



Amazon.com's Pro Forma Earnings Target*

"We continue to make progress toward reaching pro forma operating profitability in the fourth quarter of 2001." Warren Jenson, chief financial officer, Amazon.com, Inc., second quarter earnings announcement, July 23, 2001¹

Amazon.com, the world's leading Internet retailer, has never earned a profit. After the sharp decline in Internet stock prices and some visible failures during 2000 (e.g., Pets.com), Amazon decided to shift strategies from growth and market share to becoming profitable by the end of 2001. On January 30, 2001, Warren Jenson, Amazon's CFO stated:

"Over the past year, our U.S. pro forma operating loss decreased from 24 percent of net sales in the fourth quarter of 1999 to less than 2 percent in the fourth quarter of 2000. While the strength of consumer spending remains uncertain, and there are no guarantees, we expect Amazon.com as a whole to reach operating profitability in the fourth quarter of this year."

Thus, Amazon has set a well-publicized earnings target for 2001, albeit not one based on GAAP earnings. Pro forma earnings are GAAP earnings after eliminating selected items that would normally appear on the income statement such as goodwill amortization. The practice has been criticized in the financial press, e.g., see "Brazilianriver.com" in Exhibit 1.² Responding to similar criticism, Amazon reconciled GAAP and pro forma earnings for the first time in its first quarter 2001 financial statements. Attached are data from Amazon's third quarter 2001 financial statements announced on October 23, 2001. Use these statements to address the questions below. State any assumptions you think are necessary. Attachments include:

- Exhibit 1: "Brazilianriver.com"
- Exhibit 2: Balance Sheets for June 30, 2001 and December 31, 2000.
- Exhibit 3: Pro Forma Earnings data for nine months and three months ending September 2001
- Exhibit 4: Statements of Cash Flows for nine months and three months ending September 2001
- Exhibit 5: Stock prices leading up to the 3rd quarter earnings announcement

* This case was prepared by Robert M. Bowen, Brooke Elliott, Frank Hodge and Jane Kennedy of the University of Washington from publicly available data for class discussion purposes only. First draft, October 18, 2001

¹ To listen to Warren Jenson giving a powerpoint presentation to analysts on June 5, 2001, see <http://www03.activate.net/streeffusion/amzn/jun/index.htm>.

² According to Dow Jones Business News, June 18, 2001, the Chief Accountant of the SEC, Lynn Turner, says the SEC is investigating four companies it suspects might be trying to deceive investors by issuing so called pro forma earnings.

Questions:

1. What amount of pro forma earnings does Amazon report for the nine months ended September 30, 2001? How does pro forma earnings compare to GAAP earnings? How does pro forma earnings differ from pro forma *operating* earnings? Which amount is Amazon predicting to be positive in the fourth quarter of 2001? What progress is the company making?
2. From an analyst's perspective, why would you want to see pro forma earnings rather than GAAP earnings? What concerns would you have about pro forma earnings?
3. We have not yet studied most of the items for which Amazon adjusts GAAP earnings to arrive at pro forma earnings. Below is a brief description of each item. Assuming you are an analyst trying to estimate the economic performance of the company, comment on whether you support each adjustment.
 - Stock based compensation – non-cash expense related to granting employees stock options. [We will study accounting for stock options in our second Microsoft case.]
 - Amortization of goodwill and other intangibles – Amazon acquired other companies (sometimes with cash but often by issuing additional common stock) at a price greater than the market value of the net assets (A-L). This premium is called 'goodwill' and was required to be amortized over no longer than 40 years.
 - Restructuring-related and other – costs related to reorganizing and/or eliminating business activities
 - Other gains, net – non-cash gains related to, say, the sale of property at greater than its book value (depreciated cost).
 - Equity in losses of equity-method investees – Amazon's non-cash pro-rata share of the earnings of firms for which Amazon owns between 20-50% of the common stock. If Amazon owns greater than 50% of the stock of another company, that company's assets and liabilities are consolidated into Amazon's financial statements. [We will study accounting for investments in other companies in the Coke vs. Pepsi case.]
 - Cumulative effect of change in accounting principle – the cumulative non-cash effect of changing accounting methods.
4. What appears to be the general theme behind these adjustments? What is your overall assessment of Amazon's pro forma reporting strategy?
5. Amazon.com released its 3rd quarter 2001 financial results in a conference call on Tuesday, October 23, 2001, after the close of trading. You can listen to a replay of the conference call at www.amazon.com/ir through at least December 31, 2001. Can you follow the conversation? What do analysts seem to be concerned about? Exhibit 4 provides the Statement of Cash Flows and Exhibit 5 shows the stock price reaction to the announcement.

