



Amazon.com, Inc.*

The first 4 1/2 years of our journey have yielded some amazing results: we've now served over 17 million customers in over 150 countries and built the leading global e-commerce brand and platform. Jeffrey P. Bezos, Founder, CEO and Chairman of the Board, Amazon.com, Inc., 1999 Annual Report

As of the end of 1999, Amazon.com was the world's leading Internet retailer. Amazon's strategy was "to be the world's most customer-centric company where customers can find and discover anything they may want to buy online." As of November 2000, the Company's web site, www.amazon.com, claimed "Earth's Biggest Selection™ of products, including free electronic greeting cards, online auctions, and millions of books, CDs, videos, DVDs, toys and games, and electronics."

Amazon was founded in 1994 and began selling books on its web site in July 1995. Sales grew from \$511,000 in 1995 to over \$1,600,000,000 in 1999. As of the end of 1999, the Company was organized into three segments:

- Books, music and videos (U.S.) – this segment represented the Company's "traditional" businesses with Books dating from Company inception (July 1995), Music added in June 1998, and DVD/Video added in November 1998. Revenue for this segment totaled \$1.3 billion in 1999.
- Early stage businesses (U.S.) – this segment represented the Company's new ventures. Examples include: Auctions (March 1999); Electronics, Toys (both July 1999); and Home Improvement, Software, and Video Games (all November 1999). Revenue for this segment totaled \$163.8 million in 1999.
- International (non-U.S.) – this segment represented the Company's operations outside of the U.S. and included sites in the U.K. (www.amazon.co.uk) and Germany (www.amazon.de) – both launched in October 1998¹ and each rated as the number one most visited e-commerce site in their respective country, according to Media Metrix ratings for Europe released in January 2000.² Revenue for this segment totaled \$167.7 million in 1999 – approximately \$20 million more than Amazon's total revenue from *all* sources in 1997.

* This case was prepared by Robert M. Bowen and Jane Kennedy of the University of Washington and Angela Davis of Washington University (St. Louis) from publicly available data for class discussion purposes only. The comments of Michelle Hanlon and Kim Sawers are appreciated. August 2001.

¹ In 2000, sites were added in France (www.amazon.fr) and Japan (www.amazon.co.jp).

² See <http://www.mediametrix.com/landing.jsp>.

Original business strategy

Amazon started as an Internet bookseller. In the years leading up to Amazon's entry, book retailing had become increasingly competitive. Small, locally-owned shops had vanished in large numbers trying to compete with the pricing and inventory of superstores such as Barnes & Noble and Borders Books and Music. Indirect competition for books had also increased during the 1990s and included all other forms of leisure activity, e.g., games, sports, movies and television. In recent decades, the number of hours the average individual spent reading had declined, suggesting at best a stagnant total demand for books. In this challenging economic environment, Amazon launched its web site in July 1995 as the "world's biggest bookstore" – presumably because they were willing to find any book in print and sell it on-line. By 1997, they had become sufficiently successful that Barnes & Noble entered the market for on-line book sales at www.barnesandnoble.com.

Beyond books

By the beginning of 1998, Amazon was in the process of broadening its offerings beyond books. In June 1998, the Company added a music store to its web site selling primarily CDs. In April 1998, the Company completed the acquisition of Internet Movie Database Ltd., positioning itself for entry into video sales. In August 1998, Amazon announced plans to acquire two companies that some suggested could turn the Company into "the Wal-Mart of the Web, directing surfers to a shopping-cart full of household items" (*Seattle Post-Intelligencer*, August 5, 1998, p. D1).

In an interview with the *Wall Street Journal* (August 5, 1998, p. B1), Amazon CEO Jeff Bezos portrayed the latest Company expansion in 'friendly' terms: "At the broadest level, we're trying to enrich the customer experience of shopping on-line." According to David Risher, senior vice president for marketing and product development, "the long-term vision is that a person should be able to come to Amazon.com and find any product they may want to buy." (*Seattle P-I*, *ibid.*)

In 1999, Amazon entered into new agreements with strategic partners to sell products and services under co-branded sections of Amazon's web site. As of the end of 1999, partners included Sothebys, HomeGrocer.com, and Pets.com. Amazon referred to these relationships as the Amazon.com Commerce Network. See Exhibit 1 for a list of strategic partners.

Amazon at the end of 1999

Despite being a leader in the new world of on-line commerce, Amazon had yet to earn a profit and some analysts didn't see the Company becoming profitable any time soon. Among the many risks outlined in its 1999 10-K filed with the Securities and Exchange Commission, the Company included the following caution about future profitability and growth:

We have incurred significant losses since we began doing business. As of December 31, 1999, we had an accumulated deficit of \$882 million. We are incurring substantial operating losses and may continue to incur such losses for the foreseeable future. These losses may be significantly higher than current losses. To succeed, we must invest heavily in marketing and promotion and in developing our product offerings and technology and operating infrastructure. In addition, the expenses associated with our recent and future acquisitions and investments and interest expense related to our outstanding notes will adversely affect our operating results. Our aggressive pricing programs have resulted in relatively low product gross margins, so we need to generate and sustain substantially higher revenues in order to become profitable. Our historical growth rates are not sustainable and our percentage growth rate will decrease in the future. [p. 8]

Internet company valuation

Since Internet companies frequently report losses, analysts have looked to other metrics to evaluate these firms, including web traffic, customer base, revenues, and growth in each of these metrics. The logic is that traffic generates customers and revenue and revenue growth (eventually) leads to profitability. In other words, companies build the capacity to serve this anticipated growth and argue that, as they more fully utilize this capacity, economies of scale will lead to the promised land of profitability. The emphasis on revenues has led to alleged abuses. A recent article in *The Washington Post* (April 2, 2000) states:

The accounting problems begin with the fact that Internet companies tend to be valued not according to their profits – most of them don't have any, actually – but by their sales revenues. Fast growth in revenue is taken by Wall Street analysts as a proxy for future financial success. A hot (if unprofitable) New Economy company will trade at 200 times revenues, for example, while an Old Economy workhorse will trade at, say, 15 times its profits. It's a goofy rewards system, and it puts intense pressure on Internet CEOs to make their revenue numbers look bigger than they actually are.

Fortune cited some of the ways companies inflate these numbers. A flagrant example was Priceline.com, the high-flying web site that lets consumers name their own price for airline tickets and other services. *Fortune* noted that Priceline had reported \$152 million of revenue in its most recent quarterly SEC filing – even though that was the total “gross bookings” customers paid for tickets, hotel rooms and the like. After paying the companies that actually supplied all the goods and services, Priceline's revenues (which it weirdly calls “gross profit”) were just \$18 million. And after paying all its other costs, Priceline reported a net loss for the quarter of \$102 million.

