The Warranty Windfall

Service contracts are cash cows—but retailers are mum about their importance

HERE'S A SECRET TWO OF the nation's largest consumer-electronics chains don't want investors to know. As TVs, portable DVD players, and other stuff fly off their shelves, Best Buy Co. and Circuit City Inc. aren't banking on them to rake in the profits. Instead, they're counting on the extended warranty contracts that they sell aggressively along with the goods.

Warranties cost virtually nothing to market, and the products they insure rarely need repairs (page 86). Says FTN Midwest Securities Corp. analyst Daryl Boehringer: "It's just pure profit flowing down to the bottom line."

Last year, profits from warranties accounted for all of Circuit City's operating income and almost half of Best Buy's, say analysts. They figure that profit margins on contracts are between 50% and 60%. That's nearly 18 times the margin on the goods themselves. For example, a four-year contract on a $3,000 flat-panel TV costs about $400. Best Buy gives its insurers $160 and keeps $240 for itself.

But you won't find details of such fabulous returns in company financial statements. "We do not share information about specific profitability of any product or service sold at Best Buy," says Best Buy spokeswoman Sue Busch Nehring in an e-mail.

Accountants say the lack of detail raises questions about the transparency of earnings. And it's certainly information investors would want to know. Stiffer competition and an accelerating fall in the prices of big-ticket electronic items threatens those profits. "With their strong dependence on service-contract revenue, any pronounced slowdown would have a large negative impact on earnings," says Boehringer.

Indeed, Wal-Mart Stores Inc. has jumped into consumer electronics in a big way and now controls 20% of the market. Best Buy, with $22 billion in sales in fiscal 2004, still has 31%. But Wal-Mart has passed Circuit City, which had $9.7 billion in sales last year and a 14% share.

Unlike the many specialist chains, Wal-Mart doesn't offer extended-service contracts; its lack of salespeople makes the contracts difficult to pitch. But if Wal-Mart, tempted by the eye-popping margins, decided to roll out its own line of warranties, it would have room to be even more cutthroat on electronics prices, and could conceivably undercut rivals on the warranty prices, too. Jim Sebastian, of SAFE LLC, a warranty consultancy, says he believes that Wal-Mart has tested contracts. Wal-Mart didn't return calls seeking comment.

GUESSING GAME

AS SERVICE CONTRACTS become more critical to its bottom line, Best Buy has actually cut back on disclosure. The Richfield (Minn.)-based chain doesn't report its warranty profits separately, though it used to give the percentage of sales that the contracts comprised. It stopped doing that after fiscal 2001 and buried the number in a revenue category labeled "other." Then for fiscal 2004 it stopped reporting the "other" category altogether.

Circuit City is more forthcoming. The Richmond (Va.)-based outfit reports how much revenue the contracts generate, along with the percentage of sales they make up—but not the profit they produce. For the year ended Feb. 29, it said its war-

Guaranteed Profits

Best Buy and Circuit City depend on selling extended-service contracts along with their electronics

	BEST BUY	CIRCUIT CITY
SERVICE CONTRACTS AS A PERCENTAGE OF SALES	4%	3.3%
AS A PERCENTAGE OF OPERATING PROFITS	45%	100%
PROFIT MARGINS ON CONTRACTS	60%	50%+

Figures are for year through February, 2004

Data: Company reports, Midwest Research, industry sources

STEVE HELBER/AP/WIDE WORLD

BIG PICTURE A Richmond (Va.) shopper checks out plasma TVs

ranty revenue totaled $326 million, or 3.3% of sales. Clearly, says SAFE's Sebastian, the retailers "don't want to disclose to J.Q. Public how much money they are making on these contracts."

Using details gleaned from industry sources, though, analyst Boehringer put together estimates of just how lucrative these contracts are. For the year ended Feb. 28, he estimates contract profits accounted for 45%, or $600 million, of Best Buy's $1.3 billion operating profit. He figures that without contract profits, Circuit City would have posted an operating loss from continuing operations of $195 million last year instead of a $564,000 profit.

