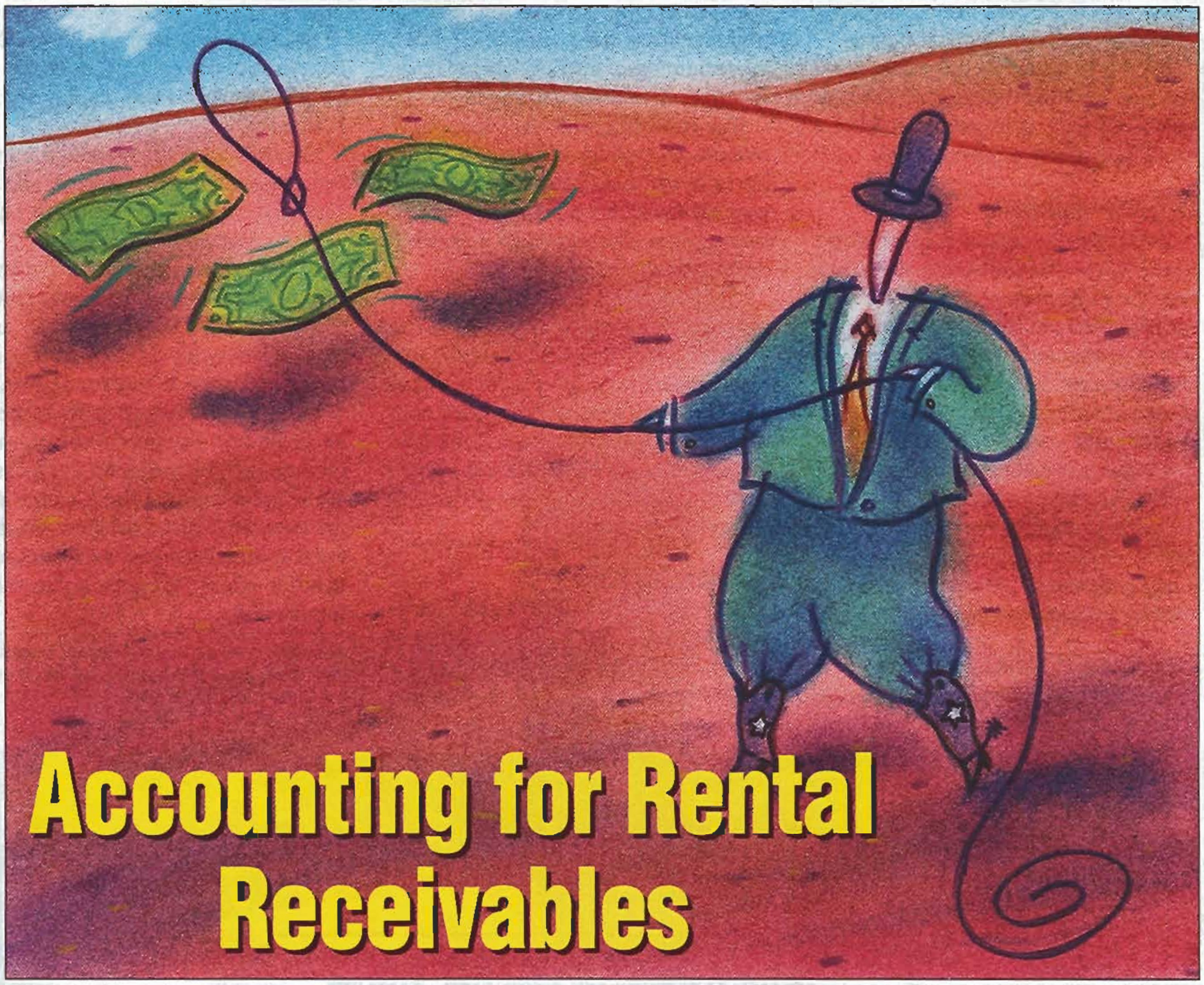
by Alan Friedman



Accounting for Rental Receivables

Q: Alan, is it ever appropriate to record accounts receivable from rental contracts? Does it matter if they are "rent-to-own" vs. "rent-to-rent" contracts?

My understanding is you should not be recording rental contract receivables on your balance sheet.

—John Gray, Back Office Support Services (a provider of music retail accounting software support)

A: John, you have asked the most excellent question about one of the most confusing facets of music retailing today—accounting for music instrument rentals.

I could literally write a book on the topic of music instrument rental accounting, taxation and operation. Maybe I'll do that one day—along with my tentative projects to lose some weight, lower my cholesterol and tour with the Rolling Stones—but until then, I'll take simple comfort in being able to answer your question in little more than 500 words (a feat much greater than my ability to lose weight).

Why is rental accounting so confusing? Well, it predominantly stems from a "flip-flopping" of tax positions taken by the Internal Revenue Service over the past several years. Couple that with the mystifying and perplexing rules of FASB #13—Accounting for Leases.

No, FASB does not stand for Funny Accountants Seem Boring. It stands for "Financial Accounting Standards Board," the authoritative organization that guides accountants on the proper accounting and reporting of financial transactions.

Try taking the unique rental service offered by music retailers; add the unusual—but required—legal jargon found in most instrument rental contracts; properly report it on a financial statement applying the complex rules of FASB #13; and explain your out-of-the-ordinary taxation and depreciation methods to an aggressive IRS auditor. Right there, you've got a recipe for disaster (a situation more explosive than my wife's meat loaf).

Here's my way-over-simplified answer to your excellent question deserving of a novel-length reply. You are correct—there should never be a rental contract receivable for "future" rental income on your balance sheet. However, it is perfectly acceptable, even proper, to have rental contract receivables for income that has been "earned" and not yet collected. Let me explain.

Suppose you have a customer that signs a rental contract for a saxophone in September. The contract stipulates that the customer will rent the instrument for $50 a month under a 36-month "rent-to-own" contract. He pays you the first month's rent and walks out with the sax. You would *never* record a $1,750 rental receivable. You have not earned that income yet. Instead, only record the $50 you received as rental income.

Let's say that same customer fails to make the October payment. Is it OK to record the $50 October payment owed to you as rental income with an offsetting increase to rental contract receivables? Absolutely, yes. You earned that income by the mere passage of time during which the instrument was in the hands of the customer. It's even acceptable to record any late fees you charge as income.

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Lastly, it makes no difference whether it's a "rent-to-own" or "rent-to-rent" (a.k.a. "rent-only") contract. Rental income is recorded on a month-to-month basis whether you have received the $50 rental payment or not, as long as the instrument remains out on rent.

However, let me caution you, don't keep recording rental and late fee income for an overly extended period of time (for example, three months or more). Rental payments are generally due on the first day of each month. If a customer hasn't paid you by the end of each month, something is wrong. There's a chance you will never see that money. Continually booking rental and late fee income may set you up for one big, fat "bad debt" write-off down the road of false financial euphoria.

John, I'll be publishing my 20-volume book on rental taxation next month and will ship you a copy in case you're having trouble falling asleep. Until then, consider this your crash course in accounting for rental receivables.

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