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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**Form 10-Q**

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(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2005

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from        to        .

Commission File No. 000-22513

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**Amazon.com, Inc.**

(Exact Name of Registrant as Specified in its Charter)

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Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

91-1646860  
(I.R.S. Employer  
Identification No.)

1200 12th Avenue South, Suite 1200, Seattle, Washington 98144-2734  
(206) 266-1000

(Address and Telephone Number, Including Area Code, of Registrant's Principal Executive Offices)

**Securities registered pursuant to Section 12(b) of the Act:**

None

**Securities registered pursuant to Section 12(g) of the Act:**

Common Stock, par value \$.01 per share

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☒ No ☐

411,913,319 shares of common stock, par value \$0.01 per share, outstanding as of July 22, 2005

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AMAZON.COM, INC.  
FORM 10-Q  
For the Quarterly Period Ended June 30, 2005

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# PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

### AMAZON.COM, INC. CONSOLIDATED STATEMENTS OF CASH FLOWS (in millions) (unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,		Twelve Months Ended June 30,	
	2005	2004	2005	2004	2005	2004
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	\$ 533	\$ 769	\$ 1,303	\$ 1,102	\$ 701	\$ 642
OPERATING ACTIVITIES:						
Net income	52	76	130	188	531	276
Adjustments to reconcile net income to net cash provided by (used in) operating activities:						
Depreciation of fixed assets, including internal-use software and website development, and other amortization	26	18	55	36	95	73
Stock-based compensation	26	22	45	29	74	65
Other operating expense (income)	2	(7)	3	(8)	2	(7)
Loss (gains) on sales of marketable securities, net	—	—	—	(1)	—	(1)
Remeasurements and other	(18)	(16)	(32)	(36)	5	11
Non-cash interest expense and other	1	1	3	2	5	4
Deferred income taxes	44	(1)	94	(8)	(154)	(8)
Cumulative effect of change in accounting principle	—	—	(26)	—	(26)	—
Changes in operating assets and liabilities:						
Inventories	13	(5)	85	8	(93)	(96)
Accounts receivable, net and other current assets	9	(5)	19	10	8	(24)
Accounts payable	54	23	(370)	(233)	150	115
Accrued expenses and other current liabilities	7	10	(25)	(62)	21	8
Additions to unearned revenue	38	27	66	50	125	104
Amortization of previously unearned revenue	(31)	(25)	(56)	(49)	(113)	(104)
Interest payable	21	25	(41)	(34)	(6)	(6)
Net cash provided by (used in) operating activities	244	143	(50)	(108)	624	410
INVESTING ACTIVITIES:						
Purchases of fixed assets, including internal-use software and website development	(46)	(14)	(73)	(24)	(138)	(56)
Sales and maturities of marketable securities and other investments	142	43	490	612	1,305	866
Purchases of marketable securities	(235)	(251)	(738)	(755)	(1,568)	(948)
Proceeds from sale of subsidiary	—	—	—	—	—	5
Acquisitions, net of cash acquired	(5)	—	(20)	—	(91)	—
Net cash used in investing activities	(144)	(222)	(341)	(167)	(492)	(133)
FINANCING ACTIVITIES:						
Proceeds from exercises of stock options and other	9	20	19	35	44	106
Repayments of long-term debt and capital lease obligations	—	(1)	(266)	(156)	(267)	(367)
Net cash provided by (used in) financing activities	9	19	(247)	(121)	(223)	(261)
Foreign-currency effect on cash and cash equivalents	(13)	(8)	(36)	(5)	19	43
Net increase (decrease) in cash and cash equivalents	96	(68)	(674)	(401)	(72)	59
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 629	\$ 701	\$ 629	\$ 701	\$ 629	\$ 701
SUPPLEMENTAL CASH FLOW INFORMATION:						
Cash paid for interest	\$ —	\$ —	\$ 84	\$ 86	\$ 105	\$ 119
Cash paid for income taxes	1	1	5	1	8	2

See accompanying notes to consolidated financial statements.

**AMAZON.COM, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in millions, except per share data)  
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net sales	\$ 1,753	\$ 1,387	\$ 3,655	\$ 2,918
Cost of sales	1,303	1,046	2,746	2,216
Gross profit	450	341	909	702
Operating expenses (1):				
Fulfillment	158	126	324	255
Marketing	42	34	87	68
Technology and content	106	71	198	130
General and administrative	38	31	85	60
Other operating expense (income)	2	(7)	3	(8)
Total operating expenses	346	255	697	505
Income from operations	104	86	212	197
Interest income	9	5	18	11
Interest expense	(22)	(26)	(48)	(54)
Other income (expense), net	(1)	—	2	1
Remeasurements and other	18	16	32	36
Total non-operating income (expense), net	4	(5)	4	(6)
Income before income taxes	108	81	216	191
Provision for income taxes	56	5	112	3
Income before change in accounting principle	52	76	104	188
Cumulative effect of change in accounting principle	—	—	26	—
Net income	\$ 52	\$ 76	\$ 130	\$ 188
Basic earnings per share:				
Prior to cumulative effect of change in accounting principle	\$ 0.13	\$ 0.19	\$ 0.25	\$ 0.46
Cumulative effect of change in accounting principle	—	—	0.07	—
	\$ 0.13	\$ 0.19	\$ 0.32	\$ 0.46
Diluted earnings per share:				
Prior to cumulative effect of change in accounting principle	\$ 0.12	\$ 0.18	\$ 0.24	\$ 0.44
Cumulative effect of change in accounting principle	—	—	0.07	—
	\$ 0.12	\$ 0.18	\$ 0.31	\$ 0.44
Weighted average shares used in computation of earnings per share:				
Basic	411	405	410	404
Diluted	425	425	425	425
(1) Includes stock-based compensation as follows:				
Fulfillment	\$ 5	\$ 3	\$ 8	\$ 4
Marketing	2	2	3	3
Technology and content	13	13	23	16
General and administrative	6	4	11	6
Total stock-based compensation	\$ 26	\$ 22	\$ 45	\$ 29

See accompanying notes to consolidated financial statements.

**AMAZON.COM, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in millions, except per share data)

	June 30, 2005	December 31, 2004
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 629	\$ 1,303
Marketable securities	696	476
	<u>1,325</u>	<u>1,779</u>
Cash, cash equivalents, and marketable securities	1,325	1,779
Inventories	383	480
Deferred tax assets, current portion	63	81
Accounts receivable, net and other current assets	155	199
	<u>1,926</u>	<u>2,539</u>
Total current assets	1,926	2,539
Fixed assets, net	267	246
Deferred tax assets, long-term portion	206	282
Goodwill	154	139
Other assets	48	42
	<u>\$ 2,601</u>	<u>\$ 3,248</u>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 735	\$ 1,142
Accrued expenses and other current liabilities	317	361
Unearned revenue	52	41
Interest payable	32	74
Current portion of long-term debt and other	8	2
	<u>1,144</u>	<u>1,620</u>
Total current liabilities	1,144	1,620
Long-term debt and other	1,521	1,855
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, \$0.01 par value:		
Authorized shares — 500		
Issued and outstanding shares — none	—	—
Common stock, \$0.01 par value:		
Authorized shares — 5,000		
Issued and outstanding shares — 412 and 410 shares	4	4
Additional paid-in capital	2,161	2,123
Accumulated other comprehensive income	27	32
Accumulated deficit	(2,256)	(2,386)
	<u>(64)</u>	<u>(227)</u>
Total stockholders' deficit	(64)	(227)
	<u>\$ 2,601</u>	<u>\$ 3,248</u>
Total liabilities and stockholders' deficit	\$ 2,601	\$ 3,248

See accompanying notes to consolidated financial statements.

AMAZON.COM, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

**Note 1 — Accounting Policies**

***Unaudited Interim Financial Information***

We have prepared the accompanying consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. These consolidated financial statements are unaudited and, in our opinion, include all adjustments, consisting of normal recurring adjustments and accruals necessary for a fair presentation of the consolidated balance sheets, operating results, and cash flows for the periods presented. Operating results for the periods presented are not necessarily indicative of the results that may be expected for 2005 due to seasonal and other factors. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our 2004 Annual Report on Form 10-K. On January 1, 2005, we adopted Statement of Financial Accounting Standards (“SFAS”) No. 123(R), “*Share-Based Payment*.” Certain prior period amounts have been reclassified to conform to the current period presentation.

***Principles of Consolidation***

The consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, and those entities relating to *www.joyo.com*, in which we have a variable interest. Intercompany balances and transactions have been eliminated.

