

# Revenue Recognition Case Study

## LEASES

### SCENARIO:

On January 1, 2021 Company ABC enters into a 5 year lease for office space. The lease includes options for three additional five year terms. Company ABC reasonably expects to use one of the three additional terms, but as of January 1, 2021 expects to out grow the space after 10 years.

The Daily Treasury Yield Curve as of 1/1/21 for 5 years is 2.50% and for 10 years is 2.66%

The lease is a triple net lease that requires base monthly rents of \$5,000 with annual 3% increases. CAM charges, including real estate taxes and property insurance, are paid at a rate of \$2,000 a month and are reconciled at the end of the year.

### LEASE ASSESSMENT:

Based on the information provided the lease is an operating lease with a 10 year life. CAM payments are not part of the lease liability or lease asset as they are not fixed, based on a index or upfront costs.

### CALCULATIONS:

The table below reflects the total cost of the lease based on the indexed inflation for base payments:

MONTHLY			
Date	Base Rents	CAM	Total Payment
2021	\$5,000	\$2,000	\$7,000
2022	\$5,150	\$2,000	\$7,150
2023	\$5,305	\$2,000	\$7,305
2024	\$5,464	\$2,000	\$7,464
2025	\$5,628	\$2,000	\$7,628
2026	\$5,796	\$2,000	\$7,796
2027	\$5,970	\$2,000	\$7,970
2028	\$6,149	\$2,000	\$8,149
2029	\$6,334	\$2,000	\$8,334
2030	\$6,524	\$2,000	\$8,524
	<u>\$57,319</u>		
	\$5,732	Straight line base rent (Total Divided By 10 Year Life of Lease)	

**Below are the entries related to this lease under both existing GAAP and the new lease standard:**

To record the initial set up of the operating lease:

**NEW STANDARD:**

Operating Lease Asset	\$600,808.55	
Operating Lease Liability		\$600,808.55

**OLD STANDARD:**

Would not need an entry, as there is no balance sheet effect for setting up the lease.

To record the first month rent payment:

**NEW STANDARD:**

Rent Expense (Base portion)	\$5,732	
Rent Expense (CAM portion)	\$2,000	
Operating Lease Liability	\$5,000	
Cash		\$7,000
Operating Lease Asset		\$5,732

**OLD STANDARD\*:**

Rent Expense (Base portion)	\$5,000	
Rent Expense (CAM portion)	\$2,000	
Cash		\$7,000

\*Assuming that straight line rent expense adjustmentr was deemed to be immaterial

A summary of the 10 years of rent paid and expense under both the new and old standards is as follows:

Date	Cash Paid	Rent - Old	Rent - New	CAM - Both	Combined - Old	Combined - New
2021	\$84,000	\$60,000	\$68,784	\$24,000	\$84,000	\$92,784
2022	\$85,800	\$61,800	\$68,784	\$24,000	\$85,800	\$92,784
2023	\$87,660	\$63,654	\$68,784	\$24,000	\$87,654	\$92,784
2024	\$89,568	\$65,564	\$68,784	\$24,000	\$89,564	\$92,784
2025	\$91,536	\$67,531	\$68,784	\$24,000	\$91,531	\$92,784
2026	\$93,552	\$69,556	\$68,784	\$24,000	\$93,556	\$92,784
2027	\$95,640	\$71,643	\$68,784	\$24,000	\$95,643	\$92,784
2028	\$97,788	\$73,792	\$68,784	\$24,000	\$97,792	\$92,784
2029	\$100,008	\$76,006	\$68,784	\$24,000	\$100,006	\$92,784
2030	\$102,288	\$78,293	\$68,784	\$24,000	\$102,293	\$92,784
	\$927,840	\$687,840	\$687,840	\$240,000	\$927,840	\$927,840

Amortization of the lease liability is recorded monthly throughout the life of the lease. The 'interest' component is recorded against the Lease Asset, reducing the lease asset monthly, while the principal component is recorded against the lease liability monthly. This will result in the lease asset and liability only equaling on the date of lease inception. It is important to note, that with an operating lease no interest or amortization is recorded, everything is recorded through rent expense. Below is the first year of the lease amortization:

Date	Cash Paid	Rent Expense	CAM	Principal	Amortization	Lease Asset	Lease Liability
1/1/2021						\$600,808.55	\$600,808.55
1/1/2021	\$7,000	\$5,732	\$2,000	\$5,000.00	\$(5,732.00)	\$595,076.55	\$595,808.55
2/1/2021	\$7,000	\$5,732	\$2,000	\$3,679.29	\$(4,411.29)	\$590,665.26	\$592,129.26
3/1/2021	\$7,000	\$5,732	\$2,000	\$3,687.45	\$(4,419.45)	\$586,245.81	\$588,441.81
4/1/2021	\$7,000	\$5,732	\$2,000	\$3,695.62	\$(4,427.62)	\$581,818.19	\$584,746.19
5/1/2021	\$7,000	\$5,732	\$2,000	\$3,703.81	\$(4,435.81)	\$577,382.38	\$581,042.38
6/1/2021	\$7,000	\$5,732	\$2,000	\$3,712.02	\$(4,444.02)	\$572,938.36	\$577,330.36
7/1/2021	\$7,000	\$5,732	\$2,000	\$3,720.25	\$(4,452.25)	\$568,486.11	\$573,610.11
8/1/2021	\$7,000	\$5,732	\$2,000	\$3,728.50	\$(4,460.50)	\$564,025.61	\$569,881.61
9/1/2021	\$7,000	\$5,732	\$2,000	\$3,736.76	\$(4,468.76)	\$559,556.85	\$566,144.85
10/1/2021	\$7,000	\$5,732	\$2,000	\$3,745.05	\$(4,477.05)	\$555,079.80	\$562,399.80
11/1/2021	\$7,000	\$5,732	\$2,000	\$3,753.35	\$(4,485.35)	\$550,594.45	\$558,646.45
12/1/2021	\$7,000	\$5,732	\$2,000	\$3,761.67	\$(4,493.67)	\$546,100.78	\$554,884.78

The entry that would be made related to the June rent payment would be as follows:

Rent Expense (Base portion)	\$5,732.00	
Rent Expense (CAM portion)	\$2,000.00	
Operating Lease Liability	\$3,712.02	
Cash		\$7,000.00
Operating Lease Asset		\$4,444.02

The follow pages show a mock balance sheet and income statement both under the new lease standard and the existing standard.



