lease term, the improvement has a value of $100,000 or more AND the University pays the construction vendor directly, then the capital improvement must be processed through the CAPS system in accordance with the Property, Plant and Equipment policy. If these requirements are not met, the asset is recorded as a prepaid asset and is amortized over the life of the lease.

IV. Other Lease Topics:

Note that these topics apply to both Lessee and Lessor arrangements.

A. Record Inter-Tub Leases 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.

B. Account for executory costs correctly

Executory costs include utilities, repairs, maintenance, insurance, common area expenses, and taxes paid for the leased asset during its contract agreement period. If significant executory costs are determinable at the lease commencement date, tubs should include these amounts in the lease payment present value measurement as part of the lease classification assessment in section I.

C. Maintain supporting documentation

For all leases, follow the records retention schedule legal contract and agreement documentation requirements. Generally, schools and units are required to keep the following documentation on file for the life of the leased asset plus an additional seven years. Some funding sources may require additional retention periods (e.g., sponsored funding).

- The master lease agreement
- A copy of the completed “Lease Classification Form” (Appendix C, completed with the facts of the lease).
- Supporting documentation for any additional assumptions used in determining whether the lease is finance or operating
- For finance leases, tubs must also maintain a schedule of payments showing amortization of the lease-related liability.

D. Make required disclosures for year-end lease reporting

The University is required to disclose the total gross assets and liabilities for finance and operating leases as well as both finance 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 $100,000 per lease.

Definitions

Cash Basis: Recognizing lease expense as cash is paid.

Control: Control of an asset means that the lessee has the right to obtain substantially all of the economic benefits for the use of the asset and the right to direct the use of asset.

Commencement date: The date when the lessor makes the asset available for the lessee’s use. The lease classification analysis and its inputs are measured at this date.

Direct-Financing Lease: A lessor only type lease that meets none of the five criteria in Section I but meets both additional criterions in Lessor Accounting section III.

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. If the amounts become determinable after the lease commencement date, they are considered period costs and therefore must be expensed as incurred.

Fair market value: Probable price at which a willing buyer will pay to 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.

Finance lease: A lease considered to have the economic characteristics of asset ownership where the lessee obtains substantially all of the control and benefits of the asset. A finance 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.

Fixed payments: Unavoidable payments that are specified in the lease. Fixed payments represent

amounts that will not vary based on changes in facts or circumstances that occur after the commencement date.

Incremental borrowing rate: Interest rate a lessee would have to pay if, instead of leasing, they finance the purchase of the same asset.

Initial direct costs: Initial direct costs are the incremental costs of entering into a lease that are only incurred as a direct result of the lease being executed. Examples of initial direct costs include commissions paid upon executing the lease and costs paid to existing tenants as an incentive to vacate the leased premises. These costs are incurred only if the lease is executed and would not have been incurred if the lease had been drafted and negotiated, but ultimately had not been signed by both parties. These costs exclude legal fees, costs of evaluating the prospective lessee's financial conditions, costs of negotiating lease terms, and general overheads.

Inception date: The date when the contract is executed. A tub must determine whether a contract is or contains a lease at this date.

Intangible asset: An asset with no physical substances such as internet domain names, licensing agreements, broadcast rights, patent technology, trademarks, etc.

Lease: A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (PP&E) for a period of time in exchange for consideration.
In order to control the use of an asset, the tub should determine at lease inception if it has both the ability to determine how the asset is used and the right to substantially all of the economic benefits arising from the asset. The determination of whether or not a contract is a lease or contains a lease is made at the lease inception date. For additional guidance determining if a contract is or contains a lease See appendix A.

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.

Lease incentives: Lessor provided incentives paid, or payable, to the lessee that reduce the lessee's lease payment. A rent-free period, an up-front cash payment, payment for tenant improvement allowance, and payment of lessee costs, such as moving expenses, are common lease incentives.

Lessee: A person or entity who rents land or property. An individual or entity who has the right to use something of value gained through a lease agreement with the real owner of the property (lessor).

Lessor: The owner of an asset that is leased under an agreement to a lessee.

New leases: For purposes of this policy, new leases are leases entered into after 6/30/2022, including addenda to or extensions of existing leases.

Operating lease: From the perspective of a lessee, any lease other than a finance lease. Operating leases are treated as rental expenses by the lessee tub. Detailed operating lease information must be retained and submitted to FAR at year-end for proper financial statement recording and disclosure. From the perspective of a lessor, any lease other than a sales-type lease or a direct financing lease.

