

BEST BUY CO INC
Form 10-Q
October 05, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended August 26, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 1-9595

BEST BUY CO., INC.

(Exact name of registrant as specified in its charter)

Minnesota

(State or other jurisdiction of incorporation or organization)

41-0907483

(I.R.S. Employer Identification No.)

7601 Penn Avenue South

Richfield, Minnesota
(Address of principal executive offices)

55423

(Zip Code)

(612) 291-1000

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. **Yes x No o**

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). **Yes x No o**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). **Yes o No x**

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. **Yes o No o**

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APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. Common Stock, \$.10 Par Value 480,250,000 shares outstanding as of August 26, 2006.

BEST BUY CO., INC.

FORM 10-Q FOR THE QUARTER ENDED AUGUST 26, 2006

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PART I FINANCIAL INFORMATION
 ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

BEST BUY CO., INC.

CONSOLIDATED CONDENSED BALANCE SHEETS

ASSETS

(\$ in millions, except per share amounts)

(Unaudited)

	August 26, 2006	February 25, 2006	August 27, 2005
CURRENT ASSETS			
Cash and cash equivalents	\$ 1,104	\$ 748	\$ 614
Short-term investments	1,564	3,051	2,211
Receivables	483	439	389
Merchandise inventories	4,049	3,338	3,250
Other current assets	687	409	378
Total current assets	7,887	7,985	6,842
PROPERTY AND EQUIPMENT			
Property and equipment	5,151	4,836	4,436
Less accumulated depreciation	2,364	2,124	1,913
Net property and equipment	2,787	2,712	2,523
GOODWILL			
	1,010	557	529
OTHER INTANGIBLE ASSETS			
	83	44	42
LONG-TERM INVESTMENTS			
	277	218	122
OTHER ASSETS			
	363	348	201
TOTAL ASSETS	\$ 12,407	\$ 11,864	\$ 10,259

NOTE: The consolidated balance sheet as of February 25, 2006, has been condensed from the audited financial statements.

See Notes to Consolidated Condensed Financial Statements.

BEST BUY CO., INC.CONSOLIDATED CONDENSED BALANCE SHEETSLIABILITIES AND SHAREHOLDERS EQUITY

(\$ in millions, except per share amounts)

(Unaudited)

	August 26, 2006	February 25, 2006	August 27, 2005
CURRENT LIABILITIES			
Accounts payable	\$ 3,858	\$ 3,234	\$ 2,760
Unredeemed gift card liabilities	392	469	358
Accrued compensation and related expenses	263	354	216
Accrued liabilities	958	878	916
Accrued income taxes	399	703	254
Current portion of long-term debt	496	418	12
Total current liabilities	6,366	6,056	4,516
LONG-TERM LIABILITIES	392	373	380
LONG-TERM DEBT	184	178	540
MINORITY INTERESTS	31		
SHAREHOLDERS EQUITY			
Preferred stock, \$1.00 par value: Authorized 400,000 shares; Issued and outstanding none			
Common stock, \$.10 par value: Authorized 1.5 billion shares; Issued and outstanding 480,250,000, 485,098,000 and 492,444,000 shares, respectively	48	49	49
Additional paid-in capital	389	643	973
Retained earnings	4,690	4,304	3,600
Accumulated other comprehensive income	307	261	201
Total shareholders equity	5,434	5,257	4,823
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 12,407	\$ 11,864	\$ 10,259

NOTE: The consolidated balance sheet as of February 25, 2006, has been condensed from the audited financial statements.

See Notes to Consolidated Condensed Financial Statements.

BEST BUY CO., INC.CONSOLIDATED STATEMENTS OF EARNINGS

(\$ in millions, except per share amounts)

(Unaudited)

	Three Months Ended		Six Months Ended	
	August 26, 2006	August 27, 2005	August 26, 2006	August 27, 2005
Revenue	\$ 7,603	\$ 6,702	\$ 14,562	\$ 12,820
Cost of goods sold	5,701	4,991	10,895	9,551
Gross profit	1,902	1,711	3,667	3,269
Selling, general and administrative expenses	1,572	1,450	3,000	2,769
Operating income	330	261	667	500
Net interest income	21	18	44	31
Earnings before income tax expense and minority interests	351	279	711	531
Income tax expense	121	91	247	173
Minority interests				
Net earnings	\$ 230	\$ 188	\$ 464	\$ 358
Basic earnings per share	\$ 0.48	\$ 0.38	\$ 0.96	\$ 0.73
Diluted earnings per share	\$ 0.47	\$ 0.37	\$ 0.94	\$ 0.71
Dividends declared per common share	\$ 0.08	\$ 0.07	\$ 0.16	\$ 0.15
Basic weighted average common shares outstanding (in millions)	482.0	491.2	483.3	491.2
Diluted weighted average common shares outstanding (in millions)	496.5	509.1	498.4	507.5

See Notes to Consolidated Condensed Financial Statements.