## Company ABC

Lease Case Study - Old Standard

### Balance Sheet

As of December 31

<b>ASSETS</b>		<b>2021</b>
<b>Current Assets</b>		
Cash and cash equivalents		\$44,879
Accounts receivable, net		\$321,546
Inventory		\$85,649
Total Current Assets		\$452,074
<b>Property and Equipment, net</b>		\$94,787
<b>Operating Lease Asset</b>		\$ -
<b>TOTAL ASSETS</b>		\$546,861
<b>LIABILITIES AND RETAINED EARNINGS</b>		
<b>Current Liabilities</b>		
Current portion of operating lease liability		\$ -
Accounts payable		\$233,124
Other accrued expenses		\$309,133
Total Current Liabilities		\$542,257
<b>Long-Term Liabilities</b>		
Operating lease liabilities		\$ -
<b>Total Liabilities</b>		\$542,257
<b>Retained Earnings</b>		\$4,604
<b>TOTAL LIABILITIES AND RETAINED EARNINGS</b>		\$546,861



**COMPANY ABC***Lease Case Study - New Standard***Balance Sheet****As of December 31**

<b>ASSETS</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
<b>Current Assets</b>					
Cash and cash equivalents	\$44,879	\$21,555	\$60,222	\$51,004	\$19,899
Accounts receivable, net	\$321,546	\$343,313	\$370,456	\$384,441	\$411,555
Inventory	\$85,649	\$74,666	\$79,951	\$71,249	\$69,555
Total Current Assets	\$452,074	\$439,534	\$510,629	\$506,694	\$501,009
<b>Property and Equipment, net</b>	\$94,787	\$85,668	\$96,222	\$90,004	\$10,036
<b>Operating Lease Asset</b>	\$546,101	\$491,499	\$45,592	\$378,294	\$319,516
<b>TOTAL ASSETS</b>	\$1,092,962	\$1,016,701	\$1,042,443	\$974,992	\$922,561
<b>LIABILITIES AND RETAINED EARNINGS</b>					
<b>Current Liabilities</b>					
Current portion of operating lease liability	\$47,618	\$50,783	\$54,082	\$57,530	\$61,120
Accounts payable	\$233,124	\$255,939	\$276,673	\$251,586	\$266,462
Other accrued expenses	\$309,133	\$223,423	\$297,706	\$276,823	\$269,729
Total Current Liabilities	\$589,875	\$530,145	\$628,461	\$585,939	\$597,311
<b>Long-Term Liabilities</b>					
Operating lease liabilities	\$507,267	\$456,484	\$402,402	\$344,872	\$283,752
<b>Total Liabilities</b>	\$1,097,142	\$986,629	\$1,030,863	\$930,811	\$881,063
<b>Retained Earnings</b>	\$(4,180)	\$30,072	\$11,580	\$44,181	\$41,498
<b>TOTAL LIABILITIES AND RETAINED EARNINGS</b>	\$1,092,962	\$1,016,701	\$1,042,443	\$974,992	\$922,561



**COMPANY ABC***Lease Case Study - Old Standard***Income Statement****For Years Ended December 31**

<b>Assets</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
<b>Revenues</b>	\$6,114,495	\$6,524,982	\$7,005,741	\$7,319,999	\$7,577,545
<b>Cost of Good Sold</b>	\$5,240,864	\$5,587,941	\$6,018,748	\$6,259,726	\$6,617,444
Gross Profit	\$873,631	\$937,041	\$986,993	\$1,060,273	\$960,101
<b>Operating Expenses</b>					
Other operating expenses	\$785,027	\$810,005	\$912,701	\$934,888	\$870,000
Rent	\$84,000	\$85,800	\$87,654	\$89,564	\$91,531
Total Operating Expenses	\$869,027	\$895,805	\$1,000,355	\$1,024,452	\$961,531
<b>NET INCOME (LOSS)</b>	\$4,604	\$41,236	\$(13,362)	\$35,821	\$(1,430)

**COMPANY ABC***Lease Case Study - New Standard***Income Statement****For Years Ended December 31**

<b>Assets</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
<b>Revenues</b>	\$6,114,495	\$6,524,982	\$7,005,741	\$7,319,999	\$7,577,545
<b>Cost of Good Sold</b>	\$5,240,864	\$5,587,941	\$6,018,748	\$6,259,726	\$6,617,444
Gross Profit	\$873,631	\$937,041	\$986,993	\$1,060,273	\$960,101
<b>Operating Expenses</b>					
Other operating expenses	\$785,027	\$810,005	\$912,701	\$934,888	\$870,000
Rent	\$92,784	\$92,784	\$92,784	\$92,784	\$92,784
Total Operating Expenses	\$877,811	\$902,789	\$1,005,485	\$1,027,672	\$962,784
<b>Net Income (Loss)</b>	\$(4,180)	\$34,252	\$(18,492)	\$32,601	\$(2,683)