ASK ALAN | BY ALAN FRIEDMAN

Forecasting Rental Depreciation

Q: Alan, I have a follow-up question to the issue of rental contract income that's earned, but not yet received (see Ask Alan, November 2003). How would you handle depreciation related to this income…book it and reverse it if the income isn't received?

—Pat Rettig, Maestro Music Business Software

A: Ah yes, depreciation…that esoteric concept of spending cash, booking an expense and getting a tax deduction—all with differing amounts for the same asset. No wonder everyone gets a C+ in their Accounting 101 class and immediately switches to a Fine Arts major. Who can understand these crazy accounting notions?

And now, Pat, you want an explanation of how to apply depreciation rules to income that may be written off? How about if I explain the concepts of "trigonometric differentials" as they relate to the calculus differentiation instead. I think I learned that useless crap during my college years, too. Hey, all you math geeks, chill out, I'm just kidding.

Let me attempt to explain something I do know—the importance of depreciation, the dangers of its misuse and how it relates to your most excellent question.

'Erroneous useful lives will cause profits to be overstated by not taking enough depreciation expense.'

Technically speaking, "depreciation" is an accounting term used to describe the systematic cost allocation through which the decline in usefulness of a company's tangible asset is recorded over time. Say what? How about this one: Depreciation is a system of accounting which aims to distribute the cost or other basic value of any tangible capital asset, less salvage value (if any), over the estimated useful life of that asset in a systematic and rational manner. It is a process of allocation, not valuation. That calculus discussion is starting to look pretty good, right?

In more simple terms, depreciation is a method used to record an appropriate amount of expense reflecting the use of a tangible asset, like a rental horn. Moreover, I believe the real purpose of depreciation is to accurately measure, or "match," the true cost of using an asset against the income it generates for a specific period of time.

Let's look at the chart on page 40 to better understand this important, but hard to define or understand, concept. Which of the three methods do you think most accurately reflects the first year's depreciation and resulting "net" income from renting a trumpet that cost $300, generated $30 a month in rental income and is expected to last five years?

If you guessed that Method No. 1 is wrong—you're right! Method No. 1 matches one year's rental income with the entire $300 cost of that rental horn (recorded as depreciation), when that horn has a useful life of five years.

Accordingly, Method No. 3 reflects the correct amount of depreciation: $60, which is the $300 cost divided by the five years it's expected to be useful.

What if that horn is rented on a three-year "rent-to-own" basis? I would argue that Method No. 2 reflects a more accurate amount of depreciation: $100, which is the $300 cost divided by the three years it's expected to be useful.

Here's where things get a little tricky. Yes, it's possible that horn will be rented, returned and re-rented several times, supporting a useful life way beyond the initial three-year rent-to-own contract. But unless you have a crystal ball and can assure me that horn will be returned (and won't be

rented for the three years, whereupon title transfers to the renter), I'm going to suggest the more conservative approach, writing these instruments off over the three years.

I make this suggestion under the accounting principle of conservativeness. When in doubt, we accountants are required to employ the most conservative accounting methods. This is done to not mislead the reader of the financial statements. Just like MCI/WorldCom did by capitalizing assets and depreciating them over way too long a period of time, this is how a lot of retailers get themselves into financial reporting hot water.

I sometimes find retailers and their accountants foolishly recording depreciation expense based on long (seven- to 10-year) useful lives. Guess what? Those assets may not last longer than three years! These erroneous useful lives will cause profits to be overstated by not taking enough depreciation expense, until the day of reckoning when the assets are disposed of at losses a few years later.

Some of you will argue my aggressive depreciation can cause a retailer "banking distress" by eroding net income with too much depreciation. Perhaps, but when the useful lives of assets are unknown (as they are with all rent-to-own instruments), I'd rather give a conservative financial picture than a false sense of financial euphoria. If I'm right, net income is properly stated.

If I'm wrong, net income is understated only for a short time; the retailer will soon become wildly profitable once depreciation runs out.

Either way, at least we're not lying to our creditors and bankers by overstating income. Plus, most bankers are smart enough to add back some, or most, depreciation in calculating a profitability and cash flow.

	Method 1	Method 2	Method 3
Rental Income	$360	$360	$360
Depreciation expense	(300)	(100)	(60)
Net rental income	$60	$260	$300

Now let's answer Pat's question. Recording depreciation should begin once the rental instrument is placed in service. Once you start, you should not stop recording depreciation as long as that instrument is out on rent or held out for rent.

Even if you eventually record a bad debt from the non-collection and write-off of rental receivables, you should still reflect the expense of having that instrument out in the customer's hands, or sitting on the shelf waiting to be rented. Accordingly, you would always book depreciation and never reverse it.

By the way, Pat, I won't be offended if $\cos A + \cos B = 2\cos[A + B]\cos[A-B]$ means more to you than the crap I just wrote. MI

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