Think Tank by Alan Friedman

# Accounting Basics for Rental Revenue

CPA Alan Friedman, a senior partner with Friedman, Kannenberg & Co., P.C. in West Hartford, Conn., works with music industry clients throughout the nation. At NAMM '98, Friedman will lead a number of NAMM University seminars including "Business Survival Skills for Retailers," "How to Buy," and "Bar Coding for Retailers."

ASIDE FROM SALES REVENUE, music instrument rentals probably provide the largest source of revenue for the typical music dealer. Unfortunately, instrument rental programs can be one of the most burdensome activities to administer, and one of the most misunderstood activities to account, finance and tax. The proper procedure eludes many dealers, bankers and CPAs alike. This confusion often results in poor cash flow, misapplied sales tax, overpaid income taxes, erroneous financial statements and poorly-structured financing.

### RTO Confusion

Rent-to-own (RTO) programs make perfect business sense. With RTO programs parents don't have to commit $1,000 for a saxophone that little Johnny won't play after three months of sore lips. Instead they make monthly payments over a specified period of time in exchange for using that musical instrument. If Johnny decides he wants to play guitar, his parents can simply return the saxophone to the dealer, at any time, with no further obligation. Or if he turns out to be the next Charlie Parker, the customer can keep renting the instrument for the full rental period, and own the instrument after the final rental payment is made.

Although the RTO process sounds pretty easy, many dealers report revenue and related expenses inconsistently and incorrectly. Much of the confusion may have originated from the flip-flopping by the IRS on how these transactions should be taxed. Accounting methods dictated by the IRS are not always the same as Generally Accepted Accounting Principles (GAAP), the authoritative guidelines for financial reporting. As the IRS kept changing the rules on installment sales, depreciation lives and rental income recognition, music retailers changed how they accounted for these rental contracts, sometimes in haphazard and inconsistent ways.

### This is How You (Don't) Do It

Mom and Dad walk in your store and rent Junior a new saxophone with a $1,200 list price. The sax typically sells for $1,000 and has a $600 dealer cost. They sign a 24-month contract, plunk down $50 and walk out with hopes of Junior making the marching band. Junior, on the other hand, wants to start an alternative-rap-metal-funk band with his buddies. You don't care, because you just made a big sale.

The first mistake made by most retailers is assuming a $1,200 sale has occurred. Even if you're smart enough to show a $1,150 receivable and offsetting deferred revenue, you're still treating the transaction as if you sold the sax. Here are three reasons why that's not the case:

1) Mom and Dad have no legal obligation to rent the instrument for the entire 24 months, so there's no guarantee you'll earn the full $1,200 (or any part of it) under this contract.

2) Mom and Dad don't own the instrument; you do. Title won't pass to them until they make all 24 payments. Therefore, the cost of that saxophone should still be on your books.

3) Are you still showing the sax as

an inventoried item? Or did you remove it from your books and record the related $600 cost under "Cost of Goods Sold"? Both ways are wrong. The sax should be removed from inventory (because it's no longer available to be sold), reclassified to the "Instrument Rental Pool" (a Fixed Asset category) and depreciated over its useful life.

## This is How You Do It

As soon as the rental instrument arrives at your store, it should be recorded at cost as a (long-term) rental asset, and depreciated over its useful life for book purposes. If your accounting software forces you to receive the item into inventory, it should allow you to either transfer/reclassify the item out of inventory to a "rental pool" category, or "mark" the item as a rental (depreciable) asset.

As the instrument leaves the store on rental, any income received up front should be recorded as "rental" income, not as "sales" income. As payments continue to be received under the rental contract, they should continue to be classified as rental income.

Only after the final contract payment is made does the cost of the asset and related depreciation get removed from the books, with any resulting gain or loss recognized at that time.

## Avoid Accounting Pitfalls

You need to be aware of some other pitfalls. Review the legal wording of your rental contracts. Contracts mentioning APR interest, finance charges, different price comparisons, lower rental payments during a trial period, or long rental periods are all no-no's and will disqualify you from favorable tax treatment. Also, make sure the states in which you do business recognize your accounting method for sales tax purposes. Finally, make sure your accounting software has adopted the correct accounting methodology for rentals.

Music instrument rental programs can provide a lucrative source of revenue for your store. Don't bury yourself in an accounting, tax and administrative nightmare. Do it the right way, and get help if you don't know how. mi

## The Hidden Dangers of RTOs

Using the wrong accounting method can result in several serious problems. Here are six.

1) A gross overstatement of sales and net earnings.
2) Significant income and sales taxes paid prematurely.
3) No reporting of fixed (long-term) assets and related depreciation. This causes bankers to finance this activity with short-term credit lines instead of long-term debt.
4) Severe cash-flow shortages, with credit facilities totally exhausted.
5) Erroneous financial statements. Ask your accountants how they feel about misleading financial statements issued to your banker, with the accountants' report attached, and watch them turn a lovely shade of green.
6) Non-compliance with IRS Rev.Proc. 95-38, which allows you to recognize RTO income over the rental period (instead of all up front), and take accelerated depreciation (now 3 years, thanks to the Taxpayer Relief Act of 1997) on the rental assets.

| | WRONG | RIGHT |
|---|---|---|
| CURRENT ASSETS | | |
| Cash | $ 50 | $ 50 |
| Accounts receiveable | 1,150 | — |
| Inventory | — | — |
| | 1,200 | 50 |
| FIXED ASSETS | | |
| Instrument Rental Pool | — | 600 |
| Less Accumulated Depreciation | — | 10 |
| | $ 1,200 | $ 640 |
| LIABILITIES | | |
| Accounts Payable | $ 600 | $ 600 |
| OWNER'S EQUITY (NET INCOME) | 600 | 40 |
| | $ 1,200 | $ 640 |

| | WRONG | RIGHT |
|---|---|---|
| SALES | $ 1,200 | $ — |
| COST OF GOODS SOLD | 600 | — |
| GROSS PROFIT | 600 | — |
| OTHER INCOME | | |
| Rental Income | — | 50 |
| GROSS OPERATING INCOME | 600 | 50 |
| EXPENSES | | |
| Depreciation | — | 10 |
| NET INCOME | $ 600 | $ 40 |

The left-hand column shows a popular, but incorrect, way to account for an RTO contract. The dealer has (a) recorded a sale, (b) shown a $1,150 receivable, and (c) removed the saxophone from inventory to the "Cost of Goods Sold" account. This accounting method prematurely recognizes income that hasn't been earned, overstates gross profits and distorts key financial rations (such as current ratio, gross profit percent and inventory turns). The right-hand column shows the correct method—a more conservative and accurate reflection of what has taken place. The dealer has simply (a) recorded the $50 as rental income, (b) reclassified the saxophone as a fixed asset, and (c) has taken one month of depreciation over a 60 month useful life (1/60 x $600 = $10). Under both methods, the dealer still owes $600 to the supplier (just like in real life).