Exhibit 1

CFO.com**Dow Jones Business News****June 18, 2001****'Brazilianriver.com'**

A recent panel indicates that regulators are getting fed up with abuse of 'pro-forma' earnings.

The panel members were winking while trying to be "discreet."

And you may have needed an atlas to help you get the reference.

But a rudimentary knowledge of geography and a passing familiarity with some of the events that have precipitated the dot.com implosion of recent times left the reference and its context unmistakable.

Speaking Thursday (June 7) at an SEC Disclosure & Accounting Conference in New York, co-moderator Daniel V. Dooley, a PricewaterhouseCoopers partner, led into a panel discussion about the problems connected with pro-forma earnings announcements with reference to a "hypothetical" firm:

"For the sake of discretion, let's just call it 'Brazilian river.com,'" Dooley said. "And let's just say that the 'net' in its net earnings stands for "not exactly true."

Dooley, as part of a panel that included Lynn Turner, the SEC's chief accountant, included in his none-too-veiled reference to Amazon.com, allusions to recent press coverage of the firm and the latest attempt of its top management to put a positive spin on earnings.

The day before the conference, the New York Times and other media outlets gave wide coverage to a pronouncement by Amazon CFO Warren Jensen that the firm would be profitable in 2002, based upon a "pro-forma" concept of operating profit that excludes interest payments on \$2.1 billion in debt and costs related to acquisitions, layoffs, and stock-option grants.

This latest round of criticism comes in the wake of an [April announcement at a Financial Executives International conference in New York](#) that both the FEI and the National Investor Relations Institute were issuing "[best practices](#)" [guidelines for press releases](#) mandating that earnings press releases containing pro-forma results, or statements of earnings excluding certain items or broken down by business segments, also contain a reconciliation to GAAP.

Industry wags have since taken to referring to the initiative as "The Amazon guidelines."

"What we're saying here is that 'we are profitable after we exclude a slew of numbers,' "or 'we are profitable after we exclude all our expenses,'" said Dooley at the latest conference, referring to the "spin" the fake firm named after the Brazilian river has been giving to its earnings announcements"

"They seem to have a regular periodicity to their non-recurrence," he said likening the dot-com's earnings releases to explanations his wife would repeatedly give him with each annual reconciliation of his family's budget.

Another participant, Alan Levinson, a senior partner at Washington, D.C.-based Fulbright & Jaworski, and a former director of the SEC's division of corporation finance, predicted that patience on the part of regulators may soon be coming to an end.

"I'm not part of the SEC enforcement division, but I can assure you today that you are going to see enforcement actions," he told the audience of lawyers, accountants, and senior financial executives assembled to hear the panel, referring to alleged abuses of pro-forma earnings.

The SEC's Turner, for his part, echoed much of this criticism, and noted that analysts have played a "major role" in disseminating "hype and spin" over "the last two or three years."

"I tell investors if you see pro-forma numbers you should raise a red flag and read the 10-K," he said.

"Not all but most, analysts are potato heads," said Dooley, criticizing the tendency of many to disregard costs such as interest, taxes, depreciation, and amortization when making estimates of profitability.

