Making (More) Money with Rentals Instruments

Presented by

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Seminar Objectives:

- **Identify the "benefits", the "costs" and the "dangerous pitfalls" of musical instrument rental programs**
- **Teach you the "correct"** ***accounting and tax methods*** **for rental programs**
- **Provide some "valuable advice" and "support resources" to manage and grow your rental business**
- **Have some FUN along the way – if you have any questions, "yell 'em out"!**

Not every retailer has the:

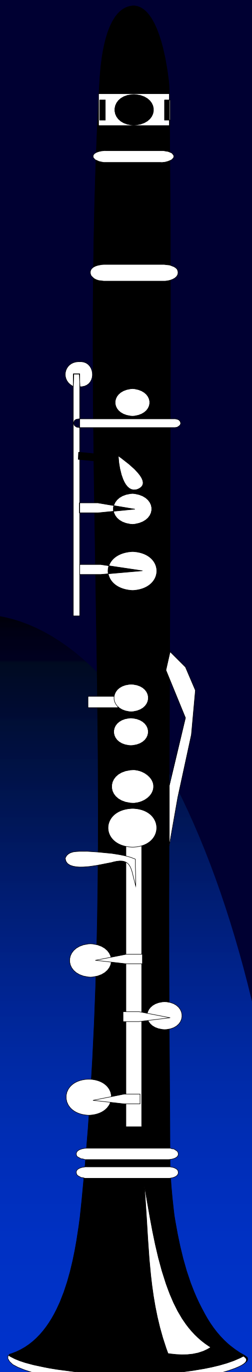
- financial resources to fund a rental program
- office staff to administer a rental program
- relationships needed to attract rental customers - and key suppliers too!

The “Correct Way” to Account for Rental Programs

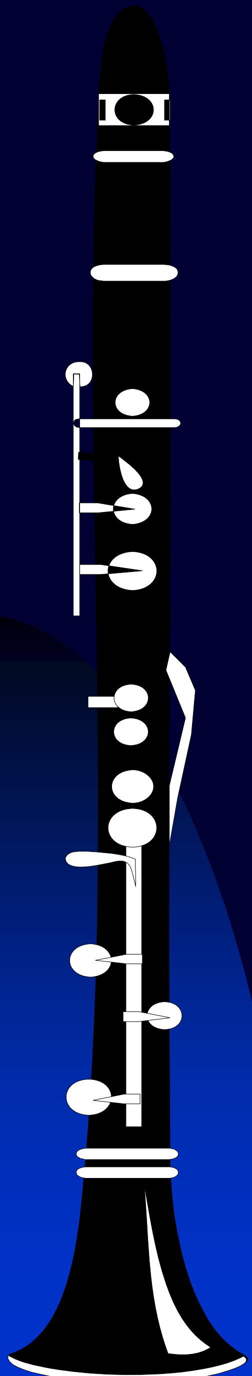
Definitions

- **Music Instrument Rental Program:** ***a service offered by (school) music dealers that allows customers to rent band & orchestra instruments on a month-to-month “trial basis” (instead of inducing a “hesitant” customer into buying the instrument)***

Definitions



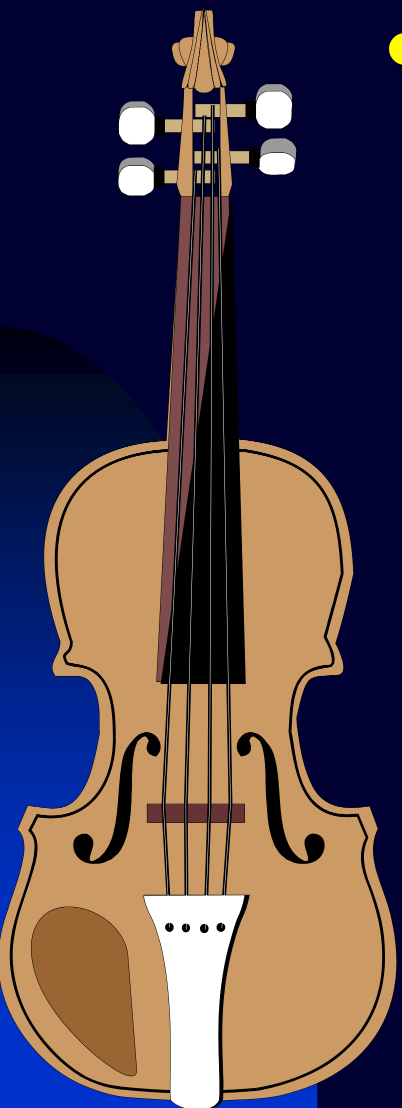
- **"Rent-to-Own" Contract:**
  a rental contract that states the customer can rent a musical instrument month-to-month for a stated number of months, whereby a portion of each month's rental payment can be applied to the purchase of that instrument or a new instrument