BEST BUY CO., INC.CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITYFOR THE SIX MONTHS ENDED AUGUST 26, 2006

(\$ and shares in millions)

(Unaudited)

	Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balances at February 25, 2006	485	\$ 49	\$ 643	\$ 4,304	\$ 261	\$ 5,257
Net earnings, six months ended August 26, 2006				464		464
Other comprehensive income, net of tax:						
Foreign currency translation adjustments					51	51
Other					(5)	(5)
Total comprehensive income						510
Stock options exercised	4		94			94
Stock-based compensation			59			59
Tax benefits from stock options exercised and employee stock purchase plan			31			31
Issuance of common stock under employee stock purchase plan			23			23
Repurchase of common stock	(9)	(1)	(461)			(462)
Common stock dividend, \$0.16 per share				(78)		(78)
Balances at August 26, 2006	480	\$ 48	\$ 389	\$ 4,690	\$ 307	\$ 5,434

See Notes to Consolidated Condensed Financial Statements.

BEST BUY CO., INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(\$ in millions)

(Unaudited)

	Six Months Ended	
	August 26, 2006	August 27, 2005
OPERATING ACTIVITIES		
Net earnings	\$ 464	\$ 358
Adjustments to reconcile net earnings to total cash used in operating activities:		
Depreciation	246	222
Asset impairment charges	21	
Stock-based compensation	59	62
Deferred income taxes	(28)	(31)
Excess tax benefits from stock-based compensation	(22)	(21)
Other	14	(1)
Changes in operating assets and liabilities, net of acquired assets and liabilities:		
Receivables	(15)	(13)
Merchandise inventories	(548)	(385)
Other assets	(5)	(21)
Accounts payable	231	(75)
Other liabilities	(185)	(19)
Accrued income taxes	(263)	(273)
Total cash used in operating activities	(31)	(197)
INVESTING ACTIVITIES		
Additions to property and equipment, net of \$23 non-cash capital expenditures in the six months ended August 27, 2005	(299)	(280)
Acquisition of businesses, net of cash acquired	(421)	
Purchases of available-for-sale securities	(1,635)	(995)
Sales of available-for-sale securities	3,060	1,805
Proceeds from property dispositions		42
Changes in restricted assets	(16)	12
Other, net	12	10
Total cash provided by investing activities	701	594
FINANCING ACTIVITIES		
Repurchase of common stock	(462)	(262)
Issuance of common stock under employee stock purchase plan and for the exercise of stock options	117	187
Dividends paid	(78)	(73)
Long-term debt payments	(7)	(66)
Proceeds from issuance of long-term debt	38	7
Excess tax benefits from stock-based compensation	22	21
Other, net	37	37
Total cash used in financing activities	(333)	(149)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	19	12
INCREASE IN CASH AND CASH EQUIVALENTS	356	260
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	748	354
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 1,104	\$ 614

BEST BUY CO., INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation:

In the opinion of management, the accompanying financial statements contain all adjustments necessary for a fair presentation as prescribed by accounting principles generally accepted in the United States. All adjustments were comprised of normal recurring adjustments, except as noted in the Notes to Consolidated Condensed Financial Statements. Due to the seasonal nature of our business, interim results are not necessarily indicative of results for the entire fiscal year. Our revenue and earnings are typically greater during our fiscal fourth quarter, which includes the majority of the holiday selling season. These interim financial statements and the related notes should be read in conjunction with the financial statements and notes included in our Annual Report on Form 10-K for the fiscal year ended February 25, 2006.

To maintain consistency and comparability, we reclassified certain prior-year amounts to conform to the current year presentation as described in Note 1, *Summary of Significant Accounting Policies*, of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended February 25, 2006. In addition, to be consistent with our accounting policies, we reclassified selected balances from receivables to cash and cash equivalents in our February 25, 2006, consolidated condensed balance sheet. These reclassifications had no effect on previously reported operating income, net earnings or shareholders' equity.

Effective June 8, 2006, we acquired a 75% interest in Jiangsu Five Star Appliance Co., Ltd. (Five Star). Consistent with China's statutory requirements, Five Star's fiscal year ends on December 31. Therefore, we have decided to consolidate Five Star's financial results on a two-month lag. There were no significant intervening events which would have materially affected our consolidated financial statements had they been recorded during the quarter. See Note 2, *Acquisitions*, for further details regarding this transaction.

The following table illustrates the primary costs classified in each major expense category (the classification of which varies across the retail industry):

Cost of Goods Sold

- Total cost of products sold including:

Freight expenses associated with moving merchandise inventories from our vendors to our distribution centers;

Vendor allowances that are not a reimbursement of specific, incremental and identifiable costs to promote a vendor's products;

Cash discounts on payments to vendors;

- Cost of services provided including:

Payroll and benefits costs for services employees;

Cost of replacement parts and related freight expenses;

- Physical inventory losses;

- Markdowns;

Selling, General & Administrative Expenses (SG&A)

- Payroll and benefit costs for retail and corporate employees;

- Occupancy costs of retail, services and corporate facilities;

- Depreciation related to retail, services and corporate assets;

- Advertising;

- Vendor allowances that are a reimbursement of specific, incremental and identifiable costs to promote a vendor's products;

- Charitable contributions;

- Outside service fees;

- Long-lived asset impairment charges; and

- Other administrative costs, such as credit card

- Customer shipping and handling expenses; service fees, supplies, and travel and lodging.
- Costs associated with operating our distribution network, including payroll and benefit costs, occupancy costs, and depreciation;
- Freight expenses associated with moving merchandise inventories from our distribution centers to our retail stores; and
- Promotional financing costs.

