IDEAS

ASK ALAN | BY ALAN FRIEDMAN

SELLING RENTALS

Alan,

How should a customer's rental equity (or rental credits) be accounted for when put toward the purchase of a new instrument? My accounting software currently removes prior rental payments from rental income and reassigns it to sales income when the rental instrument is sold. But I believe you've said it should be left alone and any credit for rental payments should be merely deducted from the instrument's sale price.

Michael Schaner
PM Music Center
Aurora, Ill.

Thanks for asking about this great and often misunderstood issue. You are correct in your recollection of my opinion — that all instrument rental payments should be recorded as rental payments and left alone, no matter what ultimately happens to the instrument.

I maintain that when built-up rental credits get applied toward an instrument purchase, those credits should be merely reflected in the instrument's sale price, effectively as a sales discount. The rental credits should *not* be recorded as an ever-increasing liability — they are being built up because we don't know if the credits will be used by the customer. Nor should they be recorded as a reduction in rental income if and when they are "cashed in."

Accounting for rental equity when put toward an instrument purchase

As I stated, each instrument rented for a period of time is generating income that should be recorded as rental income. To later reduce the amount of recorded rental income by the amount of these built-up credits (especially after the accounting year has ended and financial statements and tax returns have been filed) is, in my opinion, erroneous.

It's tantamount to saying that the instrument was rented for less than what the store actually collected and reported, and that it's now effectively an ongoing series of prior-period adjustments (an accounting mistake made in a prior year that has been corrected in a future year — not good). It also erroneously distorts (by reducing) rental income and erroneously inflates (by increasing) sales income, gross profit and gross profit percent of the rented instrument now being sold. This makes all sales and rental activity analysis wrong and/or misleading.

IMPROPER SOFTWARE USAGE

One last point, based on my 20 or so years of experience using Tri-Tech AIMsi and other music retail accounting software solutions. Just because software lets a rental transaction be recorded a certain way doesn't necessarily make that way correct. I truly love AIMsi and the other popular music retail software solutions because, when properly installed and set up, they produce the accurate, meaningful financial data music store owners need to run a business.

But these same fabulous software packages can also be used in a flawed way by an uninformed user. Let me be clear: I am not saying the software *itself* is flawed. I am saying some users have set up their software in a flawed way, such as letting rental credits reduce rental income or recording the sale of a rented instrument as rental income instead of as sales income.

Mike, your question is excellent because this issue is often misunderstood by music store owners and their accountants, as they try to record and report these transactions in conformity with Generally Accepted Accounting Principles (GAAP), other accounting pronouncements (FASB #13), our tax code and just plain-old good management reporting. If you're having trouble falling asleep or get frequently constipated, I can send you a copy of the Internal Revenue Code, which makes for excellent toilet reading. **MI**

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