***Use of Estimates***

The preparation of financial statements in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. Estimates are used for, but not limited to, inventory valuation, depreciable lives, internally-developed software, sales returns, receivables valuation, restructuring-related liabilities, incentive discount offers, valuation of investments, valuation of acquired intangibles, taxes, stock-based compensation, and contingencies. Actual results could differ materially from those estimates.

***Business Combinations***

We acquired certain companies in the first half of 2005 for an aggregate cash purchase price of \$24 million. Acquired intangibles totaled \$7 million and have estimated useful lives of between one and three years. The excess of purchase price over the fair value of the net assets acquired was \$16 million and is classified as “Goodwill” on our consolidated balance sheets. The results of operations of each of the acquired businesses have been included in our consolidated results from each transaction closing date forward. The effect of these acquisitions on consolidated net sales and operating income for the first half of 2005 was not significant.

***Accounts Receivable, Net and Other Current Assets***

Included in “Accounts receivable, net and other current assets” are prepaid expenses of \$14 million and \$12 million at June 30, 2005 and December 31, 2004, representing advance payments for insurance, licenses, and other miscellaneous expenses.

AMAZON.COM, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)  
(unaudited)

***Goodwill***

We have elected to perform our annual analysis of goodwill during the fourth quarter of each year, and we update our analysis whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Based on our 2004 analysis, no impairments were present, and no indicators of impairment were identified in the first half of 2005.

***Other Assets***

Included in "Other assets" on our consolidated balance sheets are amounts primarily related to deferred issuance charges on our long-term debt, certain equity investments, and other intangibles. At June 30, 2005 and December 31, 2004, deferred issuance charges were \$14 million and \$19 million; equity investments were \$18 million and \$15 million; and other intangibles, net were \$13 million and \$5 million.

***Income Taxes***

Income tax expense includes U.S. and International income taxes, plus the provision for U.S. taxes on undistributed earnings of international subsidiaries not deemed to be permanently invested.

Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes. See Note 8 — "Income Taxes." SFAS No. 109, "*Accounting for Income Taxes*," requires deferred tax assets be evaluated for future realization and be reduced by a valuation allowance to the extent we believe a portion will not be realized. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income, the carry-forward periods available to us for tax reporting purposes, and other relevant factors. Significant judgment is required in making this assessment, and it is very difficult to predict when, if ever, our assessment may conclude that the remaining portion of our deferred tax assets are realizable.

Classification of deferred tax assets between current and long-term categories is based on the expected timing of realization, and the valuation allowance is allocated on a pro-rata basis.

***Shipping Activities***

Outbound shipping charges to customers are included in "Net sales" and were \$103 million and \$84 million for Q2 2005 and Q2 2004 and \$211 million and \$178 million for the first half of 2005 and 2004. Outbound shipping-related costs are included in "Cost of sales" and totaled \$148 million and \$119 million for Q2 2005 and Q2 2004 and \$311 million and \$255 million for the first half of 2005 and 2004. The net cost to us of shipping activities was \$45 million and \$35 million for Q2 2005 and Q2 2004 and \$100 million and \$77 million for the first half of 2005 and 2004.

***Internal-use Software and Website Development***

Costs incurred to develop software for internal use are required to be capitalized and amortized over the estimated useful life of the software in accordance with SOP 98-1, "*Accounting for the Costs of Computer*

AMAZON.COM, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)  
(unaudited)

*Software Developed or Obtained for Internal Use.* Costs related to design or maintenance of internal-use software are expensed as incurred. During Q2 2005 and Q2 2004, we capitalized \$22 million (including \$3 million of stock-based compensation) and \$10 million of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of \$12 million and \$7 million. For the first half of 2005 and 2004, we capitalized \$40 million (including \$5 million of stock-based compensation) and \$17 million of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of \$21 million and \$14 million.

***Depreciation of Fixed Assets***

Fixed assets include assets purchased under capital leases and internal-use software and website development. Depreciation is recorded on a straight-line basis over the estimated useful lives of the assets (generally two years for shorter-lived assets such as software and desktop computers, three years for our technology infrastructure, five years for furniture and fixtures, and ten years for heavy equipment). Depreciation expense is classified within the corresponding operating expense categories on the consolidated statements of operations. Depreciation expense for fixed assets, including amortization of internal-use software and website development, was \$25 million and \$18 million for Q2 2005 and Q2 2004 and \$47 million and \$35 million for the first half of 2005 and 2004.

***Stock-Based Compensation***

*Effect of Early Adoption of SFAS 123(R)*

Prior to January 1, 2005, we accounted for stock-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. The intrinsic value method of accounting resulted in compensation expense for restricted stock and restricted stock units at their estimated fair value on date of grant based on the number of shares granted and the quoted price of our common stock, and for stock options to the extent option exercise prices were set below market prices on the date of grant. Also, to the extent we granted stock options subsequent to December 31, 2002 or stock awards were subject to an exchange offer, other modifications, or performance criteria, such awards were subject to variable accounting treatment. To the extent stock awards were forfeited prior to vesting, the corresponding previously recognized expense was reversed as an offset to operating expenses.

As of January 1, 2005, we adopted SFAS No. 123(R) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The fair value of restricted stock and restricted stock units is determined based on the number of shares granted and the quoted price of our common stock, and the fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under SFAS No. 123, *Accounting for Stock Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*. Such value is recognized as expense over the service period, net of estimated forfeitures, using the accelerated method under SFAS 123(R). Because we implemented SFAS 123(R), we no longer have employee stock awards subject to variable accounting treatment.

The adoption of SFAS 123(R) resulted in a cumulative benefit from accounting change of \$26 million in Q1 2005, which reflects the net cumulative impact of estimating future forfeitures in the determination of period expense, rather than recording forfeitures when they occur as previously permitted.



AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)  
(unaudited)

Prior to the adoption of SFAS 123(R), cash retained as a result of tax deductions relating to stock-based compensation was presented in operating cash flows, along with other tax cash flows, in accordance with the provisions of the Emerging Issues Task Force (“EITF”) Issue No. 00-15, “*Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option*.” SFAS 123(R) supersedes EITF 00-15, amends SFAS 95, “*Statement of Cash Flows*,” and requires tax benefits relating to excess stock-based compensation deductions to be prospectively presented in the statement of cash flows as financing cash inflows. Tax benefits resulting from stock-based compensation deductions in excess of amounts reported for financial reporting purposes were \$1 million and \$2 million for Q2 2005 and the first half of 2005.

On March 29, 2005, the SEC published Staff Accounting Bulletin (“SAB”) No. 107, which provides the Staff’s views on a variety of matters relating to stock-based payments. SAB 107 requires stock-based compensation be classified in the same expense line items as cash compensation. We have reclassified stock-based compensation from prior periods to correspond to current period presentation within the same operating expense line items as cash compensation paid to employees.

The application of SFAS 123(R) had the following effect on reported amounts relative to amounts that would have been reported using the intrinsic value method under previous accounting (in millions, except per share amounts):

	Three months ended June 30, 2005			Six months ended June 30, 2005		
	Using Previous Accounting	SFAS 123(R) Adjustments	As Reported	Using Previous Accounting	SFAS 123(R) Adjustments	As Reported
Income from continuing operations	\$ 109.8	\$ (5.4)	\$ 104.4	\$ 231.7	\$ (19.5)	\$ 212.2
Income before income taxes	113.9	(5.4)	108.5	235.9	(19.5)	216.4
Income before cumulative effect of change in accounting principle	57.6	(5.4)	52.2	123.4	(19.5)	103.9
Net income	57.6	(5.4)	52.2	123.4	6.9	130.3
Basic earnings per share:						
Prior to cumulative effect of change in accounting principle	\$ 0.14	\$ (0.01)	\$ 0.13	\$ 0.30	\$ (0.05)	\$ 0.25
Cumulative effect of change in accounting principle	—	—	—	—	0.07	0.07
	\$ 0.14	\$ (0.01)	\$ 0.13	\$ 0.30	\$ 0.02	\$ 0.32
Diluted earnings per share:						
Prior to cumulative effect of change in accounting principle	\$ 0.14	\$ (0.02)	\$ 0.12	\$ 0.29	\$ (0.05)	\$ 0.24
Cumulative effect of change in accounting principle	—	—	—	—	0.07	0.07
	\$ 0.14	\$ (0.02)	\$ 0.12	\$ 0.29	\$ 0.02	\$ 0.31
Cash flow from operating activities	\$ 245	\$ (1)	\$ 244	\$ (48)	\$ (2)	\$ (50)
Cash flow from financing activities	8	1	9	(249)	2	(247)

**AMAZON.COM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(unaudited)**

*Valuation Assumptions for Stock Options*

The fair value for each stock option granted was estimated at the date of grant using a Black-Scholes option-pricing model, assuming no dividends and the following assumptions.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Average risk-free interest rate	3.7%	2.9%	3.7%	2.5%
Average expected life (in years)	4.5	3.3	4.5	3.3
Volatility	38.6%	57.7%	38.6%	60.3%

Expected volatilities are based on historical volatilities of our common stock; the expected life represents the weighted average period of time that options granted are expected to be outstanding giving consideration to vesting schedules and our historical exercise patterns; and the risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option.