In addition to the Priceline example of grossed-up revenue, the *Fortune* article “Presto Chango! Sales Are Huge!” (March 20, 2000), discusses the reporting of barter revenue. For Internet firms, barter revenue typically stems from the exchange of advertising space. In the case of barter transactions, firms record equal amounts of barter revenue and advertising expense. Hence, this practice does not impact net income (see Appendix 1 for sample journal entries). The recorded amount of revenue and expense is determined by managers’ assessment of the fair value of advertising surrendered on their site. Although media firms have long engaged in barter transactions, the portion of total revenue derived from barter transactions has generally not been significant. However, according to *Fortune*, the magnitude of barter revenue reported by Internet firms is often material: Specifically, “. . . it’s not unusual to find startups that derive half their revenues from barter, even established Web brands such as VerticalNet, Sportsline, and EDGAR Online can get more than 18%.”

The “Bubble” bursts

During 2000, stock prices of Internet firms fell dramatically. Amazon’s stock prices for 2000 are shown in Figure 1 and compared to the Standard & Poor’s 500 (an index of 500 generally mature firms) and the NASDAQ index (of generally smaller, higher-growth firms).

On Monday morning, June 26, 2000 the Today show’s co-anchor Katie Couric interviewed Jeff Bezos, founder and CEO of Amazon about the previous Friday’s analyst report that sent the company’s stock price skidding. Jeff referred to the report’s forecast of a cash shortage by early 2001 as ‘hogwash.’ He went on to reiterate that Amazon would be producing *positive* cash from operations in 2000. On Friday, June 23, MSNBC.com reported the following:

AMAZON SHARES plunged 8 1/8, or 19.35 percent, to 33 7/8 after Lehman Brothers fixed-income analyst Ravi Suria said that while Amazon may be one of the best-established brands on the Internet, “we find the credit extremely weak and deteriorating.” In addition, Suria cautioned that Amazon could run out of cash by the end of the first quarter of 2001. The combination of negative cash flow, poor working capital management and high debt load put Amazon under “extremely high risk,” Suria said.

Amazon spokesman Bill Curry called the Lehman report “pure hogwash” and said the company is “nowhere near running out of cash.” “We ended the first quarter with more than \$1 billion in cash and we expect to generate positive cash flow from operations over the rest of the year,” Curry said.

But those comments did little to stop the slide, and as of Friday’s close Amazon stock was down some 70 percent from its 52-week high of 113 in December.

If Suria’s comments weren’t bad enough, influential Internet stock analyst Mary Meeker of Morgan Stanley Dean Witter warned that there was probably “no upside” to

her second- and third-quarter revenue estimates for Amazon and that she saw no catalysts for the stock “until they make or break the December quarter.”

Meeker pointed to the slowdown in consumer retail spending for the pressure on Amazon’s revenues. Retail sales softened in May, falling 0.3 percent, after a 0.6-percent drop in April. Both declines were widely attributed to an increase in interest rates.

As of late 2000, some analysts continued to speculate that Amazon would experience cash flow problems in 2001.

The Data

Use data provided in Amazon's 1999 financial statements to address the questions below. State any assumptions you think are necessary. Attachments include:

- Appendix 1: Examples of internet accounting issues
- Appendix 2: Return on Equity and its Components
- Appendix 3: Data to calculate ROE and components for Amazon.com, 1996 – 1999.
- Figure 1: Amazon stock prices for 2000
- Exhibit 1: Strategic Relationships
- Exhibit 2: 1997 letter to shareholders and also appended to 1999 letter to shareholders
- Exhibit 3: Report of the Independent Auditors
- Exhibit 4: Balance Sheets for years ended December 31, 1998 and 1999.
- Exhibit 5: Statements of Operations for the years ended December 31, 1997, 1998, and 1999
- Exhibit 6: Statements of Cash Flows for the years ended December 31, 1997, 1998, and 1999
- Exhibit 7: Excerpts of notes to the financial statements

Questions:

A. Basic Financial Statement Analysis

1. ROE is a fundamental measure of performance used by analysts. Attached in Appendix 2 is an explanation of return on equity (ROE) and its components: profit margin (PM), asset turnover (AT), and financial leverage (L). Appendix 3 provides data necessary to compute these ratios for Amazon.com for the years 1996 through 1999. Calculate each of these four ratios for each year. Comment on any trends that you observe.
2. Despite a history of increasing losses, Amazon common stock had consistently commanded a high market value. At December 31, 1999, Amazon’s stock price was \$76.125 and the number of shares outstanding was 345,155(000). Calculate the market value of equity (a.k.a. the “market cap”) and the “market-to-book” ratio for Amazon at December 31, 1999. What factors supported the Company’s high market-to-book ratio at the end of 1999, i.e., the large difference between the stock market’s valuation and the Company’s accounting records? Finance.yahoo.com reports a market cap for Amazon of \$6.75 billion as of 23 January 2001. Speculate as to why Amazon’s market cap dropped so dramatically in 2000.
3. Analysts have argued that, for Amazon and other Internet companies to become profitable, they must generate ‘economies of scale.’ That is, Amazon must add costs at a lower rate than revenue increases. In theory, this is accomplished by spreading relatively fixed costs

such as a large distribution center over increasing sales. Consider each of the major expense categories on the income statement (i.e., Cost of sales, Marketing and sales, Technology and content, and General and administrative) and discuss whether Amazon's results are consistent or inconsistent with improving 'economies of scale' over time. Provide support for your analysis.

4. Amazon has touted its ability to use supplier credit to help finance the growth of the company. The purpose of this question is to compare total purchases in 1999 to the amount of cash paid to suppliers.
 - a. Note 1 discusses various accounting policies used by Amazon.com. Refer to the *Cost of Sales* paragraph and estimate the amount of purchases in 1999 assuming that cost of sales included costs in addition to the cost of merchandise purchased for resale. According to note 1, these additional costs amounted to \$227.3 million in 1999, and included outbound shipping costs (e.g., what UPS charges Amazon for shipments) and the cost of supplies used to package products for shipment.
 - b. Assuming all purchases of merchandise were made "on account" and all accounts payable related exclusively to credit from suppliers, estimate the amount of cash paid to suppliers in 1999.
 - c. What do you infer from comparing your estimates in parts a. and b. above?

