To: "George W. Gallinger" <bac524@mainex1.asu.edu>
Subject: Amazon’s Own Books Could Confuse Some Readers

George,

I don’t think it appropriate that I circulate an article concerns one of my own customers. You may do want you want with it though! If there were ever a case study to analyze in a classroom environment it is Amazon...unbelievable.

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Amazon.com’s Own Books Could Confuse Some Readers
By Nick Wingfield
Staff Reporter of The Wall Street Journal
You almost have to be a wizard-in-training of Harry Potter’s stature -- or at least a very savvy accountant -- to figure out how much money is making in these days.

Everyone knows Amazon.com’s claim to fame is selling huge volumes of books, compact disks and a growing number of other goods to consumers over the Internet. But some of its biggest sales recently have come from promoting other Internet companies to Amazon’s huge customer base, not from Harry Potter novels.

The issue is that these Internet companies often pay in stock for the promotions. Treating the stock payment as revenue, which accounting experts say is legal, raises questions.

To wit: What happens when the value of the securities fall? In Amazon’s case, the company doesn’t go back and restate its revenue. Instead, it records the losses in other less-scrutinized areas of its financial statements, including lines devoted to investment gains and losses.

The company’s accounting treatment has drawn the scrutiny of the Securities and Exchange Commission. In its third-quarter earnings announcement last month, Seattle-based Amazon revealed that the regulators are scrutinizing both its accounting treatment and its disclosure of stock deals with other dot-coms. Amazon says it believes it is appropriately handling both matters.

With Internet stocks far off their highs, Amazon would appear to be taking a hit. It disclosed in its third-quarter earnings a $33.8 million “noncash loss,” connected Internet audio company Audible and credit-card issuer NextCard.

Amazon hasn’t gone out of its way to call investors’ attention to the stock component of the payments from commerce partners. But its most recent federal filing does state that 64% of the $166 million it received in payments from commerce partners during the nine months ended Sept. 30 was in stock. It stashed much of that payment as unearned revenue to be booked on its top line, over the term of the marketing alliances with the companies, usually one to three years. The company recorded $94.3 million on its top line from its commerce partnerships during the first nine months of the year. During those nine months, Amazon posted $1.8 billion in total revenue.

The concern of investors -- and possibly the SEC -- is that money-losing...
Internet operations like Amazon are generally valued as a multiple of revenue, rather than of earnings. But "the value of those securities has gone down dramatically and the quality of revenues associated with them is very low," says Tom Courtney, an analyst at BancAmerica Securities. Adds John Spytek, a technology analyst at Banc One Investment Advisors, which has a small position in Amazon: "We all start with revenues" in valuing the company. "If they find ways to over-inflate it, it becomes an issue."

The appealing aspect to investors of the Amazon Commerce Network is that it is potentially very profitable. Selling what is, in effect, advertising space to other Internet companies carries little marginal cost to Amazon. Indeed, in the first half of this year, Amazon reported that the network's gross profit margin was 99%.

But the value of the stock portion of these payments is generally determined by the publicly traded share price of a stock at the moment Amazon completes a deal with a commerce partner. (When a commerce partner is closely held, there is a more subjective valuation process.) And for anyone watching the carnage in the consumer Internet sector, it is obvious that dot-com stock is a serious risk compared with cold cash.

In looking stock as revenue, Amazon says -- and accounting experts and Wall Street analysts agree -- that the company is in accordance with generally accepted accounting principles. "Accounting regulators have come out with some pretty clear guidelines," says Tim Stone, Amazon's director of investor relations. "Receipt of equity for service is something that's been a long-standing practice in corporate America."

But critics fret about the effect of the accounting treatment at unprofitable companies where revenue and gross margins become very closely watched gauges of performance. "To say that this is a means of payment with a high probability of being paid stretches the rule in my opinion," says Baruch Lev, an accounting and finance professor at New York University's Stern School of Business, who maintains that revenue must be backed by cash or some other equally dependable form of payment. "Equity, particularly for companies that are not highly liquid, strains" the accounting rule for revenue.

So what happens to Amazon's finances when those Internet shares sink? For stock that has already been recorded as revenue, Amazon doesn't go back and restate revenue for previous quarters. By the same token, its recorded revenue doesn't get a retroactive kick if the stock of a commerce partner rockets. Unearned revenue doesn't change, either.

When Amazon determines a stock is permanently "impaired," it records an investment loss. During the most-recent quarter, even as Amazon took the $33.8 million loss connected with the Amazon Commerce Network partners, it recognized an overall investment gain of $12.4 million.

For stocks that aren't deemed permanently impaired, the company lists the declines on its balance sheet as unrealized losses. Along these lines, Amazon took a combined unrealized $65.6 million loss during the third quarter on Internet luxury-goods retailer Ashford.com, online grocer Webvan Group, according to its federal filing. Ashford and Sotheby's are commerce partners.
Some other commerce-partner losses are reflected through Amazon's use of so-called equity-method accounting to address ownership stakes generally ranging from 20% to 50%. During the nine months ended Sept. 30, Amazon recorded $266.9 million in total equity-method losses. Overall, Amazon.com posted net losses totaling $866.1 million during the period.

Amazon says its new commerce partnerships will be based primarily on cash payments, and it has renegotiated some older pacts so that cash is a bigger slice, though the deals are at lower terms. There is no guarantee that cash-starved Internet companies will be able to pay Amazon, of course. But Amazon counters that more of its new partners are established companies like Microsoft and Hewlett-Packard.

To critics, the change can't happen soon enough. "I think people tend to focus on revenue," largely overlooking any investment losses that could follow, says Sirine Hafez, an analyst at the Center for Financial Research and Analysis, Rockville, Md., which has published a report critical of Amazon's accounting. "I don't want to say no one pays attention, but it definitely gets less attention."

Amazon's Mr. Stone thinks investors in fact do look for the losses. "I can tell you investors are pretty darn interested in all aspects of our financial statements," he says.

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