*Fair Value Disclosures — Prior to SFAS 123(R) Adoption*

Stock-based compensation for the first half of 2004 was determined using the intrinsic value method. The following table provides supplemental information for Q2 2004 and the first half of 2004 as if stock-based compensation had been computed under SFAS 123 (in millions, except per share data):

	Three Months Ended June 30, 2004	Six Months Ended June 30, 2004
Net income — as reported	\$ 76	\$ 188
Add: Stock-based compensation, as reported	22	29
Deduct: Total stock-based compensation determined using a fair value-based method for all awards	(20)	(39)
Net income — SFAS 123 fair value adjusted	\$ 78	\$ 178
Basic earnings per share — as reported	\$ 0.19	\$ 0.46
Diluted earnings per share — as reported	0.18	0.44
Basic earnings per share — SFAS 123 fair value adjusted	0.19	0.44
Diluted earnings per share — SFAS 123 fair value adjusted	0.18	0.42

**AMAZON.COM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(unaudited)**

**Note 2 — Cash, Cash Equivalents, and Marketable Securities**

The following table summarizes, by major security type, our cash, cash equivalents, and marketable securities at fair value:

	June 30, 2005	December 31, 2004
	(in millions)	
Cash	\$ 187	\$ 408
Cash equivalents pledged as collateral (See Note 4)	9	10
Commercial paper and short-term securities (1)	433	885
	<u>629</u>	<u>1,303</u>
Cash and cash equivalents	629	1,303
Corporate notes and bonds	348	29
U.S. Treasury notes and bonds	179	140
Asset-backed and agency securities	161	295
Equity securities and other	8	12
	<u>696</u>	<u>476</u>
Marketable securities (1)	696	476
	<u>\$ 1,325</u>	<u>\$ 1,779</u>
Total cash, cash equivalents, and marketable securities (2)	\$ 1,325	\$ 1,779

(1) At June 30, 2005, gross unrealized gains and losses were not significant.

(2) Includes amounts held in foreign currencies of \$679 million and \$970 million at June 30, 2005 and December 31, 2004. Amounts held in foreign currencies are primarily Euros, British Pounds, and Yen.

We are required to pledge a portion of our marketable securities as collateral for standby letters of credit that guarantee certain of our contractual obligations, a line of credit, and real estate lease agreements. See “Note 4 — Commitments and Contingencies.”

**Note 3 — Long-Term Debt and Other**

Our long-term debt and other long-term liabilities are summarized as follows:

	June 30, 2005	December 31, 2004
	(in millions)	
4.75% Convertible Subordinated Notes due February 2009 (1)	\$ 900	\$ 900
6.875% PEACS due February 2010 (2)	593	935
Other long-term debt and capital lease obligations	36	23
	<u>1,529</u>	<u>1,858</u>
Less current portion of other long-term debt and capital lease obligations	(8)	(3)
	<u>\$ 1,521</u>	<u>\$ 1,855</u>
Total long-term debt and other	\$ 1,521	\$ 1,855

(1) The 4.75% Convertible Subordinated Notes are convertible into our common stock at the holders’ option at a conversion price of \$78.0275 per share. Total common stock issuable upon conversion of our outstanding 4.75% Convertible Subordinated Notes is 11.5 million shares, which is excluded from our calculation of earnings per share as its effect is anti-dilutive. We have the right to redeem the 4.75% Convertible Subordinated Notes, in whole or in part, by paying the principal and a redemption premium, plus any

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)  
(unaudited)

accrued and unpaid interest. At June 30, 2005, the redemption premium, which decreases by 47.5 basis points on February 1 of each year until maturity, was 1.9%.

- (2) In Q1 2005, we redeemed an aggregate principal amount of €200 million (\$265 million based on the Euro to U.S. Dollar exchange rate on the date of redemption) of our outstanding 6.875% Premium Adjustable Convertible Securities due February 2010 (“6.875% PEACS”). Under the Indenture, no redemption premium was required. We recorded a charge in Q1 2005, classified in “Remeasurements and other,” of approximately \$4 million related to the redemption, consisting of \$2 million in unamortized deferred issuance charges and \$2 million relating to unrealized losses from our currency swap to hedge a portion of our 6.875% PEACS (“Euro Currency Swap”) terminated in Q2 2003. Accrued and unpaid interest of \$0.9 million was also paid at redemption and recorded to “Interest expense.” The 6.875% PEACS are convertible into our common stock at the holders’ option at a conversion price of €84.883 per share (\$102.76, based on the exchange rate as of June 30, 2005). Total common stock issuable upon conversion of our outstanding 6.875% PEACS is 5.8 million shares, which is excluded from our calculation of earnings per share as its effect is anti-dilutive. The U.S. Dollar equivalent principal, interest, and conversion price fluctuate based on the Euro/U.S. Dollar exchange ratio. We have the right to redeem the 6.875% PEACS, in whole or in part, by paying the principal plus any accrued and unpaid interest. No premium payment is required for early redemption.

**Note 4 — Commitments and Contingencies**

**Commitments**

We lease office and fulfillment center facilities and fixed assets under non-cancelable operating and capital leases. Rental expense under operating lease agreements was \$17 million and \$13 million for Q2 2005 and Q2 2004, and \$32 million and \$27 million for the first half of 2005 and 2004.

The following summarizes our principal contractual commitments, excluding open orders for purchases that support normal operations, as of June 30, 2005:

	Six Months Ending December 31, 2005	Year Ended December 31,					
		2006	2007	2008	2009	Thereafter	Total

- (1) Under our 6.875% PEACS, the principal payment due in 2010 and the annual interest payments fluctuate based on the Euro/U.S. Dollar exchange ratio. At June 30, 2005, the Euro to U.S. Dollar exchange rate was 1.2107. Due to fluctuations in the Euro/U.S. Dollar exchange ratio, our remaining principal debt obligation under this instrument since issuance in February 2000 has increased by \$110 million as of June 30, 2005. The principal and interest commitments reflect the partial redemptions of the 6.875% PEACS and 4.75% Convertible Subordinated Notes.
- (2) Pursuant to SFAS No. 13, *Accounting for Leases*, lease agreements are categorized at their inception as either operating or capital leases depending on certain defined criteria. Although operating leases represent

**AMAZON.COM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(unaudited)**

obligations for us, pursuant to SFAS No. 13 they are not reflected on the balance sheet. As of June 30, 2005, we have remaining obligations under operating leases for equipment and real estate totaling \$488 million. If we had applied to our operating leases the same convention used for capital leases, which, however, would not be in accordance with GAAP, we would have recorded approximately \$374 million of additional obligations on our balance sheet at June 30, 2005.

- (3) Includes \$12 million related to restructuring-related leases and other commitments, consisting of \$6 million due within 12 months and included in “Accrued expenses and other current liabilities,” and \$7 million due after 12 months and included in “Long-term debt and other” on our balance sheet. These amounts are net of anticipated sublease income of \$8 million.

***Pledged Securities***

We are required to pledge a portion of our marketable securities as collateral for standby letters of credit that guarantee certain of our contractual obligations, a line of credit, and real estate lease agreements. The amount required to be pledged for real estate lease agreements changes over the life of our leases and with fluctuations in our market capitalization, which is common shares outstanding multiplied by the closing price of our common stock, and based on our credit-rating. Information about collateral required to be pledged under these agreements is as follows:

	Standby Letters of Credit (1)	Line of Credit (2)	Real Estate Leases (3)	Total
	(in millions)			
Balance at December 31, 2004	\$ 50	\$ 2	\$ 22	\$ 74
Net change in collateral pledged	(7)	3	2	(2)
Balance at June 30, 2005 (4)	\$ 43	\$ 5	\$ 24	\$ 72

- (1) Pursuant to available standby letter-of-credit facilities totaling \$130 million.  
(2) Pursuant to an available line of credit totaling \$10 million.  
(3) At June 30, 2005, our market capitalization was \$13.6 billion. The required amount of collateral to be pledged will increase by \$6 million if our market capitalization is equal to or below \$13 billion and decrease by \$5 million if our market capitalization exceeds \$18 billion.  
(4) Includes \$9 million of cash equivalents pledged as collateral. See “Note 2 — Cash, Cash Equivalents, and Marketable Securities.”