Definitions

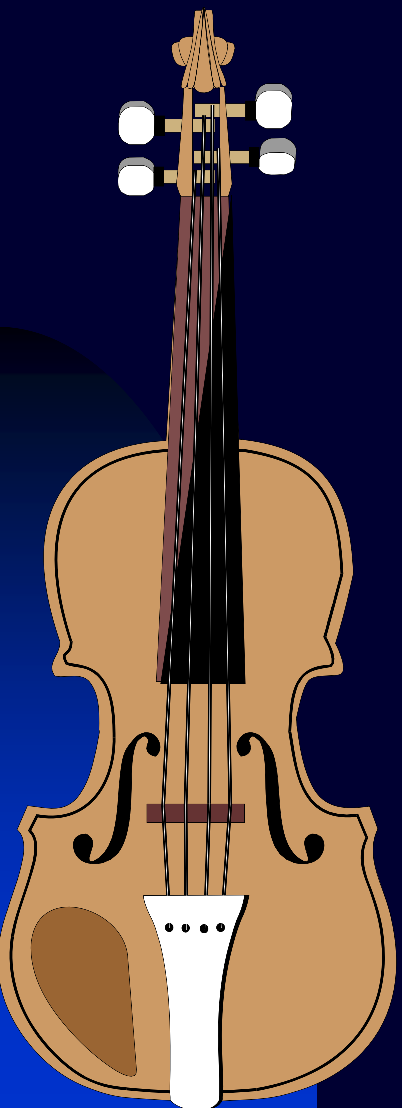
- **“Rent-to-Own” Contract (continued):** ***the contract also states that title to the instrument remains with the retailer until all contracted payments are made, at which time title passes to the customer; the customer can return the instrument at any time with no further obligation for rent or rental payment***

Definitions



- **“Rent-to-Rent” Contract:** ***also known as “rent only”, this rental contract states the customer can rent a musical instrument on a month-to-month basis for an indefinite length of time***

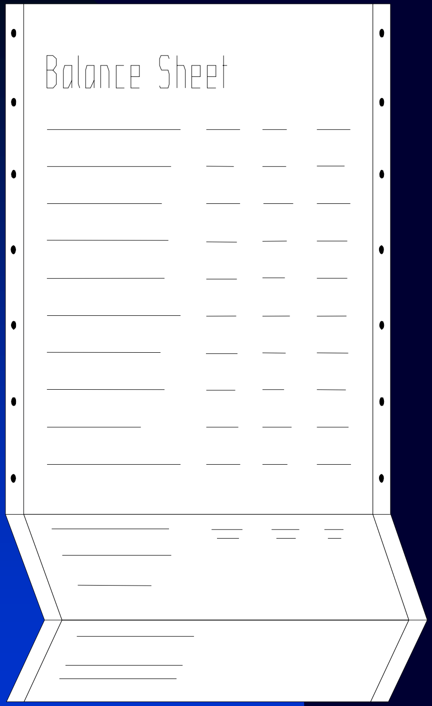
Definitions



- **"Rent-to-Rent" Contract (continued):** ***the contract states that title to the instrument remains with the retailer always; the customer can return the instrument at any time with no further obligation for rent or rental payment***

Definitions

- **Depreciation:** ***an accounting methodology that ratably "expenses" the cost of a business asset over its useful life – the purpose of which is to properly match the "revenue" generated by that asset with the "expense" of using that asset***



Depreciation example:

You buy a horn for $360, and rent it for 36 months at $25/month. Which is the correct depreciation for year #1 – Method **A** or **B**?