Period of Time: May be described in terms of the amount of use of an asset (e.g., number of production units) or the number of years or months specified in an agreement.

Residual value guarantee: 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.

Right of Use (ROU) Asset: An asset that represents a lessee's right to use an underlying asset for the lease term.

Sales-Type Lease: A lessor only type lease that meets one or more of the five criteria in Section I.

Straight Lined Reporting: The usage of the rental arrangement is on a consistent basis over time (e.g., used at about the same rate month to month) and therefore the expense is taken consistently over the lease term. To calculate straight-line lease expense, aggregate the total cost of all payments and divide by the total contract term.

Variable payments: A variable payment is a payment in a lease that varies based on changes in facts and circumstances occurring after the commencement date, other than the passage of time. They will be adjusted subsequently and reflected as an operating expense for operating and finance leases in the period in which they occur. The only variable payments included in "lease payments" are those that are based on an index or rate.

Contact/Responsible Office

Financial Accounting and Reporting: *Associate Director of Financial Reporting or your Tub Analyst*

Revision History

07/01/2022 – Formalized policy to document changes made 07/01/2019 to the Lease Accounting Standards. Harvard completed an historical review (7/1/19-6/30/22) and made adjustments as needed to comply with the new standards.
07/01/2014 – Formerly called Accounting for Leases

Related Resources/Appendices

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

Appendix B: Examples of Proper Accounting for Lessees

Appendix C: Lease Classification Form - Interactive

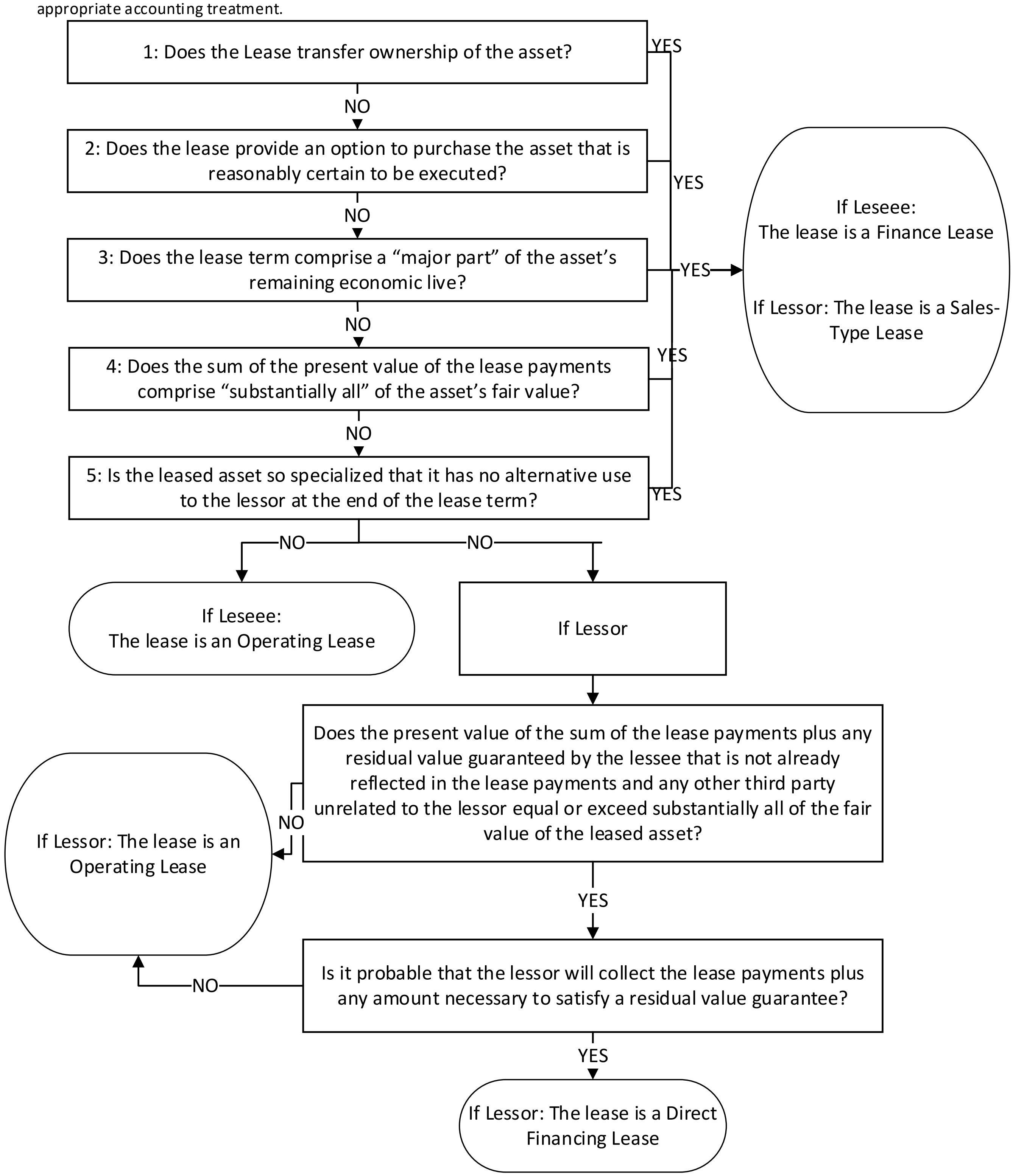
Financial Management of Property, Plan, and Equipment (Capital Assets and Equipment)

