

Notes to Consolidated Financial Statements

\$ in thousands, except per share amounts

1. Summary of Significant Accounting Policies

Description of Business

The Company has operated in a single business segment, selling personal computers and other home office products, consumer electronics, entertainment software, major appliances and related accessories principally through its retail stores. During the fourth quarter of fiscal 2001, the Company acquired the common stock of Musicland Stores Corporation (Musicland) and Magnolia Hi-Fi, Inc. (Magnolia Hi-Fi). Musicland is principally a mall-based retailer of pre-recorded home entertainment products. Magnolia Hi-Fi is a Seattle-based, high-end retailer of audio and video products. The results of the acquired businesses have been included in the consolidated financial statements since the dates of acquisition (see Note 2).

Basis of Presentation

The consolidated financial statements include the accounts of Best Buy Co., Inc. and its subsidiaries. Significant intercompany accounts and transactions have been eliminated. All subsidiaries are wholly owned.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts in the consolidated balance sheets and statements of earnings, as well as the disclosure of contingent liabilities. Actual results could differ from these estimates and assumptions.

Fiscal Year

The Company's fiscal year ends on the Saturday nearest the end of February. Fiscal 2001 included 53 weeks, while fiscal 2000 and 1999 each included 52 weeks.

Cash and Cash Equivalents

The Company considers short-term investments with a maturity of three months or less when purchased to be cash equivalents. Cash equivalents are carried at cost, which approximates market value. Restricted cash amounts are not significant.

Recoverable Costs From Developed Properties

The costs of acquisition and development of properties which the Company intends to sell and lease back or recover from landlords within one year are included in current assets.

Merchandise Inventories

Merchandise inventories are recorded at the lower of cost or market. The primary methods used to determine cost are the average cost method and the retail inventory method.

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Property and Equipment

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets or, in the case of leasehold improvements, over the shorter of the estimated useful lives or lease terms. Useful lives for buildings, leasehold improvements, fixtures and equipment generally range from 30 to 40 years, 10 to 20 years and 3 to 15 years, respectively. When indicators of impairment exist, the Company evaluates long-lived assets for impairment using undiscounted cash flow analysis.

Goodwill

Goodwill represents the excess of cost over the fair value of net assets of businesses acquired in fiscal 2001. Goodwill is being amortized using the straight-line method over 20 years. The Company periodically reviews goodwill for impairment and assesses whether significant events or changes in business circumstances indicate that the carrying value of the goodwill may not be recoverable. An impairment loss would be recorded in the period such determination is made. The Company believes that no material impairment of goodwill existed at March 3, 2001.

Revenue Recognition

The Company recognizes revenues from the sale of merchandise at the time the merchandise is sold. Service revenues are recognized at the time the service is provided.

The Company sells extended service contracts, called Performance Service Plans, on behalf of an unrelated third party. In those states where the Company is deemed to be the obligor on the contract at the time of sale, the net commission revenue from the sale is recognized ratably over the term of the service contract, generally two to five years. For contracts sold in all other states, the net commission revenue is recognized at the time of sale.

Stock-Based Compensation

The Company accounts for employee stock-based compensation using the intrinsic value method as prescribed under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. The Company also presents pro forma net earnings and earnings per share in Note 5 as if the Company had adopted Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*.

Pre-Opening Costs

Non-capital expenditures associated with opening new stores are expensed as incurred.

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Advertising Costs

Advertising costs, which are included in selling, general and administrative expenses, are expensed the first time the advertisement runs.

Earnings per Share

Basic earnings per share is computed based on the weighted average number of common shares outstanding. Diluted earnings per share is computed based on the weighted average number of common shares outstanding adjusted by the number of additional shares that would have been outstanding had the potentially dilutive common shares been issued. Potentially dilutive shares of common stock include stock options and other stock-based awards granted under stock-based compensation plans. Convertible preferred securities were assumed to be converted into common stock, and any related interest expense, net of income taxes, was added back to net earnings when the assumed conversion resulted in lower earnings per share.

The Company completed two-for-one stock splits effected in the form of 100% stock dividends distributed on March 18, 1999, and May 26, 1998. All share and per share information reflects these stock splits.

Reclassifications

Certain previous year amounts have been reclassified to conform to the current year presentation. These reclassifications had no impact on net earnings or total shareholders' equity.

