

# **Selling extended warranties via independent companies lowers price but hurts consumers**

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Retailers selling home appliances and electronics goods typically make 15-20 percent profit from these products but realize more than 200 percent profit from selling extended warranties for them. A new study that appears in the January issue of *Marketing Science*, a publication of the Institute for Operations Research and the Management Sciences (INFORMS), finds that even though selling warranties through independent firms will lower extended warranty prices, the consumers may actually be worse off.

The research, *Risk Preferences and Demand Drivers of Extended Warranties*, was conducted by Pranav Jindal, assistant professor of marketing at Pennsylvania State University's Smeal College of Business.

Combining conjoint analysis, one of the most widely used market research tools, with economic models, Jindal analyzed stated choices of more than 550 consumers drawn from an online panel, and addressed two key questions—"Why do consumers buy extended warranties?" and "Why do consumers pay such a high premium for extended warranties?"

"Paying \$500 for a new laptop is not the same as paying \$500 for repairing or replacing a laptop you already own," Jindal said.

"Consumers view paying for repairs as a loss. Consumers feel it hurts 3-4 times worse than paying the price of the product itself. This hurt drives consumers to buy extended warranties."

This behavior of consumers is called loss aversion.

Through an online survey, the author collected data on consumer choices for washing machines and extended warranties to show that loss aversion along with peace of mind are the key reasons why consumers buy extended warranties for their products.

"Consumers search for low product prices but do not search for low warranty prices," says Jindal. "So, they are locked in by retailers selling appliances and electronic goods. Conventional wisdom says that extended warranties should be sold through independent firms selling only warranties, which will make extended warranties cheaper and consumers better off. But according to this new research, obtaining extended warranties through independent firms may be cheaper but it does not make consumers happier."

This unexpected result is based on the finding that retailers discount the price of [home appliances](#) and electronic goods and in turn charge consumers a premium for extended warranties. If these retailers are not allowed to sell extended warranties, then prices of home appliances and [electronic goods](#) will go up, although extended warranties (now sold through independent retailers) will become cheaper. On average, however, consumers lose more from the increased product prices than they gain from lower extended warranty prices.

While the study focused on the role of losses, it acknowledged that other factors such as over-predicting failure rate, lack of information about repair and replacement policy, and financial constraints may also result in consumers purchasing extended warranties.

"Consumers may buy a warranty for a variety of reasons. Controlling for others, this study shows that [consumers'](#) perception of potential losses and peace of mind are important factors, and have important implications for how extended warranties should be sold," Jindal concluded. "Moving forward, it would be really interesting to get into the

consumer's mind and understand when they think a product will fail and how much they believe it will cost them to repair or replace the product."

Provided by Institute for Operations Research and the Management Sciences

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