Internal Billing Transactions Policy

Internal Transfers Policy

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.

Appendix B – Examples of Proper Lessee Accounting

Contact FAR For schools or units for assistance around lessor accounting.

Example #1 - Operating vs. Finance Lease

On July 1, Campus Services 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 total payment is $1,150,000 which is comprised of $1,100,000 base cost and $50,000 maintenance costs (paid at the end of each year).
- Lease Commissions of $200,000 to be paid at lease inception.
- The building was newly acquired by the lessor. By reviewing publicly available sale price, Campus Services determines that the building's fair value is $16,000,000.
- The implicit rate in the lease is not readily available. The University's incremental borrowing rate on July 1 is 6% (the rate that the University would have incurred to borrow same amount).

Since the lease term is 3 years or greater and annual rental payments are above $1,000,000, Campus Services assesses for finance lease classification. If annual rental payments were less than $1,000,000, or if the lease carried a term less than 3 years, the lease would 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 lessee at the end of the lease.
2.	Does lease grant lessee an option to purchase the asset that lessee is reasonably certain to exercise?	**No**	The lease agreement does not contain a purchase option (e.g., that the building can be purchased for $1 at the end of the lease term).
3.	Does the lease term make up a "major part" of the asset's remaining economic life? * * Consider "major part" to be 75% or more of the leased asset's remaining economic life.	**No**	The lease term equals 57% of the economic useful life. (20 years/35 years), which is less than 75%.
4.	Does the sum of the present value of the lease payments make up "substantially all" of the asset's fair value? * * Consider "substantially all" to be 90% or more of the fair value of the leased asset	**No**	Present value of the lease payments calculation: Annual base lease cost $1,100,000 Annual fixed maintenance costs $ 50,000 **Annual Lease Payment** **$1,150,000** The present value of a twenty-year annuity with annual lease expense of $1,150,000 and an incremental borrowing rate of 6% is calculated using the criterion 4 section of the "Lease classification form." This amount is $13,190,409. Therefore, the present value of the lease equals 82% ($13,190,409/$16,000,000) of the fair value of the lease asset, which is less than 90%.

			Note that the lease commission of $200K is considered an indirect cost and is not included in the lease payment measurement.
5.	Is the leased asset so specialized that is has no alternative use to the lessor at the end of the lease term?	**No**	The leased space will still be of use to the lessor at lease end.

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

Summary of amounts to be used in the journal entries for Example #1 below:
Lease commission payment made by the tub at the beginning of the lease: $200,000
Portion of lease commission to be recognized over the life of the lease term: $200,000/20years = $10,000 per year
Annual lease payments: $1,150,000
Annual maintenance costs included in the lease payment: $50,000

Entries by HRES (lessee)

The tub processes a payment request in B2P to record the prepaid lease commission 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 B2P to record the lease payment and maintenance cost:

Dr - O/C 7230, "Rentals+Leases of Space, GENERAL"	$1,100,000	
Dr - O/C 7120, "Improvements+Alterations to Space, Not Capitalized, GENERAL"	$ 50,000	
Cr - O/C 0375, "CO^Due to/from Consolidated Tub"*		$1,150,000

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

NOTE: The tub should include in its Commitment and Contingencies annual submission to FAR the above lease detail including any lease commission and incentive amounts. Based on this submission, FAR will make the necessary journal entry to recognize the lease on the tub-level balance sheet in the ROU Asset and Lease liability financial statement line items.