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2. Acquisitions

Effective December 15, 2000, the Company acquired the common stock of Magnolia Hi-Fi for \$88,000 in cash, including transaction costs. Effective January 31, 2001, the Company acquired the common stock of Musicland for \$425,100, including transaction costs, plus the assumption of long-term debt valued at \$271,200. Both acquisitions were accounted for using the purchase method. Accordingly, the net assets were recorded at their estimated fair values and operating results were included in the Company's financial statements from the dates of acquisition.

The purchase prices for Magnolia Hi-Fi and Musicland have been allocated on a preliminary basis using information currently available. The allocation of the purchase price to the assets and liabilities acquired is expected to be finalized by the end of fiscal 2002. Adjustments to the allocation of purchase price may occur as a result of obtaining more information regarding asset valuations, liabilities assumed and revisions of preliminary estimates of fair values made at the date of purchase. The Company is continuing to evaluate how the acquired operations will be integrated into the Company's overall business strategy. These preliminary allocations resulted in acquired goodwill of \$387,400, which is being amortized on a straight-line basis over 20 years. Amortization of goodwill was \$2,000 for fiscal 2001 and is included in selling, general and administrative expenses.

The pro forma unaudited consolidated results of operations as though Musicland had been acquired as of the beginning of fiscal 2001 and 2000 are as follows:

	2001	2000
Revenues	\$17,078,464	\$14,393,960
Net earnings	417,229	371,724
Basic earnings per share	2.02	1.82
Diluted earnings per share	1.96	1.75

The pro forma results include goodwill amortization of \$15,900 and other adjustments, principally the loss of interest income on cash used to finance the acquisition. The pro forma results exclude costs expected to be incurred in the integration and transformation of Musicland's business. The pro forma results are not necessarily indicative of what actually would have occurred had the acquisition been completed as of the beginning of each of the fiscal years presented, nor are they necessarily indicative of future consolidated results. Pro forma information related to the acquisition of Magnolia Hi-Fi is not presented, as the operating results of Magnolia Hi-Fi would not have had a significant impact on the Company's results of operations.

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3. Debt

	March 3 2001	Feb. 26 2000
Senior subordinated notes, face amount \$109,500, unsecured, due 2003, interest rate 9.0%, effective rate 8.9%	\$ 110,471	\$ —
Senior subordinated notes, face amount \$150,000, unsecured, due 2008, interest rate 9.9%, effective rate 8.5%	160,574	—
Mortgage and other debt, interest rates ranging from 5.3% to 9.4%	24,904	30,650
Total debt	295,949	30,650
Less: current portion	(114,940)	(15,790)
Long-term debt	<u>\$ 181,009</u>	<u>\$ 14,860</u>

The mortgage and other debt are secured by certain property and equipment with a net book value of \$43,500 and \$35,600 at March 3, 2001, and February 26, 2000, respectively.

During fiscal 2001, 2000 and 1999, interest paid totaled \$7,000, \$5,300 and \$23,800, respectively.

During fiscal 2001, 2000 and 1999, interest expense totaled \$6,900, \$5,100 and \$19,400, respectively, and is included in net interest income. The fair value of long-term debt approximates the carrying value.

The future maturities of long-term debt consist of the following:

Fiscal Year	
2002	\$114,940
2003	2,036
2004	895
2005	745
2006	810
Thereafter	176,523
	<u>\$295,949</u>

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Best Buy Co., Inc.

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Senior Subordinated Notes

The Company's Musicland subsidiary had \$110,500 of Senior Subordinated Notes due in 2003 (2003 Notes) and \$160,600 of Senior Subordinated Notes due in 2008 (2008 Notes) outstanding, which were assumed and recorded at their fair value as part of the Musicland acquisition. Fair value was based upon the present value of the amounts expected to be paid. Both notes contained change-in-control provisions that required the Company to offer to repurchase the notes within 30 to 60 days after the Company's acquisition of Musicland. The offer to repurchase both notes was made on February 12, 2001, at 101.0% of the aggregate principal amount of the notes plus accrued interest. The offer expired on March 16, 2001, at which time \$93,900 of the 2003 Notes had been tendered. Accordingly, these 2003 Notes have been classified to the current portion of long-term debt in the Company's balance sheet. Amounts tendered under the 2008 Notes were not significant. The Company also has options to redeem the remaining notes outstanding prior to maturity. The 2003 Notes may be redeemed at 101.1% of par until June 15, 2001, and at par thereafter. The 2008 Notes may be redeemed at 104.9% of par beginning March 15, 2003, and thereafter at prices declining annually to 100.0% of par on and after March 15, 2006.