"The fact that you get to EBIDTA is a slippery slope," he said. "It's going to get to the point where we only report revenues because the other numbers are not profitable."

See also [SEC Official Reveals Probe Into "Pro Forma" Earnings Cases \(6/18\)](#)

Exhibit 2

AMAZON.COM, INC.
Balance Sheets
(in thousands, except per share data)
(unaudited)

	<u>September 30,</u> <u>2001</u>	<u>December 31,</u> <u>2000</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 432,307	\$ 822,435
Marketable securities	235,793	278,087
Inventories	130,739	174,563
Prepaid expenses and other current assets	71,437	86,044
Total current assets	<u>870,276</u>	<u>1,361,129</u>
Fixed assets, net	288,373	366,416
Goodwill, net	62,788	158,990
Other intangibles, net	48,273	96,335
Investments in equity-method investees	7,242	52,073
Other equity investments	18,105	40,177
Other assets	51,311	60,049
Total assets	<u>\$ 1,346,368</u>	<u>\$ 2,135,169</u>
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	\$ 236,992	\$ 485,383
Accrued expenses and other current liabilities	243,229	272,683
Unearned revenue	90,288	131,117
Interest payable	41,635	69,196
Current portion of long-term debt and other	16,054	16,577
Total current liabilities	<u>628,198</u>	<u>974,956</u>
Long-term debt and other	2,172,164	2,127,464
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, \$0.01 par value:		
Authorized shares -- 500,000		
Issued and outstanding shares -- none	-	-
Common stock, \$0.01 par value:		
Authorized shares -- 5,000,000		
Issued and outstanding shares -- 371,766 and 357,140		
shares at September 30, 2001 and December 31, 2000, respectively	3,718	3,571
Additional paid-in capital	1,455,693	1,338,303
Deferred stock-based compensation	(11,306)	(13,448)
Accumulated other comprehensive loss	(36,434)	(2,376)
Accumulated deficit	(2,865,665)	(2,293,301)
Total stockholders' deficit	<u>(1,453,994)</u>	<u>(967,251)</u>
Total liabilities and stockholders' deficit	<u>\$ 1,346,368</u>	<u>\$ 2,135,169</u>

Note: The attached "Financial and Operational Highlights" are an integral part of the press release financial statements.

Exhibit 3A

Reconciliation of Reported to Pro forma earnings for the *three* months ended September 30, 2001 and 2000

AMAZON.COM, INC.						
Pro Forma Statements of Operations						
(in thousands, except per share data)						
(unaudited)						
	Three Months Ended					
	September 30, 2001			September 30, 2000		
	As Reported	Pro Forma Adjustments	Pro Forma	As Reported	Pro Forma Adjustments	Pro Forma
Net sales	\$ 639,281	\$ -	\$ 639,281	\$ 637,858	\$ -	\$ 637,858
Cost of sales	477,089	-	477,089	470,579	-	470,579
Gross profit	162,192	-	162,192	167,279	-	167,279
Operating expenses:						
Fulfillment	81,400	-	81,400	96,421	-	96,421
Marketing	32,537	-	32,537	41,921	-	41,921
Technology and content	53,846	-	53,846	71,159	-	71,159
General and administrative	21,481	-	21,481	26,217	-	26,217
Stock-based compensation	(2,567)	2,567	-	4,091	(4,091)	-
Amortization of goodwill and other intangibles	41,835	(41,835)	-	79,194	(79,194)	-
Restructuring-related and other	3,994	(3,994)	-	11,791	(11,791)	-
Total operating expenses	232,526	(43,262)	189,264	330,794	(95,076)	235,718
Loss from operations	(70,334)	43,262	(27,072)	(163,515)	95,076	(68,439)
Interest income	6,316	-	6,316	9,402	-	9,402
Interest expense	(35,046)	-	(35,046)	(33,809)	-	(33,809)
Other income (expense), net	(2,203)	-	(2,203)	3,353	-	3,353
Other gains (losses), net	(63,625)	63,625	-	12,366	(12,366)	-
Net interest expense and other	(94,558)	63,625	(30,933)	(8,688)	(12,366)	(21,054)
Loss before equity in losses of equity-method investees	(164,892)	106,887	(58,005)	(172,203)	82,710	(89,493)
Equity in losses of equity-method investees, net	(4,982)	4,982	-	(68,321)	68,321	-
Net loss	\$ (169,874)	\$ 111,869	\$ (58,005)	\$ (240,524)	\$ 151,031	\$ (89,493)
Net cash used in operating activities	\$ (64,403)		\$ (64,403)	\$ (3,688)		\$ (3,688)
Basic and diluted loss per share	\$ (0.46)		\$ (0.16)	\$ (0.68)		\$ (0.25)
Shares used in computation of basic and diluted loss per share	368,052		368,052	353,954		353,954