B. Revenue Recognition for Internet companies

Net sales reported on Amazon's 1999 income statement is affected by many issues including: a) reporting revenue net of both coupons and discounts (versus reporting gross revenue and subtracting coupons and discounts in a separate expense category), b) including outbound shipping charged to customers in revenue (versus netting outbound shipping revenue against shipping costs), and c) reporting advertising barter revenue and related advertising expense (versus netting the two against each other), and d) recording advertising revenues associated with Amazon's exchange of advertising and promotional services for receipt of common stock of other companies. See appendix 1 for examples of internet accounting issues.

1. Amazon records revenue net of any promotional coupons or discounts. Assume coupons and discounts totaled \$120 million in 1999; what would be the effect on net sales and net loss from operations if revenue was recorded at the gross amount (before deducting promotional coupons and discounts from revenue) and the promotional coupons and discounts were *included* as a part of marketing and sales expense? Briefly explain why some Internet firms prefer to report using the gross method (one sentence should be sufficient)?
2. Outbound shipping charges of \$239 million were included in net sales for 1999. Is this practice conservative or aggressive? Why? What would be the effect on net sales and net loss from operations if the outbound shipping charges were *excluded* from net sales and *included* as an offset to shipping costs in cost of sales?
3. Internet companies frequently trade advertising on each other's sites. Some Internet companies report this transaction as "barter revenue" by recording equal and offsetting amounts in Advertising Expense and Advertising Revenue, respectively. If reported, the

amount is based on the market price for the traded advertising. Amazon does not appear to report advertising barter revenue in its financial statements. Assuming that Amazon engages in advertising barter of \$100 million, but elects not to record these barter transactions, is this practice conservative or aggressive? Why? What would be the effect on net sales and net loss from operations if Amazon had *included* this advertising barter revenue in net sales on the income statement?

4. During 1999, Amazon reported \$5.8 million of revenue associated with non-cash transactions where the Company received equity securities (i.e., common stock) of other companies in exchange for advertising and promotional services to be provided by Amazon over a fixed period of time. The Company recorded the fair value of these equity securities on the date received, \$54.4 million, and is recognizing revenue over the term of the agreements as the advertising and promotional services are provided. As an analyst, what would be your concerns (if any) regarding this practice?

C. Fulfillment costs

Below is the note on fulfillment costs for Amazon.com from the 1999 Annual Report.

Fulfillment Costs

Included in marketing and sales expense are fulfillment costs, which consist of the cost of operating and staffing distribution and customer service centers. Such costs include costs attributable to receiving, inspecting and warehousing inventories; picking, packaging and preparing customers' orders for shipment; and responding to inquiries from customers. Fulfillment costs totaled \$188.4 million, \$50.3 million and \$12.1 million in 1999, 1998 and 1997, respectively.

1. Some analysts argue that fulfillment costs should be included in the cost of sales. What would be the effect on gross profit and loss from operations in 1999 if fulfillment costs were added to the cost of sales? Why do you suppose Amazon included fulfillment costs among marketing and sales expense in the income statement? Is this conservative or aggressive – why?

D. Financial Statement Analysis revisited – adjusting for Revenue Recognition and Fulfillment costs

1. The purpose of this question is to assess the overall impact of the above accounting choices on Amazon's *reported* financial performance. Estimate revenues, gross profit and gross profit percentage (i.e., gross profit/net sales) for two hypothetical scenarios: a) Amazon makes the most aggressive choices, and b.) Amazon makes the most conservative choices. [To simply, you may omit the effects discussed in B.4. above.]
2. In your opinion, where do Amazon's actual reported numbers fit along the spectrum of conservative to aggressive?

E. Inventories

1. Speculate on the relative level of inventories carried by Amazon (e.g., inventory to sales) compared to a brick-and-mortar chain such as Barnes and Noble or W.H. Smith.
2. The last-in, first-out (LIFO) method of inventory valuation is common in the U.S. but is unusual in other countries. The paragraph on *Inventories* in note 1 describes the method used by Amazon.com. If purchase prices are gradually increasing over time, would Cost of Sales would be higher or lower if Amazon had elected to use LIFO instead of the “specific identification” method. Why?
3. Briefly speculate as to why Amazon uses specific identification (and not LIFO or FIFO) for financial reporting.

Appendix 1

Examples of Internet Accounting Issues

The purpose of this appendix is to briefly review five controversial accounting issues faced by many Internet firms. Each issue relates to revenue recognition and/or expense shifting from one category (typically cost of sales) to another (typically marketing). None of these issues affect net income. These issues are important because some argue that Internet company valuations are heavily influenced by levels of (and growth in) revenue and gross profit. Note that accounting standard setters (e.g., the FASB) are reviewing these issues.

Coupons and Discounts:

Coupons and discounts are common in retail transactions. Assume that a new customer uses a \$20 coupon to reduce the price of a \$100 purchase. The first potential journal entry would record the sale net of the coupon. Sales discounts is a contra-revenue account that reduces the main account, gross sales revenue:

DR: Cash/Acct. Receivable (A)	\$80	
DR: Sales discounts (X-Rev)	\$20	
CR: Sales Revenue (Rev)		\$100

Alternatively, the sale could be recorded at its gross amount and the coupon treated as part of Marketing and Sales expense, i.e., not as an offset to sales revenue.

DR: Cash/Acct. Receivable (A)	\$80	
DR: Marketing and sales (Exp)	\$20	
CR: Sales Revenue (Rev)		\$100

The latter approach results in higher revenues, higher gross profit and higher marketing and sales expense but net income is not affected.

Outbound Shipping Revenues (and Costs):

Outbound shipping charged to customers can be included in gross revenues or netted against related outbound shipping costs included in cost of goods sold. Assume that Amazon adds \$9 of shipping and handling to the price of a \$70 customer order for a total of \$79. Further assume that the item costs \$54 (including inbound shipping) and identifiable outbound shipping and handling costs total \$8. The first potential journal entry would include the shipping as part of sales revenue and cost of sales, respectively:

DR: Cash/Acct. Receivable (A)	\$79	
CR: Sales Revenue (Rev)		\$79
DR: Cost of Sales (Exp)	\$62	
CR: Inventories (A)		\$54
CR: Acct. pay. (e.g., UPS).		\$8

Alternatively, the sale could be recorded net of the outbound shipping and the amount of outbound shipping offset against the cost of sales:

DR: Cash/Acct. Receivable (A)	\$79	
CR: Sales Revenue (Rev)		\$70
CR: Cost of sales		\$9
DR: Cost of Sales (Exp)	\$62	
CR: Inventories (A)		\$54
CR: Acct. pay. (e.g., UPS).		\$8

Gross profit is \$17 on \$79 of revenues (or a gross profit percentage of 21.5%) in the first alternative while gross profit is \$17 on \$70 of revenue (24.3%) in the second alternative.