On October 5, 1998, the Company prepaid its \$150,000, 8.6% Senior Subordinated Notes due October 1, 2000, at 102.5% of their par value. The prepayment premium of \$3,800 and the write-off of the remaining deferred debt offering costs of approximately \$1,100 were included in interest expense in fiscal 1999.

Credit Agreement

The Company has a credit agreement (the Agreement) that provides a bank revolving credit facility (the Facility) under which the Company can borrow up to \$100,000. The Agreement expires on June 30, 2002. Borrowings under the Facility are unsecured. Interest on borrowings is at rates specified in the Agreement, as elected by the Company. The Company also pays certain commitment and agent fees.

The Agreement contains covenants that require maintenance of certain financial ratios and minimum net worth. The Agreement also requires that the Company has no outstanding principal balance for a period not less than 30 consecutive days, net of cash and cash equivalents. There were no borrowings under the Facility during fiscal 2001 or 2000.

Inventory Financing

The Company has a \$200,000 inventory financing credit line, which increases to \$325,000 on a seasonal basis. Borrowings are collateralized by a security interest in certain merchandise inventories approximating the outstanding borrowings. The terms of this arrangement allow the Company to extend the due dates of invoices beyond their normal terms. The amounts extended generally bear interest at a rate approximating the prime rate. No amounts were extended under this line in fiscal 2001 or 2000. The line has provisions that give the financing source a portion of the cash discounts provided by the manufacturers.

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4. Convertible Preferred Securities of Subsidiary

In November 1994, the Company and Best Buy Capital, L.P., a special-purpose limited partnership in which the Company was the sole general partner, completed the public offering of 4.6 million convertible monthly income preferred securities with a liquidation preference of \$50 per security. The securities were convertible into shares of the Company's common stock at the rate of 4.444 shares per security (equivalent to a conversion price of \$11.25 per share). In April 1998, substantially all of the preferred securities were converted into approximately 20.4 million shares of common stock. The remaining preferred securities were redeemed in June 1998 for cash in the amount of \$671.

5. Shareholders' Equity

Stock Options

The Company currently sponsors non-qualified stock option plans for employees and the Board of Directors. These plans provide for the issuance of up to 48.8 million shares of common stock. Options may be granted only to employees or directors at option prices not less than the fair market value of the Company's common stock on the date of the grant. The options vest over a four-year period and expire over a range of five to 10 years. In addition, two plans expired in fiscal 1998 that still have outstanding options. At March 3, 2001, options to purchase 17.6 million shares were outstanding under all of these plans.

In connection with the Musicland acquisition, outstanding stock options held by certain employees of Musicland were converted into options exercisable into the Company's shares of common stock. These options were fully vested at the time of conversion and expire based on the remaining option term of up to 10 years. These options did not reduce the shares available for grant under any of the Company's other option plans. The acquisition was accounted for as a purchase and, accordingly, the fair value of these options was included as a component of the purchase price using the Black-Scholes option pricing model.

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Stock Options, cont.

As permitted by SFAS No. 123, the Company has elected to account for its stock option plans under the provisions of APB Opinion No. 25. Accordingly, no compensation cost has generally been recognized for stock options granted. Had the Company adopted SFAS No. 123, the pro forma effects on net earnings, basic earnings per share and diluted earnings per share would have been as follows:

	2001	2000	1999
Net earnings			
As reported	\$395,839	\$347,070	\$216,282
Pro forma	352,300	321,881	201,257
Basic earnings per share			
As reported	\$ 1.92	\$ 1.70	\$ 1.09
Pro forma	1.70	1.58	1.01
Diluted earnings per share			
As reported	\$ 1.86	\$ 1.63	\$ 1.03
Pro forma	1.67	1.52	.96

The fair value of each option was estimated on the date of the grant using the Black-Scholes option pricing model with the following assumptions:

	2001	2000	1999
Risk-free interest rate	6.1%	6.4%	5.6%
Expected dividend yield	0%	0%	0%
Expected stock price volatility	60%	50%	50%
Expected life of options	4.5 years	4.5 years	4.9 years

The weighted average fair value of options granted during fiscal 2001, 2000 and 1999 used in computing pro forma compensation expense was \$34.59, \$25.59 and \$8.58 per share, respectively.