	A	B
Rental income	$ 300	$ 300
Depreciation	(360)	(120)
	-------	-------
Net rental income	($ 60)	$ 180
	====	====

Here’s your “ 3-Step ” solution to recording a “typical” rental transaction

Step #1 – the instrument arrives

- When the instrument arrives in your store, try to determine if your primary intention is to "sell" or "rent" the instrument
  - If the instrument is to be sold, enter it into "inventory" at cost
  - If the instrument is to be rented, enter it into a fixed asset account called "Rental instrument pool"
  - If unsure, make your best guess

Step #2 – start depreciating

- If the instrument is going to be rented, record the instrument at cost and begin depreciating the instrument over its useful life:
  - 3 years MACRS for tax reporting if on a “rent-to-own” contract
  - 7 years MACRS for tax reporting if on a “rent-to-rent” contract
  - 3 – 10 years for financial reporting (but check with your accountant !!)

Step #3 – the instrument is rented and then … ???

- Record rental income "monthly", as you earn it. Sometime thereafter, one of three things will happen:
  - …the instrument will be returned to the store, "cleaned up" and made available for rent again
  - …the instrument will be purchased before the end of the contract, with some amount of credit given for the rental payments made
  - …the instrument will stay out on rent until the contract expires

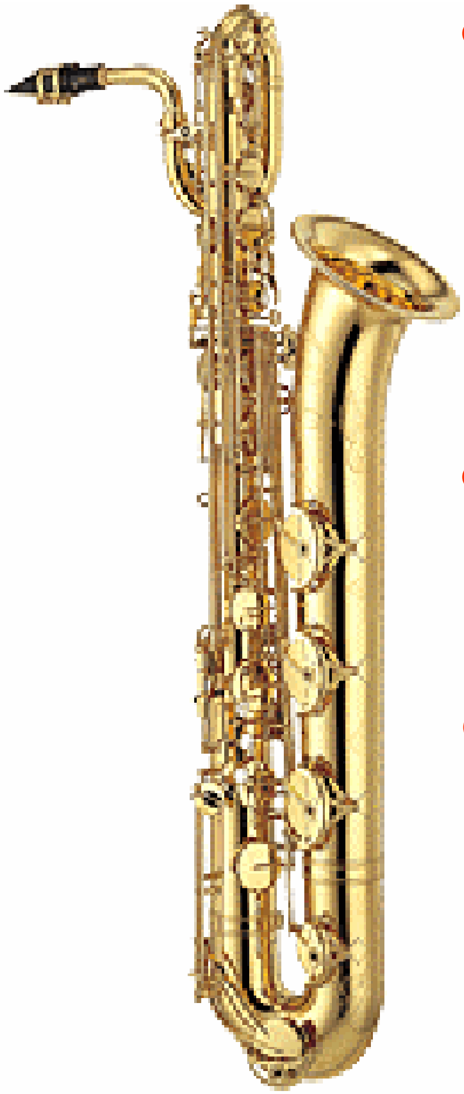
“debit” this…and “credit” that…

Each of these three steps and the eventual disposition of the instrument will require it’s own “unique” accounting and tax treatment !! Let’s take a look at an example…

Your store offers the following instrument rental program…

- Your offer all your customers a “36-month” rental program for all band instruments on a “rent-to-own” basis
- Your rental contract states that if all 36 payments are made, title to the instrument transfers to the customer upon receipt of the final 36th payment
- Your contract also allows the customer to buy the instrument at any time and apply the first 12 months of rental payments to the purchase price (which you’ve set equal to “list price”).
- Lastly, the customer can get out the contract at any time by simply returning the instrument

You buy an instrument to rent…



- You purchase a saxophone ("list price" of $700) at a landed "cost" of $360 ($350 cost plus freight-in of $10)
- Your intention is to rent the sax on a "rent-to-own" basis
- ***How do you record this transaction ?***

BALANCE SHEET	
Assets	
Current Assets	
Cash	$ -
Rental receivables	-
	-
Fixed Assets	
Rental instrument pool	360
Less accumulated depreciation	-
	360
TOTAL ASSETS	$ 360
Liabilities and Equity	
Current Liabilities	
Accounts payable	$ 360
Current portion of long-term debt	-
	360
Long-Term Debt	-
Equity	$ -
TOTAL LIABILITIES and EQUITY	$ 360