***Legal Proceedings***

A number of purported class action complaints were filed by holders of our equity and debt securities against us, our directors, and certain of our senior officers during 2001, in the United States District Court for the Western District of Washington, alleging violations of the Securities Act of 1933 (the “1933 Act”) and/or the Securities Exchange Act of 1934 (the “1934 Act”). On August 1, 2003, plaintiffs in the 1934 Act cases filed a second consolidated amended complaint alleging that we, together with certain of our officers and directors, made false or misleading statements during the period from October 29, 1998 through October 23, 2001 concerning our business, financial condition and results, inventories, future prospects, and strategic alliance transactions. The 1933 Act complaint alleges that the defendants made false or misleading statements in connection with our February 2000 offering of the 6.875% PEACS. The complaints seek damages and injunctive relief against all defendants. We dispute the allegations of wrongdoing in these complaints and have been vigorously defending ourselves in these matters. In March 2005, we signed a Stipulation of Settlement with

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)  
(unaudited)

counsel representing the plaintiff class with respect to the 1934 Act claims. In July 2005, we signed a Stipulation of Settlement with counsel representing the plaintiff class with respect to the 1933 Act claims. If finalized and approved by the Court, these settlements would dispose of all claims asserted in these lawsuits in exchange for payments totaling \$48 million, substantially all of which we expect to be funded by our insurers.

On October 29, 2002, Gary Gerlinger, individually and on behalf of all other similarly situated consumers in the United States who, during the period from August 1, 2001 to the present, purchased books online from either Amazon.com or Borders.com, instituted an action against us and Borders in the United States District Court for the Northern District of California. The complaint alleges that the agreement pursuant to which an affiliate of Amazon.com operates Borders.com as a co-branded site violates federal anti-trust laws, California statutory law, and the common law of unjust enrichment. The complaint seeks injunctive relief, damages, including treble damages or statutory damages where applicable, attorneys' fees, costs, and disbursements, disgorgement of all sums obtained by allegedly wrongful acts, interest, and declaratory relief. We dispute the allegations of wrongdoing in this complaint, and intend to vigorously defend ourselves in this matter.

Beginning in March 2003, we were served with complaints filed in several different states, including Illinois and Nevada, by a private litigant purportedly on behalf of the state governments under various state False Claims Acts. The complaints allege that we (along with other companies with which we have commercial agreements) wrongfully failed to collect and remit sales and use taxes for sales of personal property to customers in those states and knowingly created records and statements falsely stating we were not required to collect or remit such taxes. The complaints seek injunctive relief, unpaid taxes, interest, attorneys' fees, civil penalties of up to \$10,000 per violation, and treble or punitive damages under the various state False Claims Acts. It is possible that we have been or will be named in similar cases in other states as well. We do not believe that we are liable under existing laws and regulations for any failure to collect sales or other taxes relating to Internet sales and intend to vigorously defend ourselves in these matters.

On July 17, 2003, Pinpoint, Inc. filed a complaint for patent infringement in the United States District Court for the Northern District of Illinois against us and several other companies with which we have commercial agreements. The original complaint was dismissed without prejudice in December 2004, but the lawsuit was re-filed in March 2005 in the same court. The complaint alleged that our personalization technology infringed patents obtained by Pinpoint and sought injunctive relief, monetary damages in an amount no less than a reasonable royalty, treble damages for alleged willful infringement, prejudgment interest, and attorneys' fees against all defendants. On May 27, 2005, following a court ruling on the scope of the asserted patents, the plaintiff decided to drop the case and dismissed all claims with prejudice.

On January 12, 2004, Soverain Software LLC filed a complaint against us for patent infringement in the United States District Court for the Eastern District of Texas. The complaint alleges that our website technology infringes several patents obtained by Soverain purporting to cover "Internet Server Access Control and Monitoring Systems" (U.S. Patent No. 5,708,780) and "Network Sales Systems" (U.S. Patent Nos. 5,715,314 and 5,909,492) and seeks injunctive relief, monetary damages in an amount no less than a reasonable royalty, treble damages for alleged willful infringement, prejudgment interest, and attorneys' fees. On October 6, 2004, Soverain filed an amended complaint alleging that we infringe two additional patents purporting to cover "Digital Active Advertising" (U.S. Patent No. 6,195,649) and an "Open Network Payment System for Providing Real-Time Authorization of Payment and Purchase Transactions" (U.S. Patent No. 6,205,437). The patents asserted in the amended complaint have since been severed from those asserted in the original complaint, and accordingly a separate complaint has been filed for those patents. We dispute the allegations of wrongdoing in these complaints and intend to vigorously defend ourselves in this matter.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
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On January 22, 2004, IPXL Holdings, LLC brought an action against us for patent infringement in the United States District Court for the Eastern District of Virginia. The complaint alleges that aspects of our online ordering technology, including 1-Click® ordering, infringe a patent obtained by IPXL purporting to cover an “Electronic Fund Transfer or Transaction System” (U.S. Patent No. 6,149,055) and seeks injunctive relief, monetary damages in an amount no less than a reasonable royalty, prejudgment interest, and attorneys’ fees. On August 25, 2004, the Court entered a judgment in Amazon.com’s favor on the grounds that the patent claims asserted by the plaintiff were invalid and that Amazon.com’s technology did not infringe those claims in any event. The Court also awarded Amazon.com its attorneys’ fees and costs. Plaintiff is appealing that judgment.

In April 2004, we learned that the French authorities are investigating our DVD sales practices in France, and we are cooperating.

On May 21, 2004, Toysrus.com LLC filed a complaint against us for breach of contract in the Superior Court of New Jersey. The complaint alleges that we breached our commercial agreement with Toysrus.com LLC by selling, and by permitting other third parties to sell, products that Toysrus.com LLC alleges it has an exclusive right to sell on our website. The complaint seeks injunctive relief, declaratory judgment and either monetary damages of an unspecified amount or rescission of the commercial agreement and return of specific amounts paid under the agreement totaling \$200 million. We dispute the allegations of wrongdoing in this complaint and have brought counterclaims alleging breach of contract and seeking damages and declaratory relief. We intend to vigorously defend ourselves in this matter.

On September 14, 2004, BTG International Inc. filed a complaint against us for patent infringement in the United States District Court for the District of Delaware. The complaint alleges that our website technology, including our Associates program, infringes two patents obtained by BTG purporting to cover methods and apparatuses for “Attaching Navigational History Information to Universal Resource Locator Links on a World Wide Web Page” (U.S. Patent No. 5,712,979) and for “Tracking the Navigation Path of a User on the World Wide Web” (U.S. Patent No. 5,717,860) and seeks injunctive relief, monetary damages in an amount no less than a reasonable royalty, treble damages for alleged willful infringement, prejudgment interest, costs, and attorneys’ fees. We dispute the allegations of wrongdoing in this complaint and intend to vigorously defend ourselves in this matter.

On October 29, 2004 Cendant Publishing, Inc. filed a complaint against us for patent infringement in the United States District Court for the District of Delaware. The complaint alleged that our website technology, including our recommendations features, infringes a patent obtained by Cendant purporting to cover a “System and Method for Providing Recommendation of Goods or Services Based on Recorded Purchasing History” (U.S. Patent No. 6,782,370) and sought injunctive relief, monetary damages in an amount no less than a reasonable royalty, prejudgment interest, costs, and attorneys’ fees. In February 2005, Cendant voluntarily withdrew the complaint without prejudice. In June 2005, however, Cendant re-filed a new complaint containing substantially the same claims. In response, we filed a countersuit in the United States District Court for the Western District of Washington alleging that Cendant’s parent, Cendant Corporation, and its affiliates Orbitz, Inc., Budget Rent A Car System, Inc., Avis Rent A Car System, Inc., and Trilegiant Corporation infringe certain patents owned by us and our subsidiary, A9.com. We dispute Cendant’s allegations of wrongdoing in its complaint and intend to vigorously defend ourselves in these matters.

