

## **Extended Warranties and Service Contracts<sup>1</sup>**

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If you have purchased a major household appliance or a car recently, you were probably encouraged to buy an extended warranty or service contract. Some retailers promote the sale of extended warranties or service contracts while others do not. Perhaps you wonder if the extra protection is worth the additional cost.

The advisability of buying an extended warranty or service contract has been debated for years. There are advantages and disadvantages that the consumer should consider before making a decision. Your best decision is one that is based on your individual situation and what is important to you.

Some people buy service contracts because they are afraid that repairs will be needed and they will not have the money to pay for the repairs. Others think that an extended warranty or service contract ensures them faster or more reliable service than the general public receives. However, some people believe extended warranties are a waste of money since they cover only the first years of a product's life, the time when repairs are less likely to be needed.

### **What Are Extended Warranties and Service Contracts?**

An extended warranty and a service contract are basically the same thing. It is an agreement made between the owner of the serviceable product and someone who can (theoretically) fix the item if it needs service or repairs. It is much like an insurance policy that pays for repairs on a piece of equipment that is not functioning properly. The owner pays a set fee, usually by the year or for a specific number of years, and in return receives needed repairs at no additional charge. For cars, the coverage is for a specified number of miles.

Service contracts are widely used. One major department store chain has over five million customers with service contracts on its household appliances and another company has over one million customers with service contracts on its televisions. The number of extended warranties sold for new cars is increasing. Extended warranties and service contracts are big business, and a major money-maker for those that sell them.

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## Who is Responsible for Financing the Repairs Under an Extended Warranty?

Service contracts are usually handled in one of three ways by companies that sell them.

- The service contract is offered by the parent company through its retailer. The retailer sells the service contract. If the company is only one store, it keeps all of the money and does the repairs. If the company is a chain, much of the money goes to the home office. If repairs are done, the home office is billed and the local store is reimbursed for the work done.
- The retailer or company that sells the merchandise collects money for the service contract. Part of this money is paid as a flat-fee to a service company to handle any repairs that may need to be done. The same flat-fee is paid to the repair shop whether or not repairs are made.
- The retailer or company works in cooperation with a financial organization. The money is divided between the financial organization and the retailer. If repairs are needed, the store or dealer's repair department does the work and then bills the financial organization for payment.

The method the retailer uses to handle service contract funds and repair work is important to the consumer. If an individual retailer is totally responsible for the service contract, repair work will usually be done by the store or its designated service center. If a large chain, a corporation, or a finance company handles the account, repairs are usually available at different locations. Be sure to find out who will make the repairs, where the repair shop or service center is located and the quality of work done. It is also important to find out who will handle the funds used to pay for repairs, and if possible, its financial stability.

It is profitable for a business to sell service contracts because the money you pay for a service contract is divided between the retailer and a repair center or financial organization. Also, the repair center or financial organization expects to

collectively receive more money than it will have to pay out for repairs. Some individual consumers do receive repairs of greater value than the amount of money paid for the service contract. However, many others need only minor repairs or no repairs during the extended warranty period, thus they receive less value for their investments.

## What Happens to Your Money if You Do Not Need Repairs or Service?

When you paid your money it was placed in a collective fund with fees paid by many other people. From this fund, payments are made for needed repairs. If you do not need repairs, your money is used to pay for other people's repairs. You receive no refund or no value for your investment other than knowing repairs would be made if needed.

## When Should You Pay for a Service Contract?

Most service contracts are sold to people at the same time they buy the appliance or the car. People are more likely to buy at this time because they are concerned about how well the purchase will perform and they are thinking about warranties, thus extended warranty has a real appeal. Also, most major purchases are financed. The cost of the extended warranty is added to the purchase price of the car or appliance and is also financed. This ADDS to the cost, but buyers seem to be unaware of this. Fewer service contracts would be sold if a purchaser had to go back to the retailer to buy the extended warranty at the time the manufacturer's warranty expired.

Some merchants charge a lower price for a service contract purchased at the same time that you buy your new car or appliance. The reason is simple, fewer people would buy a service contract later unless their car or appliance had required repairs. The cost of the extended warranty can be kept lower by having service contracts on a mix of trouble-free purchases and those needing repairs.

When you buy an extended warranty or service contract, realize it offers very little or no additional protection during the period that the manufacturer's warranty is in effect. Unless there is substantial savings, buy a service contract at the time the

manufacturer's warranty expires. Why should the company hold your money, interest free, for several months, or a year?

## How Likely Are You to Need a Service Contract?

Most people over-estimate the number of repairs an appliance or car will need over its expected life and especially during the early years of ownership. A study by the Massachusetts Institute of Technology found that with major appliances most of the repairs needed during the first five years of ownership, occur during the first year. That is when the appliances are under the manufacturer's warranty. Publications such as *Consumers Report* publish predicted repair records for some products. Independent service centers can also give you information about the frequency of repairs needed by different makes and models of items they service. However, these service center reports may be biased by individual preferences.

## How Expensive Are Service Contracts?

Service contracts are usually reasonably priced for the first three to five years of product ownership, the time when the risks are low. After this period of time, a service contract becomes more expensive because the appliance or car is older and is more likely to need repairs. Often, service contracts or extended warranties are not offered for older merchandise.

## Does a Service Contract Ensure Better Service?

In most instances, service is no better or faster with a service contract than without one. There are some service departments however, that do take special care to see that repairs are done correctly the first time to avoid return trips. Some other service centers won't be in a hurry to make repairs because they have already received their money. A service contract does tie you to a specific repair place or type of repair center, thus preventing you from going to another place if you are dissatisfied.

## How Do I Decide if an Extended Warranty or Service Contract is a Good Investment for Me?

Find out the cost of a service call and types of repairs that commonly occur. How do these costs compare with the price of the service contract? Talk with people who own the same or similar appliances or motor vehicles. Read the service contract very carefully to learn what is covered, not covered, and under what conditions.

Many people have saved money on costly repair bills by having a service contract. However, even more people have spent more money buying a service contract than the total value of the repairs received.

What about your personal feelings? Does owning a service contract contribute to your sense of security? How does the cost of the contract affect your budget, or the amount of the monthly payment?

The merchant who sells a service contract is betting your purchase will be trouble-free. If you buy an extended warranty or service contract, you are betting you will have repair bills. Your decision to buy, or not buy, is a personal one.

## Find Out What is Covered

Before signing on the dotted line, find out the answers to the following questions. These answers may help you decide what is best for you.

- Does the contract cover both parts and labor?
- Are extra charges made for calls on weekends, holidays and at night?
- Are all parts covered or just one or two parts such as the picture tube of a TV?
- Will a prorated refund be made if the item is stolen? What if it is sold?
- Will the contract remain in effect if you should move to another city or state?
- Is there a limit to the number of repair calls or trips that can be made during the year?

- Is the extended warranty transferable if you sell the item?
- Does the contract provide for at home service, or must you return the appliance to the store or shop?
- What kind of protections are provided for secondary disasters such as a loss of food if the freezer fails?
- What provisions are made for an emergency where an appliance or vehicle requires several days to repair?
- Who is responsible for making the repairs? Will the business still be there when service is needed?
- Where are repair centers located?

### **The Decision is Yours**

You may consider depositing the annual cost of a service contract in a savings account and holding it as a fund to be used for repairs, if needed. Carefully consider all alternatives before making a decision.