Note: The attached "Financial and Operational Highlights" are an integral part of the press release financial statements.

Exhibit 3B

Reconciliation of Reported to Pro forma earnings for the *nine* months ended September 30, 2001 and 2000

AMAZON.COM, INC.
Pro Forma Statements of Operations
(in thousands, except per share data)
(unaudited)

	Nine Months Ended					
	September 30, 2001			September 30, 2000		
	As Reported	Pro Forma Adjustments	Pro Forma	As Reported	Pro Forma Adjustments	Pro Forma
Net sales	\$ 2,007,262	\$ -	\$ 2,007,262	\$ 1,789,623	\$ -	\$ 1,789,623
Cost of sales	1,482,753	-	1,482,753	1,358,146	-	1,358,146
Gross profit	524,509	-	524,509	431,477	-	431,477
Operating expenses:						
Fulfillment	265,231	-	265,231	283,481	-	283,481
Marketing	103,833	-	103,833	124,785	-	124,785
Technology and content	188,840	-	188,840	199,535	-	199,535
General and administrative	70,287	-	70,287	80,730	-	80,730
Stock-based compensation	2,700	(2,700)	-	25,909	(25,909)	-
Amortization of goodwill and other intangibles	143,496	(143,496)	-	242,562	(242,562)	-
Restructuring-related and other	176,904	(176,904)	-	16,259	(16,259)	-
Total operating expenses	951,291	(323,100)	628,191	973,261	(284,730)	688,531
Loss from operations	(426,782)	323,100	(103,682)	(541,784)	284,730	(257,054)
Interest income	23,073	-	23,073	29,842	-	29,842
Interest expense	(103,942)	-	(103,942)	(94,827)	-	(94,827)
Other expense, net	(7,265)	-	(7,265)	(4,693)	-	(4,693)
Other gains (losses), net	(18,453)	18,453	-	12,366	(12,366)	-
Net interest expense and other	(106,587)	18,453	(88,134)	(57,312)	(12,366)	(69,678)
Loss before equity in losses of equity-method investees	(533,369)	341,553	(191,816)	(599,096)	272,364	(326,732)
Equity in losses of equity-method investees, net	(28,472)	28,472	-	(267,037)	267,037	-
Loss before change in accounting principle	(561,841)	370,025	(191,816)	(866,133)	539,401	(326,732)
Cumulative effect of change in accounting principle	(10,523)	10,523	-	-	-	-
Net loss	\$ (572,364)	\$ 380,548	\$ (191,816)	\$ (866,133)	\$ 539,401	\$ (326,732)
Net cash used in operating activities	\$ (468,902)		\$ (468,902)	\$ (378,095)		\$ (378,095)
Basic and diluted loss per share:						
Prior to cumulative effect of change in accounting principle	\$ (1.55)		\$ (0.53)	\$ (2.48)		\$ (0.94)
Cumulative effect of change in accounting principle	(0.03)		-	-		-
	\$ (1.58)		\$ (0.53)	\$ (2.48)		\$ (0.94)
Shares used in computation of basic and diluted loss per share	361,782		361,782	349,258		349,258

Note: The attached "Financial and Operational Highlights" are an integral part of the press release financial statements.