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Option activity for the last three fiscal years was as follows:

	Shares	Weighted Average Exercise Price per Share
Outstanding Feb. 28, 1998	16,744,000	\$ 3.66
Granted	9,423,000	17.27
Exercised	(4,909,000)	4.56
Canceled	<u>(2,119,000)</u>	9.74
Outstanding Feb. 27, 1999	19,139,000	9.46
Granted	3,040,000	51.97
Exercised	(4,172,000)	7.75
Canceled	<u>(961,000)</u>	19.48
Outstanding Feb. 26, 2000	17,046,000	16.89
Granted	5,380,000	68.30
Assumed ⁽¹⁾	307,000	55.81
Exercised	(3,813,000)	9.16
Canceled	<u>(1,341,000)</u>	40.41
Outstanding March 3, 2001	<u><u>17,579,000</u></u>	33.19

⁽¹⁾ Represents Musicland options converted into Company options in connection with the acquisition.

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Exercisable options at the end of fiscal 2001, 2000 and 1999 were 6.3 million, 4.6 million and 5.0 million, respectively. The following table summarizes information concerning options outstanding and exercisable as of March 3, 2001:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 0 to \$10	4,784,000	4.20	\$ 2.92	3,463,000	\$ 2.86
\$10 to \$20	5,128,000	7.14	17.18	1,773,000	17.15
\$20 to \$30	74,000	7.59	23.98	24,000	24.40
\$30 to \$40	34,000	7.92	31.98	16,000	31.90
\$40 to \$50	240,000	7.32	47.25	104,000	47.24
\$50 to \$60	2,598,000	8.01	52.41	794,000	52.81
\$60 to \$70	153,000	9.39	66.59	4,000	65.38
\$70 to \$80	4,566,000	9.08	70.21	81,000	73.51
\$80 to \$90	2,000	9.09	82.64	—	—
\$ 0 to \$90	17,579,000	7.00	\$33.19	6,259,000	\$15.09

Restricted Stock Plan

The Company adopted a restricted stock award plan in fiscal 2001. The plan authorizes the Company to issue up to 1.0 million shares of the Company's common stock to eligible employees of the Company and its subsidiaries, as well as to the Board of Directors, consultants and independent contractors of the Company and its subsidiaries. Restricted shares have the same rights as other shares of common stock, except they are not transferable until fully vested. Restrictions lapse over a vesting period of three years in which 25% is vested at the time of award and 25% on each anniversary date thereafter. All shares still subject to restrictions are generally forfeited and returned to the plan if the plan participant's relationship with the Company is terminated. The number of shares granted under this plan was not significant during fiscal 2001.

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Earnings per Share

The following table presents a reconciliation of the numerators and denominators of basic and diluted earnings per common share for fiscal 2001, 2000 and 1999:

	2001	2000	1999
Numerator:			
Net earnings	\$395,839	\$347,070	\$216,282
Interest on preferred securities, net of tax	—	—	771
Net earnings assuming dilution	\$395,839	\$347,070	\$217,053
Denominator (000s):			
Weighted average common shares outstanding	206,699	204,194	199,185
Effect of dilutive securities:			
Employee stock options	5,959	8,386	8,726
Preferred securities	—	—	2,095
Weighted average common shares outstanding assuming dilution	212,658	212,580	210,006
Basic earnings per share	\$ 1.92	\$ 1.70	\$ 1.09
Diluted earnings per share	\$ 1.86	\$ 1.63	\$ 1.03

Repurchase of Common Stock

In October 1998 and September 1999, the Company's Board of Directors authorized the purchase of up to \$100,000 and \$200,000, respectively, of the Company's common stock. These plans were completed with a total of 1.8 million and 3.8 million shares purchased and retired, respectively.

In February 2000, the Company's Board of Directors authorized the purchase of up to \$400,000 of the Company's common stock from time to time through open market purchases. This plan has no stated expiration date. As of March 3, 2001, 1.9 million shares had been purchased and retired at a cost of \$100,000. No shares were repurchased in fiscal 2001.