Depending on the amount and the timing, an unfavorable resolution of some or all of these matters could materially affect our business, results of operations, financial position, or cash flows in a particular period.

AMAZON.COM, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)  
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**Note 5 — Stockholders' Deficit**

***Stock Award Plans and Shares Reserved for Future Issuance***

Common stock reserved for future issuance was as follows (in millions):

	June 30, 2005	December 31, 2004
Stock awards	111	114
Shares issuable upon conversion of 4.75% Convertible Subordinated Notes	11	11
Shares issuable upon conversion of 6.875% PEACS	6	8
<b>Total common stock reserved for future issuance</b>	<b>128</b>	<b>133</b>

***Stock Award Activity***

Employees vest in restricted stock unit awards and stock options ratably over the service term, generally between two to five years. Outstanding stock options generally have a term of 10 years from the date of grant.

We granted stock awards, which since October 2002 have consisted primarily of restricted stock units, representing 3.9 million and 1.9 million shares of common stock during Q2 2005 and Q2 2004 with a per share weighted average fair value of \$34.00 and \$46.62. For the first half of 2005 and 2004 we granted stock awards representing 4.5 million and 2.0 million shares of common stock with per share weighted average fair values of \$34.42 and \$46.63. Our annual stock awards are granted in the second quarter.

Common shares underlying outstanding stock awards were as follows:

	June 30, 2005	December 31, 2004
	(in millions)	
Stock options	16	18
Restricted stock units	10	6
<b>Outstanding stock awards, excluded from common stock outstanding</b>	<b>26</b>	<b>24</b>
Restricted stock, included in outstanding common stock	—	1
<b>Total outstanding stock awards</b>	<b>26</b>	<b>25</b>

Common shares outstanding (which includes restricted stock), plus shares underlying outstanding stock options and restricted stock units totaled 438 million and 434 million at June 30, 2005 and December 31, 2004. These totals include all stock-based awards outstanding, without regard for estimated forfeitures, consisting of vested and unvested awards, and in-the-money and out-of-the-money stock options. Common shares outstanding increased by 1.0 million shares and 2.0 million shares during Q2 2005 and the first half of 2005, and by 1.8 million and 3.3 million shares during Q2 2004 and the first half of 2004, due to exercises of stock options, vesting of restricted stock units, and matching contributions under our 401(k) savings plan.



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
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The following table summarizes our restricted stock unit activity for the first half of 2005 (in millions):

	Number of Units
Outstanding at December 31, 2004	6.4
Units granted	4.4
Units vested	(0.3)
Units cancelled	(0.6)
Outstanding at June 30, 2005	9.9

The aggregate intrinsic value of restricted stock units as of June 30, 2005 was \$327 million. Intrinsic value for restricted stock units is calculated based on the number of awards outstanding and the quoted price of our common stock as of the reporting date.

Scheduled vesting for outstanding restricted stock units at June 30, 2005 is as follows (in millions):

	Six Months Ending December 31, 2005	Year Ended December 31,					
		2006	2007	2008	2009	Thereafter	Total
Scheduled vesting — restricted stock units	0.8	2.1	3.1	2.3	1.0	0.6	9.9

The following table summarizes our stock option activity for the first half of 2005:

	Number of Options	Weighted Avg Exercise Price
Outstanding at December 31, 2004	18.4	\$ 12.98
Options granted	0.1	35.69
Options terminated	(0.8)	11.29
Options exercised	(1.7)	9.90
Outstanding at June 30, 2005	16.0	\$ 13.52

The following table summarizes information about stock options outstanding at June 30, 2005:

Range of Exercise Prices	Stock Options Outstanding			Stock Options Vested	
	Number of Awards	Remaining Life (yrs)	Weighted Avg Exercise Price	Number of Awards	Weighted Avg Exercise Price
	(in millions)			(in millions)	
\$ 0.08 – \$ 10.49	11.9	5.7	\$ 7.60	5.2	\$ 7.11
10.50 – 20.99	2.3	5.8	16.47	1.3	16.64
21.00 – 31.49	0.6	4.7	25.46	0.5	25.56
31.50 – 41.99	0.3	6.7	37.02	0.2	37.61
42.00 – 52.48	0.2	6.3	44.09	0.1	44.52
52.49 – 62.98	0.1	3.7	55.67	0.1	55.69
62.99 – 73.48	0.5	3.7	70.85	0.3	70.35
73.49 – 104.97	0.1	2.3	82.84	0.1	82.84
\$ 0.08 – \$104.97	16.0	5.6	\$ 13.52	7.8	\$ 14.90

**AMAZON.COM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(unaudited)**

The aggregate intrinsic value of stock options outstanding at June 30, 2005 was \$313 million, of which \$142 million relates to vested awards. Intrinsic value for stock options is calculated based on the exercise price of the underlying awards and the quoted price of our common stock as of the reporting date.

As matching contributions under our 401(k) savings plan, we granted 0.05 million shares of common stock for the first half of 2005. Shares granted as matching contributions under our 401(k) plan and shares of restricted stock are included in outstanding common stock when issued.

Stock-based compensation calculated under SFAS 123(R) for the first half of 2005 and calculated using the intrinsic value method for the first half of 2004 consisted of the following:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(in millions)		(in millions)	
Fixed accounting (1):				
Restricted stock units (2)	\$ 16	\$ 12	\$ 28	\$ 20
Restricted stock (3)	1	1	2	3
Stock options	9	—	15	—
Stock awards — variable accounting (4)	—	9	—	6
<b>Total stock-based compensation</b>	<b>\$ 26</b>	<b>\$ 22</b>	<b>\$ 45</b>	<b>\$ 29</b>

- (1) The fair value of restricted stock units is determined at grant date based on the number of shares granted and the quoted price of our common stock. The fair value of stock options is calculated using a Black-Scholes option valuation model. Such value is recognized as expense over the service period using the accelerated method under SFAS 123(R). Effective with our adoption of SFAS 123(R), estimates of forfeited awards are incorporated into our determination of period expenses resulting in expense recognition only for awards we expect to ultimately vest. Prior to our adoption of SFAS 123(R), to the extent awards were forfeited prior to vesting, the corresponding previously recognized expense was reversed as an offset to operating expenses.
- (2) Since October 2002, we have awarded restricted stock units as our primary form of stock-based compensation.
- (3) Includes expense associated with matching contributions of our common stock under our 401(k) savings plan.
- (4) Due to our implementation of SFAS 123(R) on January 1, 2005, we no longer have employee stock awards subject to variable accounting treatment. Prior to January 1, 2005, variable accounting treatment resulted in expense or contra-expense recognition using the cumulative expense method, calculated based on the quoted price of our common stock and vesting schedules of underlying awards. To the extent stock options were forfeited prior to vesting, the corresponding previously recognized expense was reversed as an offset to operating expenses.

As of June 30, 2005, there was \$209 million of total unrecognized compensation cost, net of estimated forfeitures of \$106 million, related to unvested stock-based compensation arrangements. This cost is expected to be recognized over a weighted-average period of 1.7 years.

During Q2 2005 and Q2 2004, the fair value of restricted stock units and restricted stock awards vested was \$6 million and \$7 million, and the intrinsic value of options exercised was \$18 million and \$76 million. The fair value of restricted stock units and restricted stock awards vested in the first half of 2005 and 2004 was \$14 million and \$18 million, and the intrinsic value of options exercised was \$40 million and \$140 million.

**AMAZON.COM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(unaudited)**

**Note 6 — Other Comprehensive Income (Loss)**

Comprehensive income was \$56 million and \$73 million for Q2 2005 and Q2 2004, and \$126 million and \$179 million for the first half of 2005 and 2004. The primary differences between net income as reported and comprehensive income are foreign currency translation adjustments and changes in unrealized gains and losses on available-for-sale securities.

**Note 7 — Remeasurements and Other**

Remeasurements and other consisted of the following:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(in millions)		(in millions)	
Foreign-currency gains on remeasurement of 6.875% PEACS (1)	\$ 42	\$ 8	\$ 77	\$ 28
Gain (loss) on sales of Euro-denominated investments, net	—	2	(2)	5
Loss on redemption of long-term debt (See Note 3)	—	—	(4)	(6)
Foreign-currency effect on intercompany balances (2)	(25)	(7)	(39)	(10)
Other (3)	1	13	—	19
<b>Total remeasurements and other</b>	<b>\$ 18</b>	<b>\$ 16</b>	<b>\$ 32</b>	<b>\$ 36</b>

- (1) Each period the remeasurement of our 6.875% PEACS from Euros to U.S. Dollars results in gains or losses recorded to “Remeasurements and other” on our consolidated statements of operations.
- (2) Represents the loss associated with the remeasurement of intercompany balances due to changes in foreign exchange rates.
- (3) In Q2 2005 and Q2 2004 we recorded a gain of \$3 million and \$14 million associated with the sale of equity investments, and in Q1 2004, we recorded a gain of \$6 million relating to the settlement of a contractual dispute.