Neither Best Buy or Circuit City will discuss why they don't disclose more about their warranty business. Best Buy's Nehring says the products and the contracts should be seen as inseparable. Circuit City spokesman William Cimino says the retailer stands by its financial reporting and adds: "We feel we give an appropriate amount of information."

Critics say the companies are taking advantage of a gray area of accounting that involves judgment calls. Charles Mulford, a Georgia Institute of Technology accounting professor and expert on financial transparency, says the companies could make a case that product and contract sales are so intertwined that they don't need to be reported separately. But he contends that the companies should treat warranty sales as a separate business and break out its revenues and profits.

Plunging prices for big-ticket items could end the easy money

Under guidelines from the rulemaking Financial Accounting Standards Board, the contracts meet one important test for separate treatment: They provide more than 10% of operating profits. The contracts also meet another FASB test because company execs clearly treat warranty sales separately when they discuss how to boost that business, says Paul R. Brown, an accounting professor at New York University's Stern School of Business.

What's more, generally accepted accounting principles, or GAAP, call for the release of any facts that are material to a business and significant enough to influence investors. The trend at Best Buy toward providing less information, Mulford says, "flies in the face of this new world calling for more transparency in accounting."

EARLY ADOPTERS

BOTH BEST BUY and Circuit City got serious about the warranty business in the mid-1990s. To jump-start contract sales, which then totaled less than 1% of revenue, Best Buy started pushing its employees to sell the contracts much harder. And it turned to insurance giant American International Group Inc. to underwrite the plans so it wouldn't have to insure the products itself. Circuit City, meanwhile, turned to insurer AON Corp. for much of its underwriting as it expanded its warranty sales.

For Best Buy, the strategic shift could not have been better timed. In the fourth quarter of fiscal 1996—when it disclosed that the contracts enjoyed higher margins than the products being insured—Best Buy's operating profit fell 19%, owing to weak Christmas sales. Had it not enlisted AIG, its earnings would have been hit even harder. With AIG now carrying the risk of payments to repair or replace goods, Best Buy could book all the warranty revenue at the time of sale, instead of amortizing it over the life of the multiyear service contract.

At first, Best Buy was a little too aggressive in how it booked the new warranty revenue that streamed in. At the end of 1999, the Securities & Exchange Commission required Best Buy to restate earnings back through fiscal 1996, when it had turned to AIG. The problem? Even though Best Buy no longer carries the risk on the contracts, the chain is still held responsible for it under the laws of a handful of states where it has stores. So Best Buy had to readjust its results by amortizing contract revenue from those states, shaving a combined $49 million off operating profit for those four years, or 7%.

Now, there's reason for investors to be worried that the gusher of warranty revenues might slow. Contracts on expensive digital TVs with liquid-crystal displays, plus plasma TVs, account for well over half of such income at both retailers, analysts figure. But deflation on high-priced electronics is accelerating: Prices now fall by 45% every 18 months, nearly twice the rate of five years ago. As prices decline, consumers become less willing to buy the service plans, figuring that if their gadget breaks, they'll just buy a new one. The trend led to a fall last year in Circuit City's contract revenues to 3.3% of sales, from 3.6% the year before. So the company got employees to focus more intensely on selling contracts, a campaign that paid off in the latest quarter, when the figure kicked up to 4.1%.

Deflation isn't the only negative for investors. The retailers are in a sweet spot now as consumers switch from analog to digital TVs, but that transition will wind down in the next couple of years, analysts say. Soon investors may be wishing they could buy an extended warranty on profits at the electronics chains.

–By Robert Berner in Chicago

WARRANTIES

When Service Contracts Make Sense

So you're almost out the door of Big Box with your latest high-tech toy. You've already succumbed to the sales associate's exhortations to buy those expensive Godzilla cables to hook it up to your TV. Then comes the inevitable final pitch: "Would you like an extended warranty for that?"