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6. Operating Lease Commitments

The Company currently both owns and leases portions of its corporate facilities and conducts essentially all of its retail and the majority of its distribution operations from leased locations. The terms of the lease agreements generally range from three to 16 years for Best Buy stores and three to 20 years for Musicland stores. The leases require payment of real estate taxes, insurance and common area maintenance in addition to rent. Most of the leases contain renewal options and escalation clauses, and the majority of the Musicland stores and several Best Buy stores require contingent rents based on specified percentages of sales. Certain Musicland store leases provide the Company with an early cancellation option if sales for a designated period do not reach a specified level as defined in the lease. Certain leases contain covenants related to maintenance of financial ratios. Also, the Company leases various equipment under operating leases. Transaction costs associated with the sale and leaseback of properties and any gain or loss are recognized over the terms of the lease agreements. Proceeds from the sale and leaseback of properties are included in the net change in recoverable costs from developed properties.

The composition of total rental expenses for all operating leases during the past three fiscal years, including leases of buildings and equipment, was as follows:

	2001	2000	1999
Minimum rentals	\$299,090	\$227,500	\$186,100
Percentage rentals	615	500	500
	<u>\$299,705</u>	<u>\$228,000</u>	<u>\$186,600</u>

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Future minimum lease obligations by year (not including percentage rentals) for all operating leases at March 3, 2001, were as follows:

Fiscal Year	
2002	\$ 388,000
2003	377,000
2004	346,000
2005	315,000
2006	289,000
Thereafter	2,282,000

Master Lease

During fiscal 2001, the Company entered into a \$60 million, five-year master lease agreement for the purpose of constructing and leasing new retail locations. An operating lease agreement will be entered into for certain retail stores providing for an initial lease term of five years. The leases will require payment of real estate taxes, insurance and common area maintenance.

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7. Benefit Plans

The Company sponsors retirement savings plans for employees meeting certain age and service requirements. The plans provide for Company-matching contributions, which are subject to annual approval by the Company's Board of Directors. The total matching contributions were \$6,800, \$4,600 and \$3,100 in fiscal 2001, 2000 and 1999, respectively.

The Company has a deferred compensation plan for certain management employees. The liability for compensation deferred under this plan was \$27,500 and \$18,900 at March 3, 2001, and February 26, 2000, respectively, and is included in long-term liabilities. The Company has elected to match its liability under the plan through the purchase of life insurance. The cash value of the insurance, which includes funding for future deferrals, was \$33,900 and \$26,500 in fiscal 2001 and 2000, respectively, and is included in other assets. Both the asset and the liability are carried at fair value.

8. Income Taxes

The following is a reconciliation of income tax expense to the federal statutory tax rate:

	2001	2000	1999
Federal income tax at the statutory rate	\$224,518	\$196,899	\$123,087
State income taxes, net of federal benefit	26,942	22,503	14,206
Tax-exempt interest income	(9,006)	(5,592)	(3,232)
Other	3,186	1,690	1,334
Income tax expense	<u>\$245,640</u>	<u>\$215,500</u>	<u>\$135,395</u>
Effective tax rate	38.3%	38.3%	38.5%

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Income tax expense consists of the following:

		2001	2000	1999
Current:	Federal	\$179,314	\$164,938	\$120,892
	State	23,533	21,329	15,252
		<u>202,847</u>	<u>186,267</u>	<u>136,144</u>
Deferred:	Federal	37,850	25,725	(665)
	State	4,943	3,508	(84)
		<u>42,793</u>	<u>29,233</u>	<u>(749)</u>
Income tax expense		<u>\$245,640</u>	<u>\$215,500</u>	<u>\$135,395</u>

Deferred taxes are the result of differences between the basis of assets and liabilities for financial reporting and income tax purposes. Significant deferred tax assets and liabilities consist of the following:

	March 3 2001	Feb. 26 2000
Accrued expenses	\$ 46,481	\$ 19,001
Deferred revenues	13,057	25,009
Compensation and benefits	30,681	17,293
Inventory	8,319	—
Other	19,827	2,763
Total deferred tax assets	<u>118,365</u>	<u>64,066</u>
Property and equipment	93,454	42,937
Inventory	—	15,639
Other	4,870	4,606
Total deferred tax liabilities	<u>98,324</u>	<u>63,182</u>
Net deferred tax assets	<u>\$ 20,041</u>	<u>\$ 884</u>

Income taxes paid (net of refunds) were \$61,700, \$82,600 and \$84,000 in fiscal 2001, 2000 and 1999, respectively.

9. Legal Proceedings

The Company is involved in various legal proceedings arising during the normal course of conducting business. Management believes that the resolution of these proceedings, either individually or in the aggregate, will not have a significant adverse impact on the Company's consolidated financial statements.