Barter Revenue:

Barter transactions typically involve a non-cash exchange of advertising by Internet firms. The journal entry a company would record for a barter transaction is as follows:

DR: Barter/Advertising exp.	?	
CR: Advertising Revenue		?

The question is what amount of revenue to report. U.S. GAAP states that the revenue and expense should be recognized at fair value only if the fair value of the advertising can be determined from past transactions. U.S. GAAP further states that if the fair value of the advertising surrendered cannot be determined, the transaction should likely be recorded at zero.

Note that firms engaged in barter transactions with positive fair value can still elect to take a conservative stance with respect to revenue recognition and not report any bartered advertising as revenue.

Reporting barter revenue results in higher revenues, higher gross profit and higher marketing and sales expense but net income is not affected.

Grossed-up Revenue:

Assume a customer purchases a \$300 airline ticket from an online “travel agent” and the agent receives a \$20 fee. The journal entry the company would record under the net method would be:

Net method:

DR: Accounts receivable/Cash	\$ 300	
CR: Revenue (Fees earned)		\$ 20
CR: Due to airline (L) or cash		280

Under the grossed-up method, the gross price of the ticket is recorded as revenue and the related cost of the ticket is recorded as Cost of Sales:

Grossed-up method:

DR: Accounts receivable/Cash	\$300	
CR: Sales Revenue		\$300

DR: Cost of sales (Exp)	280	
CR: Due to airline (L) or cash		280

Reporting grossed-up revenue results in higher revenues – but the same gross profit and net income.

Fulfillment Costs:

Fulfillment costs include the cost of operating and staffing warehouses and customer service centers. Amazon states that their fulfillment costs “include costs attributable to receiving, inspecting and warehousing inventories; picking, packaging and preparing customers’ orders for shipment; and responding to inquiries from customers.” Amazon includes these costs in Marketing and sales expense:

DR: Marketing and sales (Exp)	\$x	
CR: Cash, Payables, etc.		\$x

Some analysts argue that most of these costs belong in cost of sales rather than in marketing and sales.

DR: Cost of Sales (Exp)	\$x	
CR: Inventories (A)		\$y
CR: Cash, Payables, etc.		\$z

Reporting fulfillment costs in Cost of sales would reduce gross profit and marketing and sales expense but not affect net income.

Appendix 2

Return on Equity and its Components³

Return on equity is currently the most popular measure of financial performance. Senior managers and analysts use ROE to compare performance across time and across companies. ROE is popular because it measures the efficiency with which management uses the owner's capital. In short, it measures the "bang per Euro" (franc, buck, peso, pound, lira, yen, etc.).

ROE is measured as net income divided by shareholders' equity.⁴ ROE can be evaluated in terms of three components as follows:

$$\text{ROE} = \text{NI/Sales} \times \text{Sales/Assets(Avg.)} \times \text{Assets (Avg.)/SE (Avg.)} = \text{NI/SE (Avg.)}$$

Management can influence ROE through these three basic components. The first component, profit margin (NI/Sales), provides information on the amount of profit squeezed out of each dollar of sales. The second component, asset turnover (Sales/Assets), measures the amount of sales generated by each dollar of assets employed. The third component, financial leverage (Assets/SE), measures the amount of assets financed per dollar of shareholders' equity. The greater the debt owed by a corporation, the greater the financial leverage and the higher this ratio. If management acts to increase any of these components, ROE will increase with a few exceptions. For example, if profit margin is negative, increasing leverage will *decrease* ROE. Companies with similar ROE may have markedly different components.

³ This brief section is based on material in "Analysis for Financial Management" (Sixth edition, Irwin McGraw-Hill, Boston), by Robert C. Higgins.

⁴ Shareholders' equity can be measured at the beginning, ending or average for a period. A case can be made for any of these choices but we prefer average assets (if the data are available). It is important to be consistent or know what denominator is being used when comparing ROE across firms.

Appendix 3

Analysis of ROE and its Components for Amazon.com, 1996-1999**Amazon.com: Analysis of ROE**

Fiscal Year Ended December 31:	2000	1999	1998	1997	1996
Assets		\$2,471,551	\$648,460	\$149,006	\$8,271
Liabilities		\$2,205,273	\$509,715	\$120,520	\$4,870
Shareholders' equity (SE)		\$266,278	\$138,745	\$28,486	\$3,401
Average Assets		\$1,560,006	\$398,733	\$78,639	\$4,136
Average SE		\$202,512	\$83,616	\$15,944	\$1,701
Sales		\$1,639,839	\$609,819	\$147,787	\$15,746
Net Income		(\$719,968)	(\$124,546)	(\$31,020)	(\$5,777)

Profit Margin (PM)*

Asset Turnover (AT)*

Leverage (L)*

ROE= PM x AT x L

ROE = NI/SE

*See Appendix 2 (not the textbook) for definitions of these ratios.

Figure 1
Amazon Stock prices compared to the S&P 500 and the NASDAQ index

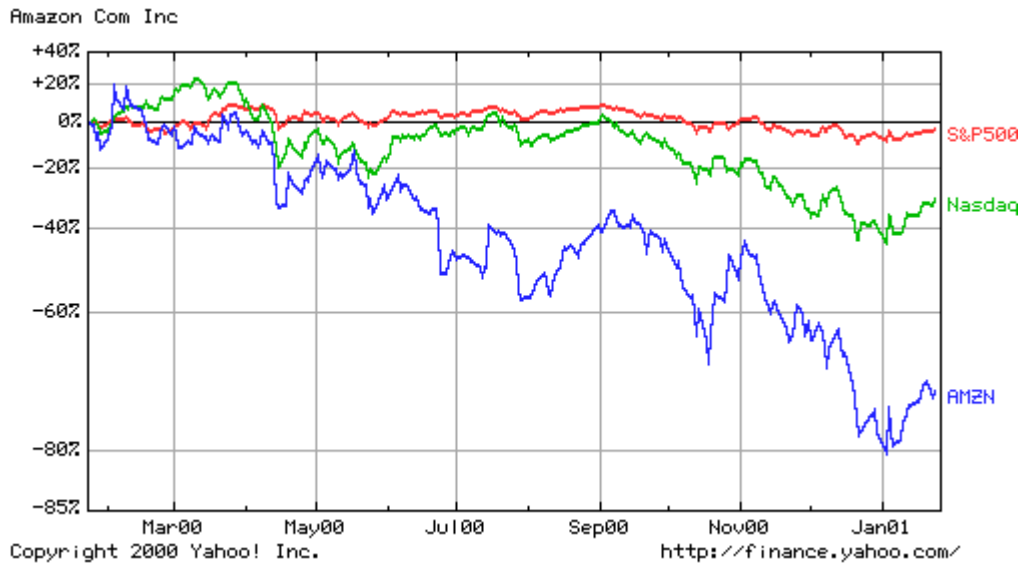


Exhibit 1 Strategic Partnerships

Amazon's November 2000 web site featured partner companies that shared similar values including "vast selection, incredible customer experience, and a great online shopping experience." These partners include:

- [drugstore.com](http://www.drugstore.com), an online retail and information source for health, beauty, wellness, personal care, and pharmacy, at www.drugstore.com.
- [Gear.com](http://www.gear.com), an online sporting-goods company that offers extraordinary deals on new equipment in a wide range of categories, at www.gear.com.
- [HomeGrocer.com](http://www.homegrocer.com), the first fully integrated Internet grocery-shopping and home-delivery service, with operations in Seattle; Portland, Oregon; Orange County, Los Angeles County, and San Diego, California; and Dallas, at www.homegrocer.com.
- [Ashford.com](http://www.ashford.com), an online retailer of luxury and premium products offering new and vintage watches, fragrances, leather accessories, sunglasses, and writing instruments, at www.ashford.com
- [eZiba.com](http://www.eziba.com), a leading online retailer of handcrafted products from around the world, at www.eziba.com.

As of the end of 1999, other partners included:

- Audible.com, Internet-delivered spoke audio for PC-based listening or playback devices
- Della.com, online service for gift registry, gift advice and personalized gift suggestions.
- Greenlight.com, online auto purchasing in partnership with local dealerships
- Kozmo.com, online one-hour delivery service for entertainment and convenience products
- Living.com, online retailer of home products and services
- NextCard, Inc., online issuer of credit cards
- Pets.com, online source of pet products, information and services. In early November 2000, Pets.com announced it would be ceasing operations and liquidating the assets of the Company.
- Sothebys, auction site devoted to art, antiques and collectibles

Exhibit 2
1997 Annual Report Letter to shareholders

Also appended to the 1999 annual report

To our shareholders:

Amazon.com passed many milestones in 1997: by year-end, we had served more than 1.5 million customers, yielding 838% revenue growth to \$147.8 million, and extended our market leadership despite aggressive competitive entry.

But this is Day 1 for the Internet and, if we execute well, for Amazon.com. Today, online commerce saves customers money and precious time. Tomorrow, through personalization, online commerce will accelerate the very process of discovery. Amazon.com uses the Internet to create real value for its customers and, by doing so, hopes to create an enduring franchise, even in established and large markets.

We have a window of opportunity as larger players marshal the resources to pursue the online opportunity and as customers, new to purchasing online, are receptive to forming new relationships. The competitive landscape has continued to evolve at a fast pace. Many large players have moved online with credible offerings and have devoted substantial energy and resources to building awareness, traffic, and sales. Our goal is to move quickly to solidify and extend our current position while we begin to pursue the online commerce opportunities in other areas. We see substantial opportunity in the large markets we are targeting. This strategy is not without risk: it requires serious investment and crisp execution against established franchise leaders.

It's All About the Long Term

We believe that a fundamental measure of our success will be the shareholder value we create over the long term. This value will be a direct result of our ability to extend and solidify our current market leadership position. The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital.

Our decisions have consistently reflected this focus. We first measure ourselves in terms of the metrics most indicative of our market leadership: customer and revenue growth, the degree to which our customers continue to purchase from us on a repeat basis, and the strength of our brand. We have invested and will continue to invest aggressively to expand and leverage our customer base, brand, and infrastructure as we move to establish an enduring franchise.

Because of our emphasis on the long term, we may make decisions and weigh tradeoffs differently than some companies. Accordingly, we want to share with you our fundamental management and decision-making approach so that you, our shareholders, may confirm that it is consistent with your investment philosophy:

- We will continue to focus relentlessly on our customers.
- We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions.
- We will continue to measure our programs and the effectiveness of our investments analytically, to jettison those that do not provide acceptable returns, and to step up our investment in those that work best. We will continue to learn from both our successes and our failures.
- We will make bold rather than timid investment decisions where we see a sufficient probability of gaining market leadership advantages. Some of these investments will pay off, others will not, and we will have learned another valuable lesson in either case.
- When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows.
- We will share our strategic thought processes with you when we make bold choices (to the extent competitive pressures allow), so that you may evaluate for yourselves whether we are making rational long-term leadership investments.

- We will work hard to spend wisely and maintain our lean culture. We understand the importance of continually reinforcing a cost-conscious culture, particularly in a business incurring net losses.
- We will balance our focus on growth with emphasis on long-term profitability and capital management. At this stage, we choose to prioritize growth because we believe that scale is central to achieving the potential of our business model.
- We will continue to focus on hiring and retaining versatile and talented employees, and continue to weight their compensation to stock options rather than cash. We know our success will be largely affected by our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner.

We aren't so bold as to claim that the above is the "right" investment philosophy, but it's ours, and we would be remiss if we weren't clear in the approach we have taken and will continue to take.

With this foundation, we would like to turn to a review of our business focus, our progress in 1997, and our outlook for the future.

Obsess Over Customers

From the beginning, our focus has been on offering our customers compelling value. We realized that the Web was, and still is, the World Wide Wait. Therefore, we set out to offer customers something they simply could not get any other way, and began serving them with books. We brought them much more selection than was possible in a physical store (our store would now occupy 6 football fields), and presented it in a useful, easy-to-search, and easy-to-browse format in a store open 365 days a year, 24 hours a day. We maintained a dogged focus on improving the shopping experience, and in 1997 substantially enhanced our store. We now offer customers gift certificates, 1-Click(SM) shopping, and vastly more reviews, content, browsing options, and recommendation features. We dramatically lowered prices, further increasing customer value. Word of mouth remains the most powerful customer acquisition tool we have, and we are grateful for the trust our customers have placed in us. Repeat purchases and word of mouth have combined to make Amazon.com the market leader in online bookselling.

By many measures, Amazon.com came a long way in 1997:

- Sales grew from \$15.7 million in 1996 to \$147.8 million -- an 838% increase.
- Cumulative customer accounts grew from 180,000 to 1,510,000 -- a 738% increase.
- The percentage of orders from repeat customers grew from over 46% in the fourth quarter of 1996 to over 58% in the same period in 1997.
- In terms of audience reach, per Media Metrix, our Web site went from a rank of 90th to within the top 20.
- We established long-term relationships with many important strategic partners, including America Online, Yahoo!, Excite, Netscape, GeoCities, AltaVista, @Home, and Prodigy.