**Note 8 — Income Taxes**

Our effective tax rate for Q2 2005 and for the first half of 2005 was higher than the 35% statutory rate associated with taxable income resulting from the Q1 2005 transfer of certain operating assets from the U.S. to international locations. We expect these asset transfers to result in tax expense for financial reporting purposes above the statutory rate throughout 2005. Since we have Net Operating Losses (“NOLs”) these asset transfers will not have a significant effect on cash taxes paid in 2005. Cash paid for income taxes was \$1 million and \$5 million in Q2 2005 and the first half of 2005, compared with \$1 million during Q2 2004 and the first half of 2004.

At June 30, 2005, approximately \$730 million of our gross deferred tax assets were related to approximately \$2.3 billion of NOLs. Our NOL deferred tax assets are reduced by a valuation allowance of approximately \$510 million due to uncertainty about their future realization. The remainder of our deferred tax assets relate to temporary timing differences between tax and financial reporting. The majority of our NOLs expire after 2016, and utilization of NOLs may be subject to certain limitations under Sections 382 and 1502 of the Internal Revenue Code of 1986 (“Internal Revenue Code”), and other limitations under state and foreign tax laws.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)  
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**Note 9 — Segment Information**

We have organized our operations into two principal segments: North America and International. We present our segment information along the same lines that our chief executive reviews our operating results in assessing performance and allocating resources.

We allocate to segment results the operating expenses “Fulfillment,” “Marketing,” “Technology and content,” and “General and administrative,” but exclude from our allocations the portions of these expense lines attributable to stock-based compensation. Additionally, we do not allocate the line item “Other operating income (expense)” to our segment operating results. A significant majority of our costs for “Technology and content” are incurred in the United States and most of these costs are allocated to our North America segment. There are no internal revenue transactions between our reporting segments.

***North America***

The North America segment consists of amounts earned from retail sales of consumer products (including from third-party sellers) through North America-focused websites, such as *www.amazon.com* and *www.amazon.ca*, from North America-focused Syndicated Stores and mail-order catalogs, and from non-retail activities such as North America-focused Merchant.com, marketing, and promotional agreements.

***International***

The International segment consists of amounts earned from retail sales of consumer products (including from third-party sellers) through internationally-focused websites, such as *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr*, *www.amazon.co.jp*, and *www.joyo.com*, from internationally-focused Syndicated Stores and from non-retail activities such as internationally-focused marketing and promotional agreements. This segment includes export sales from *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr*, *www.amazon.co.jp*, and *www.joyo.com* (including export sales from these sites to customers in the U.S. and Canada), but excludes export sales from *www.amazon.com* and *www.amazon.ca*.

**AMAZON.COM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
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Information on reportable segments and reconciliation to consolidated net income is as follows (in millions):

	Three Months Ended June 30, 2005			Three Months Ended June 30, 2004		
	North America	International	Consolidated	North America	International	Consolidated
Net sales	\$ 960	\$ 793	\$ 1,753	\$ 791	\$ 596	\$ 1,387
Cost of sales	682	621	1,303	571	475	1,046
Gross profit	278	172	450	220	121	341
Direct segment operating expenses	206	112	318	154	86	240
Segment operating income	72	60	132	66	35	101
Stock-based compensation			(26)			(22)
Other operating income (expense)			(2)			7
Income from operations			104			86
Total non-operating income (expense), net			4			(5)
Provision for income taxes			(56)			(5)
Net income			\$ 52			\$ 76

  

	Six Months Ended June 30, 2005			Six Months Ended June 30, 2004		
	North America	International	Consolidated	North America	International	Consolidated
Net sales	\$ 1,987	\$ 1,668	\$ 3,655	\$ 1,639	\$ 1,279	\$ 2,918
Cost of sales	1,430	1,316	2,746	1,193	1,023	2,216
Gross profit	557	352	909	446	256	702
Direct segment operating expenses	420	229	649	304	180	484
Segment operating income	137	123	260	142	76	218
Stock-based compensation			(45)			(29)
Other operating income (expense)			(3)			8
Income from operations			212			197
Total non-operating income (expense), net			4			(6)
Provision for income taxes			(112)			(3)
Cumulative effect of change in accounting principle			26			—
Net income			\$ 130			\$ 188

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Forward-Looking Statements

*This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact, including statements regarding guidance, industry prospects or future results of operations or financial position, made in this Quarterly Report on Form 10-Q are forward-looking. We use words such as anticipates, believes, expects, future, intends, and similar expressions to identify forward-looking statements. Forward-looking statements reflect management's current expectations and are inherently uncertain. Actual results could differ materially for a variety of reasons, including, among others, fluctuations in foreign exchange rates, changes in global economic conditions and consumer spending, world events, the rate of growth of the Internet and online commerce, the amount that Amazon.com invests in new business opportunities and the timing of those investments, the mix of products sold to customers, the mix of net sales derived from products as compared with services, competition, management of growth, potential fluctuations in operating results, international growth and expansion, outcomes of legal proceedings and claims, fulfillment center optimization, risks of inventory management, seasonality, the degree to which the Company enters into, maintains, and develops commercial agreements, acquisitions, and strategic transactions, and risks of fulfillment throughput and productivity. These risks and uncertainties, as well as other risks and uncertainties that could cause our actual results to differ significantly from management's expectations, are described in greater detail in "Additional Factors That May Affect Future Results," which, along with the previous discussion, describes some, but not all, of the factors that could cause actual results to differ significantly from management's expectations.*

### Overview

*Our primary source of revenue is the sale of a wide range of products and services to customers of our global websites. The products offered on our websites include products we have purchased from distributors, publishers, and manufacturers and products offered by third parties. Generally, we recognize gross revenue from items we sell from our inventory and recognize our net share of revenue of items sold by third parties.*

*Our financial focus is on long-term, sustainable growth in free cash flow<sup>1</sup>. Free cash flow is driven primarily by increasing operating income and efficiently managing working capital and capital expenditures. Increases in operating income result from increases in sales through our websites and a focus on keeping our operating costs low, offset by investments we make in longer-term strategic initiatives including hiring additional software engineers and computer scientists. To increase sales, we focus on improving all aspects of the customer experience, including lowering prices, improving availability, offering faster delivery times, increasing selection, expanding product information, improving ease of use, and earning customer trust. We generally focus on gross profit and operating profit dollars rather than margin percentages.*

We also seek to efficiently manage shareholder dilution while maintaining the flexibility to issue shares for strategic purposes, such as financings and aligning employee interests with shareholders. We moved to restricted stock units as our primary vehicle for equity compensation in late 2002 because we believe they better align the interests of our shareholders and employees. Restricted stock units result in charges to our income statement based on the fair value of the awards at the grant date recorded over the underlying service periods, net of estimated cancellations. Total shares outstanding plus outstanding stock awards were 438 million and 434 million at June 30, 2005 and December 31, 2004. These totals include all stock-based awards outstanding, without regard for estimated forfeitures, consisting of vested and unvested awards, and in-the-money and out-of-the-money stock options.

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<sup>1</sup> Free cash flow is defined as net cash provided by operating activities less purchases of fixed assets, including capitalized internal-use software and website development, both of which are presented on our statements of cash flows.

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*We seek to leverage our fixed customer experience costs and work to reduce our variable costs per unit.* Our customer experience costs, specifically the costs necessary to build, enhance, and add features to our websites and build and optimize our fulfillment centers, are largely fixed in that they do not vary directly with sales. The customer experience costs that remain largely variable as a percentage of sales include product costs; credit-card processing fees; bad debt; picking, packaging, and preparing orders for shipment; transportation; customer service support; and most aspects of our marketing costs. To decrease our variable costs on a per unit basis and enable us to lower prices for customers, we seek to increase our direct to publisher and manufacturer sourcing; seek to maximize volume discounts available to us from suppliers; and focus on maintaining a lean culture, including by reducing defects in our processes.