Example #2 - Operating vs. Finance 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 $1,250,000 (paid at the end of each year).
- Included in the annual lease payments are $50,000 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 estimated at $6,500,000.
- The implicit rate in the lease is not readily available. The University's incremental borrowing rate on January 1 is 7% (the rate that the University would have incurred to borrow same amount).
- HMS will make payments out of their unrestricted undesignated fund (000001).
- HMS has the right to obtain title to the equipment at the end of the lease term for the bargain price of $1.

Since annual rental payments are above $1,000,000, HMS assesses the lease for finance lease classification. If annual rental payments were less than $1,000,000, the lease would have to be treated as an operating lease.

	Criteria	Answer	Comments
1.	Does ownership of the asset transfer to the lessee 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 lessee at the end of the lease.
2.	Does lease grant lessee an option to purchase the asset that lessee is reasonably certain to exercise?	**Yes**	Yes - HMS can buy the equipment at the end of the lease for a bargain price of $1.
3.	Does the lease term make up a "major part" of the asset's remaining economic life? * * Consider "major part" to be 75% or more of the leased asset's remaining economic life.	**No***	Original term 4 years One-year renewal period** <u>1 year</u> **Total lease term** **5 years** **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. The lease term equals 63% (5 years/8 years) of the economic useful life, which is less than 75%.
4.	Does the sum of the present value of the lease payments make up "substantially all" of the asset's fair value? * * Consider "substantially all" to be 90% or more of the fair value of the leased asset	**No***	Present value of the lease payments calculation: Annual base lease cost $1,200,000 Maintenance costs <u>$ 50,000</u> **Actual lease expense** **$1,250,000** The present value of a 5-year annuity with annual lease expense of $1,250,000 and an incremental borrowing rate of 7% is calculated using the criterion 4 section of the "Lease classification form." This amount is $5,125,247. Therefore, the present value of the lease is 79% ($5,125,247/$6,500,000) of the fair value of the lease asset, which is less than 90%.
5.	Is the leased asset so specialized that is has no alternative use to the lessor at the end of the lease term?	**No**	The leased equipment will still be of use to the lessor at lease end.

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

Summary of amounts to be used in the entries below:
Annual lease payments: $1,250,000
Annual maintenance costs included in the lease payment: $50,000
Net present value of annual lease payments: $5,125,247
Liability amortization is calculated using the effective interest method - See schedule 1 on the next page
Leased asset depreciation calculation: $640,656 ($5,125,247 ÷ 8 years)

Entries:
At the inception of the lease, FAR records the following entry to establish the finance lease asset and the

Dr - O/C 1003, "CO^Equip, Scientific, Nonsponsored"	$5,125,247
Cr - O/C 2793, "CO^Finance Lease Equipment Liability" $5,125,247	

related liability:

HMS processes a payment request in B2P to record the lease payment and maintenance cost. Amounts are derived from the liability amortization table included in schedule 1:

Dr - O/C 7230, "Rentals+Leases of Space, GENERAL"	$1,250,000
Cr - O/C 0375, "CO^Due to/from Consolidated Tub" $1,250,000	

On a quarterly basis, HMS compiles a manual journal entry to amortize the finance lease liability and charge interest expense, while reversing the charge to rent expense created upon payment. 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. Once the entry is compiled by HMS, it is sent to FAR to upload/post due to central-only object code usage:

Dr – O/C 2793 "CO^Finance Lease Equipment Liability"	$891,233
Dr – O/C 7621 "Other External Interest Expense	$358,767
Cr - O/C 7230, "Rentals+Leases of Space, GENERAL" $1,250,000	
Dr - O/C 9330, "Transfers to/from Funds Invested in Equipment - PIS" Fund 000001	$891,233
Cr - O/C 9301, "Transfers to/from Unrestricted Undesignated Balances" $891,233 Fund 724001	

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

Equipment asset = $5,125,247
Equipment debt = $4,234,014 ($5,125,247 less $891,233 of lease obligation amortization)
Equipment net assets = $891,233

* Note that since the response to criterion 2 is yes, criteria 3, 4, and 5 are not required to be tested, but are shown here for informational purposes.

Schedule 1: Obligation amortization

Date	Lease payment	7% Interest Expense	Obligation amortization	Balance of lease obligation
				$ 5,125,247
Year 1	$ 1,250,000	$ 358,767	$ 891,233	$ 4,234,014
Year 2	$ 1,250,000	$ 296,381	$ 953,619	$ 3,280,395
Year 3	$ 1,250,000	$ 229,628	$ 1,020,372	$ 2,260,023
Year 4	$ 1,250,000	$ 158,202	$ 1,091,798	$ 1,168,224
Year 5	$ 1,250,000	$ 81,776	$ 1,168,224	$ 0

Note: No manual journal entries are required to amortize down the Finance Lease asset. Once the asset is recorded in Oracle Fixed Assets, the asset is automatically amortized on a monthly basis, with the straight-lined expense recorded as depreciation expense over the asset's useful life (since criterion number 2 was met):

Dr - O/C 7571, "Nonsponsored Equipment, Fixtures, Furniture Depreciation"	$640,656	
Cr - O/C 1181, "CO^Equip, Scientific, Nonsponsored, Acc Depr"		$640,656

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 $500,000, FAS must make adjusting entries to charge rent expense on a straight-line basis.