Infrastructure

- During 1997, we worked hard to expand our business infrastructure to support these greatly increased traffic, sales, and service levels:
- Amazon.com's employee base grew from 158 to 614, and we significantly strengthened our management team.
- Distribution center capacity grew from 50,000 to 285,000 square feet, including a 70% expansion of our Seattle facilities and the launch of our second distribution center in Delaware in November.
- Inventories rose to over 200,000 titles at year-end, enabling us to improve availability for our customers.
- Our cash and investment balances at year-end were \$125 million, thanks to our initial public offering in May 1997 and our \$75 million loan, affording us substantial strategic flexibility.

Our Employees

The past year's success is the product of a talented, smart, hard-working group, and I take great pride in being a part of this team. Setting the bar high in our approach to hiring has been, and will continue to be, the single most important element of Amazon.com's success.

It's not easy to work here (when I interview people I tell them, "You can work long, hard, or smart, but at Amazon.com you can't choose two out of three"), but we are working to build something important, something that matters to our customers, something that we can all tell our grandchildren about. Such things aren't meant to be easy. We are incredibly fortunate to have this group of dedicated employees whose sacrifices and passion build Amazon.com.

Goals for 1998

We are still in the early stages of learning how to bring new value to our customers through Internet commerce and merchandising. Our goal remains to continue to solidify and extend our brand and customer base. This requires sustained investment in systems and infrastructure to support outstanding customer convenience, selection, and service while we grow. We are planning to add music to our product offering, and over time we believe that other products may be prudent investments. We also believe there are significant opportunities to better serve our customers overseas, such as reducing delivery times and better tailoring the customer experience. To be certain, a big part of the challenge for us will lie not in finding new ways to expand our business, but in prioritizing our investments.

We now know vastly more about online commerce than when Amazon.com was founded, but we still have so much to learn. Though we are optimistic, we must remain vigilant and maintain a sense of urgency. The challenges and hurdles we will face to make our long-term vision for Amazon.com a reality are several: aggressive, capable, well-funded competition; considerable growth challenges and execution risk; the risks of product and geographic expansion; and the need for large continuing investments to meet an expanding market opportunity. However, as we've long said, online bookselling, and online commerce in general, should prove to be a very large market, and it's likely that a number of companies will see significant benefit. We feel good about what we've done, and even more excited about what we want to do.

1997 was indeed an incredible year. We at Amazon.com are grateful to our customers for their business and trust, to each other for our hard work, and to our shareholders for their support and encouragement.

Jeffrey P. Bezos
Founder and Chief Executive Officer
Amazon.com, Inc.

Exhibit 3

1999 10-K filed with the SEC

REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Board of Directors and Stockholders
Amazon.com, Inc.

We have audited the accompanying consolidated balance sheets of Amazon.com, Inc. as of December 31, 1999 and 1998, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 1999. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Amazon.com, Inc. at December 31, 1999 and 1998, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ ERNST & YOUNG LLP

Seattle, Washington
February 2, 2000, except for Note 15
as to which the date is February 16, 2000

Exhibit 4

AMAZON.COM, INC.

CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

ASSETS

	DECEMBER 31,	
	1999	1998
Current assets:		
Cash.....	\$ 116,962	\$ 25,561
Marketable securities.....	589,226	347,884
Inventories.....	220,646	29,501
Prepaid expenses and other current assets.....	85,344	21,308
	-----	-----
Total current assets.....	1,012,178	424,254
Fixed assets, net.....	317,613	29,791
Goodwill, net.....	534,699	174,052
Other purchased intangibles, net.....	195,445	4,586
Investments in equity-method investees.....	226,727	7,740
Other investments.....	144,735	--
Deferred charges and other.....	40,154	8,037
	-----	-----
Total assets.....	\$2,471,551	\$648,460
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable.....	\$ 463,026	\$113,273
Accrued expenses and other current liabilities.....	126,017	34,413
Accrued advertising.....	55,892	13,071
Deferred revenue.....	54,790	--
Interest payable.....	24,888	10
Current portion of long-term debt and other.....	14,322	808
	-----	-----
Total current liabilities.....	738,935	161,575
Long-term debt and other.....	1,466,338	348,140
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.01 par value:		
Authorized shares -- 150,000		
Issued and outstanding shares -- none.....	--	--
Common stock, \$0.01 par value:		
Authorized shares -- 1,500,000		
Issued and outstanding shares -- 345,155 and 318,534		
shares at December 31, 1999 and 1998, respectively....	3,452	3,186
Additional paid-in capital.....	1,195,540	298,537
Note receivable for common stock.....	(1,171)	(1,099)
Stock-based compensation.....	(47,806)	(1,625)
Accumulated other comprehensive income (loss).....	(1,709)	1,806
Accumulated deficit.....	(882,028)	(162,060)
	-----	-----
Total stockholders' equity.....	266,278	138,745
	-----	-----
Total liabilities and stockholders' equity.....	\$2,471,551	\$648,460
	=====	=====

See accompanying notes to consolidated financial statements.

Exhibit 5

AMAZON.COM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	YEARS ENDED DECEMBER 31,		
	1999	1998	1997
Net sales.....	\$1,639,839	\$ 609,819	\$147,787
Cost of sales.....	1,349,194	476,155	118,969
Gross profit.....	290,645	133,664	28,818
Operating expenses:			
Marketing and sales.....	413,150	132,654	40,077
Technology and content.....	159,722	46,424	13,384
General and administrative.....	70,144	15,618	6,741
Stock-based compensation.....	30,618	1,889	1,211
Amortization of goodwill and other intangibles.....	214,694	42,599	--
Merger, acquisition and investment-related costs.....	8,072	3,535	--
Total operating expenses.....	896,400	242,719	61,413
Loss from operations.....	(605,755)	(109,055)	(32,595)
Interest income.....	45,451	14,053	1,901
Interest expense.....	(84,566)	(26,639)	(326)
Other income, net.....	1,671	--	--
Net interest income (expense) and other.....	(37,444)	(12,586)	1,575
Loss before equity in losses of equity-method investees.....	(643,199)	(121,641)	(31,020)
Equity in losses of equity-method investees.....	(76,769)	(2,905)	--
Net loss.....	\$ (719,968)	\$ (124,546)	\$ (31,020)
Basic and diluted loss per share.....	\$ (2.20)	\$ (0.42)	\$ (0.12)
Shares used in computation of basic and diluted loss per share.....	326,753	296,344	260,682

See accompanying notes to consolidated financial statements.