*Because of our model we are able to turn our inventory quickly and have a negative operating cycle<sup>2</sup>.* On average, our high inventory velocity means we generally collect from our customers before our payments to suppliers come due. Inventory turnover<sup>3</sup> was 15 and 18 for Q2 2005 and Q2 2004. We expect some variability in inventory turnover over time since it is affected by several factors, including our product mix, our mix of third-party sales, our continuing focus on in-stock inventory availability, our future investment in new geographies and product lines, and the extent we choose to utilize outsource fulfillment providers. Accounts payable days<sup>4</sup> were 51 for each of Q2 2005 and Q2 2004. We expect some variability in accounts payable days over time since it is affected by several factors, including the mix of product sales, the mix of third-party sales, the mix of suppliers, seasonality, and changes in payment terms over time, including the effect of negotiating better pricing from our suppliers in exchange for shorter payment terms.

*Our spending in technology and content will increase as we add computer scientists and software engineers to continue to improve our process efficiency and enhance the customer experience on our websites.* We believe that advances in technology, specifically the speed and reduced cost of processing power, the improved consumer experience of the Internet outside of the workplace through lower-cost broadband service to the home, and the advances of wireless connectivity, will continue to improve the consumer experience on the Internet and increase its ubiquity in people's lives. Our challenge will be to continue to build and deploy innovative and efficient software that will best take advantage of continued advances in technology.

*Our financial reporting currency is the U.S. Dollar and changes in exchange rates significantly affect our reported results and consolidated trends.* For example, our consolidated revenue, profit, and operating and free cash flows have benefited significantly in several recent reporting periods from weakness in the U.S. Dollar in comparison to the currencies of our internationally-focused websites. We believe that our increasing diversification beyond the U.S. economy through our growing international businesses benefits our shareholders over the long term. We also believe it is important to evaluate our operating results and growth rates before and after the effect of currency changes. For example, while our revenues increased 26% during Q2 2005 in comparison with the prior year, holding currency exchange constant with the prior year our growth would have been 25%. In addition, the remeasurement of our 6.875% Premium Adjustable Convertible Securities ("PEACS") and intercompany balances can result in significant gains and charges associated with the effect of movements in currency exchange rates. Currency volatilities will likely continue, which may significantly impact (either positively or negatively) our reported results and consolidated trends and comparisons. Assuming exchange rates remain at recent levels, we expect year-over-year comparisons for our consolidated results to be negatively affected by currency exchange for each quarter of the second half and full year of 2005.

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<sup>2</sup> The operating cycle is the number of days of sales in inventory plus the number of days of sales in accounts receivable minus accounts payable days.

<sup>3</sup> Inventory turnover is the quotient of annualized cost of sales to average inventory over five quarter ends.

<sup>4</sup> Accounts payable days is the quotient of accounts payable to cost of sales, multiplied by the number of days in the period.

## Critical Accounting Judgments

The preparation of financial statements in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require it to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, we have identified the critical accounting policies and judgments addressed below. We also have other key accounting policies, which involve the use of estimates, judgments, and assumptions that are significant to understanding our results. For additional information, see Item 8 of Part II, "Financial Statements and Supplementary Data — Note 1 — Description of Business and Accounting Policies," of our 2004 Annual Report on Form 10-K. Although we believe that our estimates, assumptions, and judgments are reasonable, they are based upon information presently available. Actual results may differ significantly from these estimates under different assumptions, judgments, or conditions.

### Revenue Recognition

We recognize revenue from product sales or services rendered when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. Additionally, revenue arrangements with multiple deliverables are divided into separate units of accounting if the deliverables in the arrangement meet the following criteria: the delivered item has value to the customer on a standalone basis; there is objective and reliable evidence of the fair value of undelivered items; and delivery of any undelivered item is probable.

We evaluate the criteria of EITF 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*, in determining whether it is appropriate to record the gross amount of product sales and related costs or the net amount earned as commissions. Generally, when we are the primary party obligated in a transaction, are subject to inventory risk, have latitude in establishing prices and selecting suppliers, or have several but not all of these indicators, revenue is recorded gross. If we are not primarily obligated and amounts earned are determined using a percentage, a fixed-payment schedule, or a combination of the two, we generally record the net amounts as commissions earned. Under our Syndicated Stores arrangements, we record gross product sales and costs since we own the inventory, set prices, and are responsible for fulfillment and customer service, and the other business earns a sales commission.

Product sales and shipping revenues, net of promotional discounts, rebates, and return allowances, are recorded when the products are shipped and title passes to customers. Retail items sold to customers are made pursuant to sales contracts that generally provide for transfer of both title and risk of loss upon our delivery to the carrier. Return allowances, which reduce product revenue by our best estimate of expected product returns, are estimated using historical experience. Amounts paid in advance for subscription services, including amounts received for online DVD rentals, Amazon Prime, and other membership programs, are deferred and recognized as revenue over the subscription term.

We periodically provide incentive offers to our customers to encourage purchases. Such offers include current discount offers, such as percentage discounts off current purchases, inducement offers, such as offers for future discounts subject to a minimum current purchase, and other similar offers. Current discount offers, when accepted by our customers, are treated as a reduction to the purchase price of the related transaction, while inducement offers, when accepted by our customers, are treated as a reduction to purchase price based on estimated future redemption rates. Redemption rates are estimated using our historical experience for similar inducement offers. Current discount offers and inducement offers are presented as a net amount in "Net sales."



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Commissions and per-unit fees received from third-party sellers and similar amounts earned through our Merchant.com program are recognized when the item is sold by the third-party seller and our collectibility is reasonably assured. We record an allowance for estimated refunds on such commissions using historical experience.

### ***Inventories***

Inventories, consisting of products available for sale, are accounted for using the first-in first-out ("FIFO") method, and are valued at the lower of cost or market value. This valuation requires us to make judgments, based on currently-available information, about the likely method of disposition, such as through sales to individual customers, returns to product vendors, or liquidations, and expected recoverable values of each disposition category. Based on this evaluation, we adjust the carrying amount of our inventories to lower of cost or market value.

We provide fulfillment-related services in connection with certain of our Merchants@ and Merchant.com programs. In those arrangements, as well as other product sales by third parties, the third-party maintains ownership of the related products.

### ***Internal-Use Software and Website Development***

Included in fixed assets is the capitalized cost of internal-use software and website development, including software used to upgrade and enhance our websites and processes supporting our business. As required by Statement of Position 98-1, "*Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*," we capitalize costs incurred during the application development stage of internal-use software and amortize these costs over the estimated useful life of two years. Costs incurred related to design or maintenance of internal-use software are expensed as incurred.

During Q2 2005 and Q2 2004, we capitalized \$22 million (including \$3 million of stock-based compensation) and \$10 million of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of \$12 million and \$7 million. For the first half of 2005 and 2004, we capitalized \$40 million (including \$5 million of stock-based compensation) and \$17 million of costs associated with internal-use software and website development, which are partially offset by amortization of previously capitalized amounts of \$21 million and \$14 million.

### ***Valuation of Deferred Tax Assets***

SFAS 109, "*Accounting for Income Taxes*," requires that deferred tax assets be evaluated for future realization and reduced by a valuation allowance to the extent we believe a portion will not be realized. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income, the carry-forward periods available to us for tax reporting purposes, and other relevant factors. Significant judgment is required in making this assessment, and it is very difficult to predict when, if ever, our assessment may conclude that the remaining portion of our deferred tax assets are realizable.

### ***Stock-Based Compensation***

As of January 1, 2005, we adopted SFAS 123(R), which requires us to measure compensation cost for all outstanding unvested share-based awards at fair value and recognize compensation over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results may differ substantially from these estimates.

## **Liquidity and Capital Resources**

Our financial focus is on long-term, sustainable growth in free cash flow. Free cash flow was \$486 million for the trailing twelve months ended June 30, 2005 compared to \$354 million for the trailing twelve months ended June 30, 2004, an increase of 37%. Operating cash flows and free cash flows can be volatile and are sensitive to many factors, including changes in working capital and timing of capital expenditures. Working capital at any specific point in time is subject to many variables, including seasonality, the timing of expense payments, discounts offered by vendors, vendor payment terms, and fluctuations in foreign exchange rates.

Our principal sources of liquidity are cash flows generated from operations and our cash, cash equivalents, and marketable securities balances, which, at fair value, were \$1.3 billion and \$1.8 billion at June 30, 2005 and December 31, 2004. Amounts held in foreign currencies were \$679 million and \$970 million at June 30, 2005 and December 31, 2004, and were primarily Euros, British Pounds, and Yen.