Exhibit 4

AMAZON.COM, INC.
Statements of Cash Flows
(in thousands)
(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2001	2000	2001	2000
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	\$ 462,949	\$ 720,377	\$ 822,435	\$ 133,309
OPERATING ACTIVITIES:				
Net loss	(169,874)	(240,524)	(572,364)	(866,133)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation of fixed assets and other amortization	19,795	22,857	63,662	61,719
Stock-based compensation	(2,567)	4,091	2,700	25,909
Equity in losses of equity-method investees, net	4,982	68,321	28,472	267,037
Amortization of goodwill and other intangibles	41,835	79,194	143,496	242,562
Non-cash restructuring-related and other	1,881	11,791	70,410	16,259
Gain on sale of marketable securities, net	(1,351)	(3,205)	(1,137)	(4,157)
Other losses (gains), net	63,625	(12,366)	18,453	(12,366)
Non-cash interest expense and other	6,834	6,227	20,119	18,316
Cumulative effect of change in accounting principle	-	-	10,523	-
Changes in operating assets and liabilities:				
Inventories	(659)	8,480	44,441	56,766
Prepaid expenses and other current assets	2,960	(13,034)	18,091	(11,997)
Accounts payable	(22,594)	18,470	(253,984)	(158,317)
Accrued expenses and other current liabilities	(9,721)	12,887	(15,212)	(19,407)
Unearned revenue	33,443	64,466	76,640	66,091
Amortization of previously unearned revenue	(30,100)	(26,870)	(95,400)	(65,558)
Interest payable	(2,892)	(4,473)	(27,812)	5,181
Net cash used in operating activities	(64,403)	(3,688)	(468,902)	(378,095)
INVESTING ACTIVITIES:				
Sales and maturities of marketable securities	141,724	72,619	303,061	521,913
Purchases of marketable securities	(223,817)	(44,954)	(280,938)	(95,740)
Purchases of fixed assets, including internal-use software and web-site development	(12,925)	(41,948)	(42,787)	(97,427)
Investments in equity-method investees and other investments	-	(5,760)	-	(61,842)
Net cash provided by (used in) investing activities	(95,018)	(20,043)	(20,664)	266,904
FINANCING ACTIVITIES:				
Proceeds from exercise of stock options	1,101	4,564	14,578	39,717
Proceeds from issuance of common stock, net of issuance costs	99,831	-	99,831	-
Proceeds from long-term debt and other	-	500	10,000	681,499
Repayment of long-term debt and other	(6,466)	(3,777)	(15,135)	(12,997)
Financing costs	-	-	-	(16,122)
Net cash provided by financing activities	94,466	1,287	109,274	692,097
Effect of exchange-rate changes on cash and cash equivalents	34,313	(50,885)	(9,836)	(67,167)
Net increase (decrease) in cash and cash equivalents	(30,642)	(73,329)	(390,128)	513,739
CASH AND CASH EQUIVALENTS, END OF PERIOD	<u>\$ 432,307</u>	<u>\$ 647,048</u>	<u>\$ 432,307</u>	<u>\$ 647,048</u>
SUPPLEMENTAL CASH FLOW INFORMATION:				
Fixed assets acquired under capital leases	\$ 2,014	\$ -	\$ 4,483	\$ 4,346
Fixed assets acquired under financing agreements	-	-	-	4,844
Equity securities received for commercial agreements	-	9,009	331	106,848
Stock issued in connection with business acquisitions	-	2,130	-	32,130
Cash paid for interest	30,275	33,640	110,990	65,382

Note: The attached "Financial and Operational Highlights" are an integral part of the press release financial statements.

Exhibit 5

Stock prices for the week leading up to the 3rd quarter earnings announcement
On October 23, 2001, 5 p.m. EDT

