ASK ALAN | BY ALAN FRIEDMAN

The Useful Lives of Rental Instruments

Q: Alan, we've just implemented new rental accounting software at our store. We offer both "rent-to-own" contracts and "lease-only" contracts to our customers. How long should we be depreciating rental instruments under each of these two different contracts? Is it the same for book and tax purposes?

—Michael Guntren, Manager
Ray's Midbell Music
Sioux City, Iowa.

A: Michael, you've asked a very important question for three very important reasons:

1. The selection of a proper useful life is critical to the calculation of depreciation expense and accuracy of your rental accounting;

2. The useful life you choose will have a direct bearing on the amount of income taxes you will pay in any given year;

3. The use of improper depreciable life will cause distortions in your financial statements and will hinder management, suppliers, lenders and/or investors in making informed business decisions.

Last year, someone asked me to explain the concept of depreciation as it relates to the proper matching of rental income and depreciation expense (see *Ask Alan: Accounting for Rental Receivables*, November 2003). I'll repeat some of the essential concepts from that article, and take the topic further to better explain the dangers of using incorrect or unreasonable useful lives when calculating depreciation expense. As a bonus, I'll toss in a few accounting double entendres for free.

'The useful life you choose will have a direct bearing on the amount of income taxes you will pay in any given year.'

THE HORNY RENTER

Technically speaking, "depreciation" is the accounting term used to describe the recording of an appropriate amount of expense that reflects the use of a tangible asset (like a rental horn). Relating to rental instruments, the purpose of depreciation is to accurately measure (or "match") the true "cost" of using a rental instrument against the rental "income" that instrument generates during a specific period of time. Hence, depreciation plays an integral part in accurately determining how much profit is earned from renting instruments.

THE USEFUL LIFE

The concept of "useful life" is considered every day by all business owners. Whenever you buy something for business use, you must first decide whether the items have a one-time use (and should be "expensed") or prolonged usefulness (and should be treated as a capital asset and depreciated over its useful life).

If your rental instruments have historically lasted seven years, then depreciate them monthly over an 84-month period. Keep in mind we're talking about useful lives and related depreciation for "book" (a.k.a. financial statement reporting) purposes, not "tax" purposes, which we'll discuss later.

A BAD RASH OF JOKES & ACCOUNTING

Do you know why accountants make great lovers? Because they do it in balance.

OK, here's where things get a little tricky. What if a horn is rented on a three-year "rent-to-own" basis? I would argue that horn should be depreciated over 36 months, not 84 months. 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 retailers have a crystal ball and can assure me that horn will be returned for re-rental (instead of being rented for the full three-years, whereupon title transfers to the renter), I'm going to take the more conservative approach and write these instruments off over the worst-case scenario—three years.

I do this under the accounting principle of conservativeness. When in doubt, we accountants are required to take the most conservative alternative when recording revenues and expenses. This is done in an

effort to not mislead the reader of the financial statements.

But just like MCI/WorldCom, which capitalized assets and depreciated them over too long a period of time, retailers will get themselves into the same financial reporting hot water by not recording enough depreciation expense during the year.

The music retailer depreciating all rental instruments over seven years, when most of them are out on three-year rent-to-own contracts, will distort his or her financial statements in two different ways.

50 WAYS TO DISPLEASE YOUR LOVER

You don't need a ruler to measure the depth of this problem—just look at Charts 1 and 2.

CHART 1

RENTAL INCOME:	$900
DEPRECIATION EXPENSE:	$180
NET RENTAL INCOME:	$720
PROCEEDS UPON DISPOSITION:	$0
COST OF INSTRUMENT DISPOSED:	$240
LOSS UPON DISPOSITION:	(-) $240

CHART 2

RENTAL INCOME:	$900
DEPRECIATION EXPENSE:	$420
NET RENTAL INCOME:	$480
PROCEEDS UPON DISPOSITION:	$0
COST OF INSTRUMENT DISPOSED:	$0
LOSS UPON DISPOSITION:	$0

Let's consider a saxophone that costs $420, can generate $25 a month of rental income and has an anticipated useful life of seven years. It goes out on a three-year rent-to-own contract, all 36 monthly rental payments are made and the renter takes title to the sax upon making the 36th payment.

Chart 1 illustrates what happens when our misinformed retailer incorrectly depreciates the saxophone over a useful life of seven years.

The first section shows the accumulated rental income, "understated" depreciation, and resulting "overstated" net rental income for the first three years. Because the financials look hot and sexy, the retailer experiences the erotic sensation of "premature jubilation"—until later when he realizes he has prematurely paid income taxes on this overstated income. The second section shows the inevitable loss, as the remaining un-depreciated cost is recognized when the retailer transfers title to the renter.

Chart 2 illustrates the smarter retailer who knows how to please and satisfy his accountant by correctly depreciating the saxophone over a useful life of three years. The first section shows the accumulated rental income, depreciation and resulting "correctly stated" net rental income for the first three years. Although the financials don't look as sexy, this retailer knows how to please his banker from start to finish. The second section shows no loss upon disposition of the instrument, as the entire cost of the instrument has been properly depreciated during the rental period.

BANKER? HARDLY TOUCHED HER

Some may argue my short useful life can cause distress to a retailer and his or her banker by showing lower profits from the larger depreciation expense. Perhaps, but when the useful lives of assets are unknown (as they are with all rent-to-own instruments), I'd much rather give a conservative financial picture than a false sense of financial euphoria.

If most, or all, rent-to-own instruments leave the rental pool within three years, depreciation and the resulting net income is properly stated. If they stick around longer, net income is understated only for a short time. After three years, the retailer will become wildly profitable as they run out of depreciation. Either way, at least we're not lying to our bankers and creditors by overstating income!

LET ME FILE MY EXTENSION, BABY

Michael, now that you've acquired a full understanding of these depreciation concepts, as well as the many accounting "double entendres," here's your answer.

For tax purposes, "rent-to-own" instruments should be depreciated using the three-year MACRS method (refer to IRS Rev.Proc. 95-38 for additional rules and guidance), and seven-year MACRS for "lease only" instruments.

For book purposes, I like to use the same three- and seven-year methods for rent-to-own and rent-to-rent instruments, respectively, as I think they closely represent the useful lives of most rental instruments. However, I would encourage you to consult your accountant or tax professional, as these matters are indeed complicated and could have a material effect on both your financial statements, tax liability and sexual libido…oh behave! **MI**

Are financial questions keeping you up at night? E-mail yours to askalan@musicincmag.com.

Alan Friedman, CPA, provides accounting and financial services to music industry clients. He is a frequent speaker at NAMM U. seminars, and can be reached at 860-5421-3790.