__Year 1__

FAS processes a payment request through B2P 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.

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

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

Year 2

FAS processes a payment request through B2P 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 B2P 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.

Appendix C – Lease Classification Form

Download Excel version of Appendix C

Note: Tubs may use this high level one-page check to determine if a lease may require additional review or if it can be treated as an operating lease with no further lease classification review needed. If thresholds are met in steps 1 and 2, tubs may use the lease criterion 3 and 4 calculator to assist in their lease classification assessment

Step 1[1]: Upon the inception of the new lease, evaluate the following term threshold.

a. **Is the lease term ≥ 3 years?**

If no, the lease is an operating lease, record regularly and include lease information in your tub's annual Commitments and Contingencies submission to FAR.

Step 2[1]: If answered yes to step 1, proceed to evaluate the following additional threshold considerations:

b. **Are annual lease cash payments ≥ $1,000,000 per year? OR**
c. **Is cumulative spending over the lifetime of the contract > $10,000,000?**

If the lease does not meet one of the above thresholds, the lease is an operating lease, record appropriate lease/rent expense and include lease information in your tub's annual Commitments and Contingencies submission to FAR. If one of the above thresholds is met, additional evaluation is required for a potential Finance Lease. Please refer to the Lease Accounting Policy for further information. This interactive spreadsheet can be used to assist in the necessary calculations.
If you have any questions, please reach out to your FAR Tub Analyst.

Lease Classification – Criterion 3 and 4 Assistant

Note: The following calculator may be used to assist in the assessment of criterion 3 and 4. **As appropriate, please input lease facts in the yellow cells below, add/remove years, and drag down formulas as necessary in the table based on your lease term. If any RVG exists in your lease please enter it in the final year of the lease payment table.**

Lease Facts (input in the yellow cells)			
Lease Term (Yrs):	5	Annual Fixed Lease Base Payment	1,200,000
Estimated economic life of the leased asset*	8	Annual fixed lease maintenance costs	50,000
Fair Value of leased asset*	6,500,000	Residual Value Gurantee (RVG) - lessee guarantees that the asset will have a residual value of at least***	1,625,000
Discount Rate implicit in the lease (or obtained from FAR)**:	7.00%		

* This information will likely not be found in the lease agreement. Judgment may need to be applied in these areas and this will need to be supported by external information, such as tax assessments, vendor quotes, etc.

** The discount rate applied is dependent on current market rates at the time of lease commencement and and lease term. Reach out to FAR to determine the appropriate discount rate to use.

*** Lessees and lessors should include the full amount of the potential payment payable under a residual value guarantee in fixed lease payments when evaluating lease classification. The requirement to include the full amount of the potential payment payable under a residual value guarantee differs from the measurement guidance, which requires that lessees and lessors consider only the present value of any payment under a lessee residual value guarantee that is *probable of being owed*. Please contact FAR if you have any questions.

Criterion 3: Lease Term Test

Lease term as a % of the economic useful life	63%
Does lease term make up a "major part" (75%) of the asset's remaining economic life?	**No**

Criterion 4: PV of Sum of Lease Payments Test

Date	Period	Lease Fixed Ba	Lease Fixed Mai	RVG	Total	PV
7/1/2022	1	1,200,000	50,000		1,250,000	(1,168,224)
7/1/2023	2	1,200,000	50,000		1,250,000	(1,091,798)
7/1/2024	3	1,200,000	50,000		1,250,000	(1,020,372)
7/1/2025	4	1,200,000	50,000		1,250,000	(953,619)
7/1/2026	5	1,200,000	50,000	1,625,000	2,875,000	(2,049,835)

Sum of the present value of the lease payments	6,283,849
Make up "substantially all" (90%) of the fair value of the leased asset"	**Yes**

[1] Please note that this threshold applies to all University schools and units that are NOT subject to a standalone audit. For any units with a standalone audit requirement, locally materiality levels will need to be considered. Reach out to FAR for assistance.