Exhibit 6

AMAZON.COM, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	YEARS ENDED DECEMBER 31,		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
OPERATING ACTIVITIES:			
Net loss.....	\$ (719,968)	\$ (124,546)	\$ (31,020)
Adjustments to reconcile net loss to net cash provided (used) in operating activities:			
Depreciation and amortization of fixed assets.....	36,806	9,421	3,442
Amortization of deferred stock-based compensation.....	30,618	2,386	1,354
Equity in losses of equity-method investees.....	76,769	2,905	--
Amortization of goodwill and other intangibles.....	214,694	42,599	--
Non-cash merger, acquisition, and investment related costs.....	8,072	1,561	--
Non-cash revenue for advertising and promotional services.....	(5,837)	--	--
Loss on sale of marketable securities.....	8,688	271	--
Non-cash interest expense.....	29,171	23,970	64
	-----	-----	-----
Net cash used in operating activities before changes in operating assets and liabilities.....	(320,987)	(41,433)	(26,160)
Changes in operating assets and liabilities, net of effects from acquisitions:			
Inventories.....	(172,069)	(20,513)	(8,400)
Prepaid expenses and other current assets.....	(60,628)	(16,758)	(3,055)
Accounts payable.....	330,166	78,674	30,172
Accrued expenses and other current liabilities.....	65,121	21,615	5,274
Accrued advertising.....	42,382	9,617	2,856
Deferred revenue.....	262	--	--
Interest payable.....	24,878	(167)	--
	-----	-----	-----
Net cash provided by changes in operating assets and liabilities, net of effects from acquisitions.....	230,112	72,468	26,847
	-----	-----	-----
Net cash provided (used) in operating activities.....	(90,875)	31,035	687
INVESTING ACTIVITIES:			
Sales and maturities of marketable securities.....	4,024,551	332,084	4,311
Purchases of marketable securities.....	(4,290,173)	(546,509)	(122,385)
Purchases of fixed assets.....	(287,055)	(28,333)	(7,603)
Acquisitions and investments in businesses, net of cash acquired.....	(369,607)	(19,019)	--
	-----	-----	-----
Net cash used in investing activities.....	(922,284)	(261,777)	(125,677)
FINANCING ACTIVITIES:			
Proceeds from issuance of capital stock and exercise of stock options.....	64,469	14,366	53,358
Proceeds from long-term debt.....	1,263,639	325,987	75,000
Repayment of long-term debt.....	(188,886)	(78,108)	(47)
Financing costs.....	(35,151)	(7,783)	(2,309)
	-----	-----	-----
Net cash provided by financing activities.....	1,104,071	254,462	126,002
Effect of exchange rate changes.....	489	(35)	--
	-----	-----	-----
Net increase in cash.....	91,401	23,685	1,012
Cash at beginning of period.....	25,561	1,876	864
	-----	-----	-----
Cash at end of period.....	\$ 116,962	\$ 25,561	\$ 1,876
	=====	=====	=====
SUPPLEMENTAL CASH FLOW INFORMATION:			
Fixed assets acquired under capital leases.....	\$ 25,850	\$ --	\$ 3,463
Fixed assets acquired under financing agreements.....	5,608	--	1,500
Stock issued in connection with business acquisitions.....	774,409	217,241	--
Equity securities of other companies received for non-cash revenue for advertising and promotional services.....	54,402	--	--
Cash paid for interest, net of amounts capitalized.....	59,688	26,629	326

Exhibit 7

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 -- ACCOUNTING POLICIES

Description of Business

Amazon.com, Inc. (Amazon.com or the Company) was incorporated in July 1994 and opened its virtual doors on the Web in July 1995. Amazon.com is an Internet retailer offering more than 18 million unique items in categories including books, music, DVD/video, toys, electronics, software, video games and home improvement products. Amazon.com offers a free electronic greeting card service and also provides a community of online shoppers with an easy and safe way to purchase and sell a large selection of products through Amazon.com Auctions and zShops.

Business Combinations and Investments

For business combinations that have been accounted for under the purchase method of accounting, the Company includes the results of operations of the acquired business from the date of acquisition. Net assets of the companies acquired are recorded at their fair value at the date of acquisition. The excess of the purchase price over the fair value of tangible and identifiable intangible net assets acquired is included in goodwill in the accompanying consolidated balance sheets.

One business combination in 1998 was accounted for under the pooling of interests method of accounting. In this case, the assets, liabilities and stockholders' equity of the acquired entity was combined with the Company's respective accounts at recorded values. The consolidated financial statements reflect the restatement of all periods presented to include the accounts of the acquired entity accounted for under the pooling of interests method of accounting. The historical results of the pooled entity reflect its actual operating cost structures and, as a result, do not necessarily reflect the cost structure of the newly combined entity. The historical results do not purport to be indicative of future results.

Investments in affiliated entities in which the Company has the ability to exercise significant influence, but not control, of an investee, generally an ownership interest of the voting stock of between 20% and 50%, are accounted for under the equity method of accounting. Accordingly, under the equity method of accounting, the Company's share of the investee's earnings or loss is included in the consolidated statements of operations. The Company records its investments in equity-method investees on the consolidated balance sheets as "Investments in equity-method investees" and its share of the investees' earnings or losses in "Equity in losses of equity-method investees." The portion of the Company's investment in an equity-method investee that exceeds its claim of the net assets of the investee, if any, is assigned to goodwill and amortized over a period of three years. The goodwill amount, which was \$24.8 million as of December 31, 1999, is included in "Investments in equity-method investees" in the accompanying consolidated balance sheets, and the amortization of the goodwill is included in "Equity in losses of equity-method investees" in the accompanying consolidated statements of operations.

All other investments, which consist of investments for which the Company does not have the ability to exercise significant influence, are accounted for under the cost method of accounting. Dividends and other distributions of earnings from other investees, if any, are included in income when declared. The Company periodically evaluates the carrying value of its investments accounted for under the cost method of accounting and as of December 31, 1999 and 1998, such investments were recorded at the lower of cost or estimated net realizable value.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Marketable Securities

The Company's marketable securities, which consist primarily of high-quality short-to intermediate-term fixed income securities and money market mutual funds, are classified as available-for-sale and are reported at fair value. Unrealized gains and losses are reported, net of taxes, as a component of stockholders' equity within accumulated other comprehensive income. Unrealized losses are charged against income when a decline in fair value is determined to be other than temporary. The specific identification method is used to determine the cost of securities sold. The Company classifies all investments of cash as marketable securities, including highly liquid investments with maturities of three months or less, and reflects the related cash flows as investing cash flows. As a result of the classification of highly liquid investments within marketable securities, a significant portion of the Company's gross marketable securities purchases and maturities disclosed as investing cash flows is related to highly liquid investments.

Inventories

Inventories, consisting of products available for sale, are valued at the lower of cost (specific identification) or market.

