



Thumbs-Up Video, Inc.

In October 1988, Linda Williams was determined to open a video cassette rental store that would have a wider selection of tapes and could operate more efficiently than the few small video rental stores located in and around her hometown of Mystic, Connecticut. Williams knew that more than one-half of the homes in Mystic were equipped with video cassette recorders, but based on informal discussions with her friends and neighbors, she learned that these recorders were infrequently used. She felt that with this installed base of recorders, a new, upscale, well-stocked video cassette rental store would surely succeed.

After preparing a business plan, Williams approached a long-time friend who she felt would invest in this new venture. After considerable thought, this friend was willing to invest \$66,000 with Williams putting up the remaining \$99,000 to purchase shares in the new corporation, which was to be called Thumbs-Up Video, Inc.

In November 1988, Williams left her job as a real estate broker and began to establish her new enterprise. She first consulted with a lawyer to have the business incorporated. Because this was a fairly simple organization, the legal fees incurred were only \$2,700. Her next task was to find some land and a building in which to operate. Her connections in real estate allowed her to negotiate a favorable price of \$48,000 for a building near the center of town. The building was old and needed renovation work. The purchase documents allocated \$43,000 to the land and only \$5,000 to the building, due to its age and run-down appearance. A mortgage of \$33,600 was secured for the purchase, with the remaining \$14,400 paid in cash. Williams felt that the current building was structurally sound and with renovation work, the life of the building could be extended to 25 years. She ordered the renovation work, costing \$20,000, to begin immediately. The work lasted through December 1988. Williams paid \$5,000 in advance for the renovations, with the remainder paid in full at completion of the work on December 31, 1988.

In anticipation of the store's opening on January 2, 1989, Williams began negotiations with the major film distribution companies for purchase of a rental tape inventory. By the end of December 1988, Williams had purchased 2,000 tapes (1,000 different titles) at an average cost of \$50 per tape. Since Thumbs-Up Video was a new entity with no credit history, every vendor required a personal guarantee from Williams before they shipped the tapes "on account." All tapes were paid

Eric J. Petro prepared this case under the supervision of Professor William J. Bruns, Jr., as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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for by December 31, 1988. Although this represented a very large investment, Williams was certain that a wide selection of tapes would ensure the success of her new store.

In December 1988, equipment worth \$6,700, including a computer priced at \$3,000, was purchased for cash. Williams paid an additional \$1,000 for a computer software package to be used by the company. The software, which was specifically designed for Thumbs-Up Video, would efficiently track those tapes out on rental and those on the shelves. All of the equipment had estimated useful lives of five years. Also at the end of December 1988, \$500 of miscellaneous office supplies were ordered for delivery January 2, 1989, to be paid cash on delivery.

Williams then contracted with a local advertising agency to provide various forms of advertising for a period of one year. On January 2, 1989, \$6,000 was paid for advertising through December 1989.

The new store opened as scheduled on January 2, 1989. During the subsequent months, Williams was pleased with the way the business was developing. Confident of the success of the store, Williams purchased another 250 tapes for \$75 each on June 1, 1989. The entire amount remained unpaid at June 30. These tapes were considered new releases of feature films and multiple copies (10 copies each of 25 different titles) were purchased to satisfy expected initial demand.

For the six months ended June 30, 1989, sales amounted to \$96,000. Due to the nature of the business, most of the sales were cash sales. A limited number of customers were allowed to charge their rentals, and at June 30, 1989, only \$2,200 had not been collected from charge sales of the previous six months. Employees earned wages of \$32,000 during this six-month period. Williams drew a salary of \$30,000.

When Williams met with her accountant at the end of June 1989, she was pleased that the bank account showed a balance of \$45,500, considering that significant expenditures were made just to get the business started. She wondered if she should declare a dividend as a signal to her investor friend that the business was doing well. The accountant reminded Williams that certain accruals, including interest on the mortgage of \$2,900, still needed to be made before dividends could be declared.

While discussing the results of the business through June 30, 1989, Williams and her accountant puzzled over how to account for a certain item. They knew that the tapes held for rental had a physical life of three years, and the cost of the tapes should be amortized over that period. However, they were unsure how to account for the new release tapes. They had the same physical life, but the initial demand (which warranted 10 copies of each title to be purchased versus the usual 2) was sure to wane significantly after only one year on the shelves. Williams felt that most of the revenues from these new releases would occur in the first year, and thereafter the store would derive little or no benefit from 8 extra copies of the same title.

This matter of the amortization of new releases and several other concerns needed to be resolved before financial statements of Thumbs-Up Video, Inc., could be issued.

Required Exercises

1. Construct a set of T accounts to record the transactions that occurred at Thumbs-Up Video, Inc., from November 1988 through June 1989.
2. Prepare a Statement of Financial Position as of June 30, 1989, for Thumbs-Up Video, Inc.
3. Prepare an Income Statement for Thumbs-Up Video, Inc., from incorporation through June 30, 1989. Disregard any income taxes that might be due.