If you've done your homework, you'll just say no. For what is largely an afterthought in the buying process, extended warranties—or more accurately, service contracts—have become a huge $15 billion annual business. Typically, at least half of that goes into the seller's pocket as profit, with less than 20% spent on the repair or replacement of products. To put that in gambling terms: The house has set the odds so that for every $100 it takes in, it pays out only $20. You're betting against the house. Guess who wins.

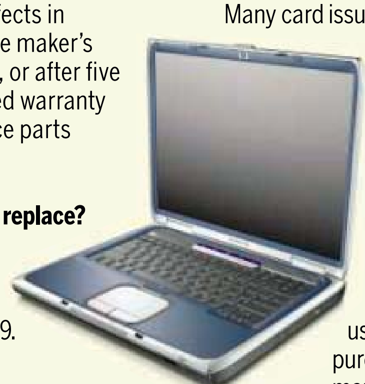
That's why consumer organizations by and large counsel against service contracts. "We basically urge people not to buy extended warranties," says Ken McEldowney, executive director of Consumer Action, a San Francisco watchdog group. "The worst ripoff is on appliances, because they have gotten so reliable."

Consumer Reports, the nonprofit product-testing magazine, generally agrees that such warranties aren't worth the money. But in its January issue it cites four products for which they might make sense: treadmills and elliptical trainers because of all their moving parts, plasma TVs because they run hot, and laptop PCs. Even so, the magazine admits that it's relying on a calculated hunch for the first three. "We don't have the data on three-year-old exercise equipment or plasma TVs," says deputy editor David Heim. For laptops, its survey of owners shows that 33% fail within three years. And it recommends buying the contract directly from the manufacturer rather than a retailer.

If you're offered an extended warranty, here's what to consider before you buy:

How likely is this equipment to break? Most major appliances either fail in the first year because of defects in manufacturing, when the maker's warranty is still in effect, or after five years, when the extended warranty has expired, as appliance parts wear out.

How much will it cost to replace? Best Buy charges $49.99 for a four-year contract on a Magnavox DVD player that sells for $39.99. Enough said.



Peace of Mind Might Pay Off...

Most experts caution against buying extended warranties for electronic and other equipment. But there are a few exceptions worth considering:

	WHY	TIP
Laptops	One third fail within three years	Buy the extra coverage from the maker, not the retailer
Treadmills, elliptical trainers	Complicated and expensive to repair	A longer warranty costs about the same as a service call
Plasma TVs	They run hot, and cooling fans can wear out	Screen burn-in of static images is not covered

Data: *Consumer Reports*

What will it cost me to repair it on my own? *Consumer Reports* figures that a vacuum cleaner or lawn mower can be repaired for two-thirds of the cost of a three-year contract. Britain's Office of Fair Trading discovered that consumers pay as much for a five-year contract on a clothes washer as it would cost to repair it four times.

How long am I covered by the manufacturer? Most factory warranties cover a year of parts and labor. So the first year of a three-year extended warranty is wasted. And how's this for outrageous: CompUSA charges $17.99 for a two-year replacement policy on a $59.99 Netgear Inc. wireless router for home networks—even though Netgear's warranty will repair or replace it free for three years.

Which credit card should I use? Many card issuers double the manufacturer's warranty for free.

If you decide that paying a premium for a peace of mind is worth it, shop around, even after the fact. You don't have to buy the contract from the retailer, and you don't have to buy it when you buy the goods—you usually have 30 days from purchase. Check with the manufacturer, which often will offer a better deal. For a Satellite laptop PC that sells for just under $1,000, Toshiba Corp. charges $199 for a three-year plan that also covers such accidental damage as dropping the laptop or spilling a Coke on the keyboard. CompUSA wants $369.99 for the extended warranty alone.

If you've already bought a warranty and you're having second thoughts, most states require the seller to give you a full refund if you change your mind within 30 days. At least that's something no casino would allow after you've placed a sucker bet.

–By Larry Armstrong in Los Angeles