Fixed Assets

Fixed assets are stated at cost less accumulated depreciation and amortization, which includes the amortization of assets recorded under capital leases. Fixed assets are depreciated on a straight-line basis over the estimated useful lives of the assets (generally two to ten years). Fixed assets purchased under capital leases are amortized on a straight-line basis over the lesser of the estimated useful life of the asset or the lease term.

Included in fixed assets is the cost of internal-use software, including software used in connection with the Company's Web sites. The Company expenses all costs related to the development of internal-use software other than those incurred during the application development stage. Costs incurred during the application development stage are capitalized and amortized over the estimated useful life of the software (generally two years).

Goodwill, Net

Goodwill, net, represents the excess of the purchase price over the fair value of assets acquired in business acquisitions accounted for under the purchase method. Goodwill is presented net of related accumulated amortization and is being amortized over lives ranging from two to four years.

Other Purchased Intangibles, Net

Other purchased intangibles, net, include identifiable intangible assets purchased by the Company, primarily in connection with business acquisitions. Other purchased intangibles are presented net of related accumulated amortization and are being amortized over lives ranging from two to four years.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Long-Lived Assets

The carrying values of intangible assets and other long-lived assets, including equity-method investments, are reviewed on a regular basis for the existence of facts or circumstances, both internally and externally, that may suggest impairment. To date, no such impairment has been indicated.

Fair Value of Financial Instruments

The carrying amounts for the Company's cash, accounts payable and other liabilities approximate fair value. The fair market value for long-term debt and marketable securities is based on quoted market prices where available.

Deferred Charges

Deferred charges consist of fees associated with the issuance of the Company's debt. The fees are being amortized and included in interest expense over the life of the related debt.

Deferred Revenue

Deferred revenue consists of advertising fees to be earned in the future under agreements existing at the balance sheet date.

Income Taxes

The Company recognizes deferred tax assets and liabilities based on differences between the financial reporting and tax bases of assets and liabilities using the enacted tax rates and laws that are expected to be in effect when the differences are expected to be recovered. The Company provides a valuation allowance for deferred tax assets for which it does not consider realization of such assets to be more likely than not.

Revenue Recognition

The Company recognizes revenue from product sales, net of any promotional gift certificates, when the products are shipped to customers, which is also when title passes to customers. Outbound shipping charges are included in net sales and amounted to \$239.0 million, \$94.1 million and \$24.8 million in 1999, 1998 and 1997, respectively. Revenue from gift certificates is recognized upon product shipment following redemption. The Company provides an allowance for sales returns based on historical experience. Revenues from services are recorded at the time the related service is performed.

During 1999, the Company recorded approximately \$5.8 million of revenue associated with noncash transactions whereby the Company received equity securities of other companies in exchange for advertising and promotional services to be provided for a fixed period of time. The Company recorded the fair value of the consideration on the date received, \$54.4 million, and is recognizing revenue ratably over the term of the agreements as the advertising and promotional services are provided.

Cost of Sales

Cost of sales consists of the actual cost of products purchased for resale and related in-bound shipping charges, out-bound shipping charges, and the actual cost of tangible supplies used to package products for shipment to customers. Outbound shipping charges and the cost of tangible supplies used to package products for shipment to customers totaled \$227.3 million, \$75.9 million and \$20.4 million in 1999, 1998 and 1997, respectively.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Fulfillment Costs

Included in marketing and sales expense are fulfillment costs, which consist of the cost of operating and staffing distribution and customer service centers. Such costs include those attributable to receiving, inspecting and warehousing inventories; picking, packaging and preparing customers' orders for shipment; and responding to inquiries from customers. Fulfillment costs amounted to \$188.4 million, \$50.3 million and \$12.1 million in 1999, 1998 and 1997, respectively.

Advertising Costs

The cost of advertising is expensed as incurred. For the years ended December 31, 1999, 1998 and 1997, the Company incurred advertising expense of \$140.9 million, \$60.2 million and \$21.2 million, respectively.

Technology and Content

Technology and content expenses consist principally of payroll and related expenses for development, editorial, systems and telecommunications operations personnel and consultants, systems and telecommunications infrastructure and costs of acquired content.

Technology and content costs are generally expensed as incurred, except for certain costs relating to the development of internal-use software, including those relating to the Company's Web sites, that are capitalized and depreciated over estimated useful lives.

Stock-Based Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and related interpretations, in accounting for its employee stock options rather than the alternative fair value accounting allowed by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. APB No. 25 provides that the compensation expense relative to the Company's employee stock options is measured based on the intrinsic value of the stock option. SFAS No. 123 requires companies that continue to follow APB No. 25 to provide a pro forma disclosure of the impact of applying the fair value method of SFAS No. 123.

Foreign Currency Translation

The functional currency of the Company's foreign subsidiaries is the local currency. Assets and liabilities of foreign subsidiaries are translated into US dollars at year-end exchange rates, and revenues and expenses are translated at average rates prevailing during the year. Translation adjustments are included in accumulated other comprehensive income, a separate component of stockholders' equity. Transaction gains and losses arising from transactions denominated in a currency other than the functional currency of the entity involved, which have been insignificant, are included in the consolidated statements of operations. To date, the Company has entered into no foreign currency exchange contracts.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of its holdings of cash and marketable securities. The Company's credit risk is managed by investing its cash and marketable securities in high-quality money market instruments and securities of the US government and its agencies, foreign governments and high-quality corporate issuers. At December 31, 1999 and 1998, the Company had no significant concentrations of credit risk.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Earnings (Loss) Per Share

Basic earnings per share excludes any dilutive effects of options, warrants and convertible securities. Basic earnings per share is computed using the weighted average number of common shares outstanding, net of shares subject to repurchase, during the period. Diluted earnings per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the period. Common equivalent shares are excluded from the computation if their effect is antidilutive.

As a result of the Company's initial public offering in May 1997, all preferred stock automatically converted into common stock. Accordingly, the 1997 net loss per share is a pro forma loss per share based on the weighted average number of shares of common stock outstanding and preferred stock on an "as if" converted basis outstanding during each period. The Company believes that this is a more meaningful presentation of earnings per share for periods prior to its initial public offering.

New Accounting Pronouncements

In December 1999, the Securities and Exchange Commission staff released Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB No. 101), which provides guidance on the recognition, presentation and disclosure of revenue in financial statements. SAB No. 101 did not impact the Company's revenue recognition policies.

In June 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. As amended by SFAS No. 137, SFAS No. 133 is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. SFAS No. 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designed as part of a hedge transaction and, if it is, the type of hedge transaction. The Company has not yet determined the impact of the adoption of SFAS No. 133 on its consolidated financial statements or business practices.

Reclassifications

Certain prior year balances have been reclassified to conform to the current year presentation.