ASK ALAN | BY ALAN FRIEDMAN

RETAIL VS. RENTAL INVENTORY

Q: Alan, I read your recent article in the October issue of *Music Inc.* ("Inventory Valuation: A Moving Target"). You did a good job describing the various options for valuing inventory sold at retail, but what about rental inventory and that dirty valuation word: depreciation? Music dealers need to know the various legal options for depreciating inventory. They also need to know that when matching revenues and expenses in the rental business, depreciation basically replaces cost of goods sold as the "cost factor."

Someday soon, the IRS will seriously question some music dealer on this issue. As a member of the board of directors of the Association of Progressive Rental Organizations, we are concerned. Your thoughts?

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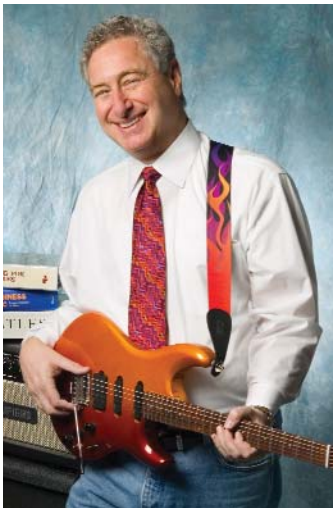
A: Ellison, thanks for asking about the important topic of depreciating rental inventory.



Understanding the valuation differences between inventory for sale and for rent

Your question and my response are now my seventh and final article in a year-long series on inventory management for the music products retailer, a perfect ending to one of the most critical facets of music store operations.

Over the years, *Music Inc.* has published several articles that answer your question. I'll address each issue in this article, but reference those previous articles for a more in-depth discussion on these matters. We've scanned several years worth of articles into printable PDF files. They can be found on our firm's Web site, fkco.com, under "Links and Resources."

OK, on to your question.

First, let me clarify the term "rental inventory." While rental inventory like band and orchestral instruments is often bought for both retail sale to customers and rental to students in school music programs, music store owners must make an important decision when these instruments arrive: keep them classified as "inventory" (a current asset) or reclassify them into a "rental instrument pool" (a fixed asset). If the intention is primarily to rent them, I strongly recommend reclassifying the instruments into a rental pool even if they remain eligible for sale.

Doing so accomplishes three important things. A store can now: attract long-term financing instead of short-term financing or no financing at all; start depreciating those assets, realizing immediate income tax benefits; and begin properly reporting and measuring the profitability of inventory sold vs. inventory rented. Why are these important? Because they all can dramatically improve a retailer's cash flow. Check out my December 2003 article, entitled "Addressing Inventory Quirks."

Second, Ellison, you are correct that "depreciation" replaces "cost of goods sold" as the cost element of inventory slated for rental. That's why I make a habit of not using the term "inventory," which generally denotes items for sale, when describing instruments held out for rent. Instead, I call them "rental instruments" or "rental pools." That's also the reason why I didn't address rentals in my most recent valuation article, as I was dealing with inventory held for retail sale.

But your observation is an excellent one, as their valuation does differ. Retail inventory should be reported at the lower of cost or its market value, but instrument rental pools should be depreciated over a specific period of time. Under current tax law, rent-to-own instruments should be depreciated over three years, and instruments for rent-only (or rent-to-rent) over seven years. Check out the January 2004 article, entitled "Forecasting Rental Depreciation," and the August 2004 article, "The Useful Lives of Rental Instruments," for more info on depreciating rental pools.

Lastly, I agree with your belief that the IRS will "seriously" question some music dealer soon on this issue of depreciating inventory, but perhaps for a different reason than you stated. IRS agents worth their salt will find a retailer's deduction from depreciating inventory assets abnormal and in contradiction with current tax law (which says inventory costs can't be deducted until that inventory is disposed of). That's why it's so important "rental inventory," as you call it, is immediately reclassified as a "fixed asset" and no longer called "inventory" — it's now part of a rental instrument pool, shown on the balance sheet as a depreciable fixed asset like vehicles, computers and leasehold improvements.

The IRS should have no problem letting you depreciate any asset you own and place in service as part of the normal course of business. But the IRS is going to question, in my opinion, two odd-ball things: fixed assets rented on a "rent-to-own" basis, where the customer has some ownership rights to that asset if certain conditions are met; and depreciating fixed assets over an unusually short three-year period.

Even though it's entirely proper, legitimate and fiscally sound to handle rental instruments in this manner, most IRS agents are unfamiliar with the accounting for rent-to-own assets. Accordingly, they'll probably go back to their office and do some research to ensure the store is in compliance with the tax rules governing rent-to-own assets and their depreciation. And therein lies the big IRS problem if the music store is not following the rental rules of Revenue Procedure 95-38. So check out the very first article I wrote for *Music Inc.* in January 1998, "Accounting Basics for Rental Revenue."

I believed back then and continue to believe this is one of the most important yet frequently misunderstood concepts in music store accounting and financial reporting. Ellison, your accounting software company has done a great job in helping music retailers understand these inventory issues and rental rules. For that, and for your most excellent question on this year-long topic, I thank you. In appreciation, I'll make sure you're sent one of our firm's nice T-shirts … paid for by *Music Inc.*, of course. **MI**

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