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Vendor allowances included in revenue for reimbursement of vendor-provided sales incentives were \$6 million and \$24 million, for the three months ended August 26, 2006, and August 27, 2005, respectively, and \$12 million and \$41 million, for the six months ended August 26, 2006, and August 27, 2005, respectively. Vendor allowances included in SG&A were \$38 million and \$35 million for the three months ended August 26, 2006, and August 27, 2005, respectively, and \$67 million and \$55 million for the six months ended August 26, 2006, and August 27, 2005, respectively. All remaining vendor allowances are initially deferred and recorded as a reduction of merchandise inventories. The deferred amounts are then included as a reduction of cost of goods sold when the related product is sold.

2. Acquisitions:

Pacific Sales Kitchen and Bath Centers, Inc.

Effective March 7, 2006, we acquired all of the common stock of Pacific Sales Kitchen and Bath Centers, Inc. (Pacific Sales) for \$411 million, or \$408 million, net of cash acquired, including transaction costs. We acquired Pacific Sales, a high-end home-improvement and appliance retailer, to enhance our ability to grow with an attractive customer base and premium brands using a proven and successful showroom format. Utilizing the existing store format, we expect to expand the number of stores in order to capitalize on the rapidly growing high-end segment of the U.S. appliance market. The acquisition was accounted for using the purchase method in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*. Accordingly, we recorded the net assets at their estimated fair values, and included operating results in our Domestic segment from the date of acquisition. We allocated the purchase price on a preliminary basis using information currently available. The allocation of the purchase price to the assets and liabilities acquired will be finalized no later than the first quarter of fiscal 2008, as we obtain more information regarding asset valuations, liabilities assumed and revisions of preliminary estimates of fair values made at the date of purchase. All goodwill is deductible for tax purposes.

The preliminary purchase price allocation, net of cash acquired, was as follows (\$ in millions):

Merchandise inventories	\$ 41
Property and equipment	2
Other assets(1)	14
Tradename	17
Goodwill	377
Current liabilities	(43)
	\$ 408

(1) Includes \$7 million related to the acquired customer backlog.

Jiangsu Five Star Appliance Co., Ltd.

Effective June 8, 2006, we acquired a 75% interest in Five Star for \$184 million, including a working capital injection of \$122 million and transaction costs. Five Star is one of China's largest appliance and consumer electronics retailers with 131 stores located in eight of China's 34 provinces. We made the investment in Five Star to further our international growth plans, increase our knowledge of Chinese customers and obtain an immediate retail presence in China. The acquisition was accounted for using the purchase method in accordance with SFAS No. 141, *Business Combinations*. Accordingly, we recorded the net assets at their estimated fair values, and included operating results in our International segment from the date of acquisition. We allocated the purchase price on a

preliminary basis using information currently available. The allocation of the purchase price to the assets and liabilities acquired will be finalized no later than the second quarter of fiscal 2008, as we obtain more information regarding asset valuations, liabilities assumed and revisions of preliminary estimates of fair values made at the date of purchase. The resulting goodwill is not deductible for tax purposes.

The preliminary purchase price allocation, net of cash acquired, was as follows (\$ in millions):

Restricted cash	\$ 204
Merchandise inventories	107
Property and equipment	37
Other assets	81
Tradename	21
Goodwill	69
Accounts payable	(363)
Other current liabilities	(47)
Debt, due 2006 to 2007, interest rates ranging from 1.9% to 6.8%	(64)
Long-term liabilities	(1)
Minority interests (1)	(31)
	\$ 13

(1) The minority interests proportionate ownership of assets and liabilities were recorded at historical carrying values.

The minority interests share of net earnings included in the three and six months ended August 26, 2006, was less than \$1 million.

3. Gift Cards:

We sell gift cards to our customers in our retail stores, through our Web sites and through selected third parties. Our gift cards do not have an expiration date. We recognize income from gift cards when: (i) the gift card is redeemed by the customer; or (ii) the likelihood of the gift card being redeemed by the customer is remote (gift card breakage) and we determine that we do not have a legal obligation to remit the value of unredeemed gift cards to the relevant jurisdictions. We determine our gift card breakage rate based upon historical redemption patterns. Based on our historical information, the likelihood of a gift card remaining unredeemed can be determined 24 months after the gift card is issued. At that time, we recognize breakage income for those cards for which the likelihood of redemption is deemed to be remote if we do not have a legal