INCOME STATEMENT	
SALES	$ -
COST OF GOODS SOLD	-
GROSS PROFIT	-
OTHER OPERATING INCOME	
Rental income	-
Less depreciation expense	-
	-
TOTAL OTHER OPERATING INCOME	-
EXPENSES	-
NET INCOME	$ -

A rental customer walks in…

- **A customer walks in and agrees to the “rent-to-own” contract to rent the sax for $30 a month for 36 months.**
- **He signs the contract, makes the 1st payment of $30 and walks out of the store with the sax in hand.**
- ***How do you record this transaction ?***

BALANCE SHEET	
Assets	
Current Assets	
Cash	$ 30
Rental receivables	-
	30
Fixed Assets	
Rental instrument pool	360
Less accumulated depreciation	(10)
	350
TOTAL ASSETS	$ 380
Liabilities and Equity	
Current Liabilities	
Accounts payable	$ 360
Current portion of long-term debt	-
	360
Long-Term Debt	-
Equity	$ 20
TOTAL LIABILITIES and EQUITY	$ 380

INCOME STATEMENT	
SALES	$ -
COST OF GOODS SOLD	-
GROSS PROFIT	-
OTHER OPERATING INCOME	
Rental income	30
Less depreciation expense	(10)
	20
TOTAL OTHER OPERATING INCOME	20
EXPENSES	-
NET INCOME	$ 20

Scenario A: The customer returns the instrument …

- The customer rents the sax for **twelve (12) months** and then decides he wants to play piano instead of sax.
- He **returns** the sax after making the 12th payment.
- ***How do you record this transaction ?***

BALANCE SHEET	
Assets	
Current Assets	
Cash	$ 360
Rental receivables	-
	360
Fixed Assets	
Rental instrument pool	360
Less accumulated depreciation	(120)
	240
TOTAL ASSETS	$ 600
Liabilities and Equity	
Current Liabilities	
Accounts payable	$ 360
Current portion of long-term debt	-
	360
Long-Term Debt	-
Equity	$ 240
TOTAL LIABILITIES and EQUITY	$ 600

INCOME STATEMENT	
SALES	$ -
COST OF GOODS SOLD	-
GROSS PROFIT	-
OTHER OPERATING INCOME	
Rental income	360
Less depreciation expense	(120)
	240
TOTAL OTHER OPERATING INCOME	240
EXPENSES	-
NET INCOME	$ 240

Scenario B: The customer rents the instrument for 36 months…

- **The customer rents the sax for the entire 36 months and makes all 36 pmts on time. He writes you a nice “thank you” note.**
- ***How do you record this transaction ?***

BALANCE SHEET

Assets	
Current Assets	
Cash	$ 1,080
Rental receivables	-
	1,080
Fixed Assets	
Rental instrument pool	360
Less accumulated depreciation	(360)
	-
TOTAL ASSETS	$ 1,080
Liabilities and Equity	
Current Liabilities	
Accounts payable	$ 360
Current portion of long-term debt	-
	360
Long-Term Debt	-
Equity	$ 720
TOTAL LIABILITIES and EQUITY	$ 1,080

INCOME STATEMENT

SALES	$ -
COST OF GOODS SOLD	-
GROSS PROFIT	-
OTHER OPERATING INCOME	
Rental income	1,080
Less depreciation expense	(360)
	720
TOTAL OTHER OPERATING INCOME	720
EXPENSES	-
NET INCOME	$ 720

Scenario C: The customer buys out the instrument early …

- **The customer rents the sax for twelve (12) months and then decides he wants to buy out the instrument instead of making the remaining 24 payments.**
- **He buys out the instrument for $340 (list price of $700 less the $360 rental payments made).**
- ***How do you record this transaction ?***

BALANCE SHEET	
Assets	
Current Assets	
Cash	$ 700
Rental receivables	-
	700
Fixed Assets	
Rental instrument pool	-
Less accumulated depreciation	-
	-
TOTAL ASSETS	$ 700
Liabilities and Equity	
Current Liabilities	
Accounts payable	$ 360
Current portion of long-term debt	-
	360
Long-Term Debt	-
Equity	$ 340
TOTAL LIABILITIES and EQUITY	$ 700

INCOME STATEMENT	
SALES	$ 340
COST OF GOODS SOLD	(240)
GROSS PROFIT	100
OTHER OPERATING INCOME	
Rental income	360
Less depreciation expense	(120)
	240
TOTAL OTHER OPERATING INCOME	340
EXPENSES	-
NET INCOME	$ 340

- "A" = Rent and return
- "B" = Rent until the end
- "C" = Rent and buy-out early

- Which is "worst" for *cash flow*? "A"
- Which is "best" for *profit*? "A"

- "A" = Rent and return
- "B" = Rent until the end
- "C" = Rent and buy-out early
  - Which scenario above is the only one that occurs for "rent-to-rent" contracts?

"A" – The only difference is 7-year depreciation is used instead of a 3-year

Advice, Guidance and Resources regarding “rental programs”

Improper” accounting methods:

- Some music retailers will record the “entire” contracted rental payments as rental income upon signing of the rental contract (36 pmts @ $30/mo = $1,080)
- Some music retailers will record the entire contracted rental pmts as “sales” income, and the instrument cost to “cost of goods sold” upon signing of the contract
- Some music retailers will use long depreciation lives (7 to 10 years) for rental instruments on “rent-to-own” contracts

These "improper" accounting methods will…

- **(1) overstate revenues**
- **(2) ignore vital tax deductions**
- **(3) causes premature income and sales tax liabilities**
- **(4) degrade cash flow**
- **(5) render financial statements erroneous and misleading**

Internal Revenue Service

DEPARTMENT OF THE TREASURY

How are rentals taxed ?

Some income tax history…

- Several years ago the IRS began taxing rental contracts as “installment sales” – taxing the entire contract up front
- After rigorous lobbying efforts, the IRS reversed itself in 1995 in RevProc 95-38
- You can avoid the “upfront” taxation on rent-to-own contracts as long as you comply with RevProc 95-38 rules
- You can also depreciate “rent-to-own” rental assets over “3 years” !!
- Some of those tax rules are…

Some IRS RevProc 95-38 rules…

- The RTO contract must be with an “individual”
- The RTO contract should be titled “Rent-to-Own Agreement”, “Lease Agreement with Purchase Option” or some other similar language that clearly indicates the instrument is being rented, not purchased
- The RTO contract provides for a weekly or monthly “level” payment
- The RTO contract provides that legal title remains with the dealer until the customer makes all the required
- The RTO contract 36 months

How do you "finance" your rentals?

Financing Rental Programs

- **Never** **finance rental instruments (or any fixed assets like furniture, equipment, vehicles and leaseholds out of cash flow) with lines of credit or vendor trade credit**
- **Only current assets (A/R, inventory) should be financed with trade credit and bank credit lines**
- **Finance your long-term assets with 3 to 10 year installment notes**

How do you "track" all these rentals contracts?

Music Retail Accounting Solutions

- **Use an "integrated" software solution that meets the special needs of music retailing (i.e. point-of-sale, instrument rentals, repairs, music lesson scheduling)**
- **Check out these solutions at NAMM:**
  - **"AIMsi" (Tri-Technical Systems)**
  - **"Maestro" (RSSS)**
  - **"Tyler" (Tyler Systems)**

Team of Rental Advisors

- Your accountant should have, at a minimum, a strong understanding of the unique issues facing “retailers”, as well as an understanding of “rental” accounting and taxation
- Your banker should understand the unique financing requirements and related cash flows of retailing and music instrument rental programs
- Lawyers need to be familiar with the state laws that affect rental contracts

…or be a rental “affiliate”

- There are music instrument rental companies who will provide music stores with a pool of band and orchestra rental instruments
- You provide these instruments to your customers to rent
- These companies will pay you a “servicing fee”
- You have no outlay of cash for the rental instruments or the monthly collection of rental payments

Doing rentals “Right” means…

- Make sure you have / can develop meaningful “relationships” with schools, band directors, music teachers and students
- Make sure you have the “financial” resources (working capital or bank credit) to finance rental instruments
- Make sure you use a “software solution” that handles rentals
- Make sure you have “admin staff” to track and collect rental contracts
- Make sure you use the “correct” rental accounting and tax methods

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