Cash provided by operating activities was \$244 million and \$143 million for Q2 2005 and Q2 2004, and cash used in operating activities was \$50 million and \$108 million for the first half of 2005 and 2004. Our operating cash flows result primarily from cash received from our customers and third-party sellers, offset by cash payments we make to suppliers of products and services, employee compensation, credit card transaction fees, operating leases, bad debt, and interest payments on our long-term debt obligations. Cash received from customers and third-party sellers generally corresponds to our net sales. Because our customers primarily use credit cards to buy from us, our receivables from customers settle quickly. Cash paid to inventory and transportation suppliers generally corresponds with cost of sales, adjusted for increases or decreases in inventory and payable levels. During Q2 2005, payments to product merchandise suppliers, which do not include payments to transportation suppliers, totaled \$1.1 billion, a 20% increase over Q2 2004. Payments to product merchandise suppliers correspond with cost of sales, and are also affected by our efforts to add product categories, increase selection of products we offer for sale, improve availability in both existing and new product categories, and take advantage of additional discounts offered to us by suppliers, and by foreign exchange rates.

Cash provided by (used in) investing activities corresponds with purchases, sales, and maturities of marketable securities, net cash flows from acquisitions, and purchases of fixed assets, including internal-use software and website development costs. Cash used in investing activities was \$144 million and \$341 million during Q2 2005 and the first half of 2005, compared to cash used in investing activities of \$222 million and \$167 million during Q2 2004 and the first half of 2004. Capital expenditures, including internal-use software and website development, were \$46 million and \$73 million during Q2 2005 and the first half of 2005, and were \$14 million and \$24 million during Q2 2004 and the first half of 2004, with the increase reflecting additional investment in development of new features and product offerings on our websites, as well as investments in fulfillment-related assets and technology infrastructure. Stock-based compensation capitalized for internal-use software and website development costs does not affect cash flows. We purchased certain companies in the first half of 2005 resulting in cash payments, net of acquired cash, of \$20 million. We believe our expenditures for repairs and improvements are sufficient to keep our facilities and equipment in suitable operating condition.

Cash provided by financing activities was \$9 million during Q2 2005, and cash used in financing activities was \$247 million for the first half of 2005. This compares to cash provided by financing activities of \$19 million during Q2 2004, and cash used in financing activities of \$121 million for the first half of 2004. In Q1 2005, we repaid €200 million of our 6.875% PEACS for \$265 million. In Q1 2004, we repaid \$150 million of our 4.75% Convertible Subordinated Notes for \$154 million. Cash inflows from financing activities primarily result from proceeds from exercises of employee stock options, which were \$9 million and \$19 million for Q2 2005 and the first half of 2005, and were \$20 million and \$35 million for Q2 2004 and the first half of 2004. We expect cash proceeds from exercises of stock options will continue to decline over time as we continue issuing restricted stock units as our primary vehicle for stock-based awards.

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Since our 6.875% PEACS, which are due in 2010, are denominated in Euros, our U.S. Dollar equivalent interest payments and principal obligations fluctuate with the Euro to U.S. Dollar exchange rate. We currently do not hedge our exposure to foreign currency effects on our interest or principal obligations relating to the 6.875% PEACS, and, as a result, any fluctuations in the exchange rate will have an effect on our interest expense and, to the extent we make principal payments, the amount of U.S. Dollar equivalents necessary for principal settlement. Additionally, since our interest payable on our 6.875% PEACS is due in Euros, the balance of interest payable is subject to gains or losses on currency movements until the date of the interest payment. Gains or losses on the remeasurement of our Euro-denominated interest payable are classified as "Other expense (income), net" on our consolidated statements of operations.

The following summarizes our principal contractual commitments as of June 30, 2005:

	Six Months Ending December 31, 2005	Year Ended December 31,					
		2006	2007	2008	2009	Thereafter	Total
(in millions)							
Operating and capital commitments:							
Debt principal and other (1)	\$ 5.9	\$ 1.2	\$ 0.3	\$ 0.3	\$ 900.9	\$ 607.5	\$ 1,516.1
Debt interest (1)	21.4	83.5	83.5	83.5	62.2	40.8	374.9
Capital leases	0.6	0.6	—	—	—	—	1.2
Operating leases (2)(3)	41.7	79.4	70.8	61.8	50.8	183.1	487.6
Purchase obligations (4)	218.2	8.9	8.9	5.5	5.5	5.5	252.5
Total commitments	\$ 287.8	\$ 173.6	\$ 163.5	\$ 151.1	\$ 1,019.4	\$ 836.9	\$ 2,632.3

- (1) Under our 6.875% PEACS, the principal payment due in 2010 and the annual interest payments fluctuate based on the Euro/U.S. Dollar exchange ratio. At June 30, 2005, the Euro to U.S. Dollar exchange rate was 1.2107. Due to fluctuations in the Euro/U.S. Dollar exchange ratio, our remaining principal debt obligation under this instrument since issuance in February 2000 has increased by \$110 million as of June 30, 2005. The principal and interest commitments reflect the partial redemptions of the 6.875% PEACS and 4.75% Convertible Subordinated Notes.
- (2) Pursuant to SFAS No. 13, *Accounting for Leases*, lease agreements are categorized at their inception as either operating or capital leases depending on certain defined criteria. Although operating leases represent obligations for us, pursuant to SFAS No. 13 they are not reflected on the balance sheet. As of June 30, 2005, we have remaining obligations under operating leases for equipment and real estate totaling \$488 million. If we had applied to our operating leases the same convention used for capital leases, which, however, would not be in accordance with GAAP, we would have recorded approximately \$374 million of additional obligations on our balance sheet at June 30, 2005.
- (3) Includes \$12 million related to restructuring-related leases and other commitments, consisting of \$6 million due within 12 months and included in "Accrued expenses and other current liabilities," and \$7 million due after 12 months and included in "Long-term debt and other" on our balance sheet. These amounts are net of anticipated sublease income of \$8 million.
- (4) Consists of legally-binding commitments to purchase inventory and significant non-inventory commitments.

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***Pledged Securities***

We are required to pledge a portion of our marketable securities as collateral for standby letters of credit that guarantee certain of our contractual obligations, a line of credit, and real estate lease agreements. The amount required to be pledged for real estate lease agreements changes over the life of our leases and with fluctuations in our market capitalization, which is common shares outstanding multiplied by the closing price of our common stock, and based on our credit-rating. Information about collateral required to be pledged under these agreements is as follows:

	Standby Letters of Credit (1)	Line of Credit (2)	Real Estate Leases (3)	Total
	(in millions)			
Balance at December 31, 2004	\$ 50	\$ 2	\$ 22	\$ 74
Net change in collateral pledged	(7)	3	2	(2)
Balance at June 30, 2005 (4)	\$ 43	\$ 5	\$ 24	\$ 72

(1) Pursuant to available standby letter-of-credit facilities totaling \$130 million.

(2) Pursuant to an available line of credit totaling \$10 million.

(3) At June 30, 2005, our market capitalization was \$13.6 billion. The required amount of collateral to be pledged will increase by \$6 million if our market capitalization is equal to or below \$13 billion and decrease by \$5 million if our market capitalization exceeds \$18 billion.

(4) Includes \$9 million of cash equivalents pledged as collateral. See Item 1 of Part 1, “Financial Statements — Note 2 — Cash, Cash Equivalents, and Marketable Securities.”

We believe that current cash, cash equivalents, and marketable securities balances will be sufficient to meet our anticipated operating cash needs for at least the next 12 months. However, any projections of future cash needs and cash flows are subject to substantial uncertainty. See “Additional Factors That May Affect Future Results.” We continually evaluate opportunities to sell additional equity or debt securities, obtain credit facilities from lenders, repurchase common stock, pay dividends, or repurchase, refinance, or otherwise restructure our long-term debt for strategic reasons or to further strengthen our financial position. The sale of additional equity or convertible debt securities would likely be dilutive to our shareholders. In addition, we will, from time to time, consider the acquisition of, or investment in, complementary businesses, products, services, and technologies, which might affect our liquidity requirements or cause us to issue additional equity or debt securities. There can be no assurance that additional lines-of-credit or financing instruments will be available in amounts or on terms acceptable to us, if at all.

**Results of Operations**

We have organized our operations into two principal segments: North America and International. We present our segment information along the same lines that our chief executive reviews our operating results in assessing performance and allocating resources.

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**Net Sales and Gross Profit**

Net sales information is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
(in millions)				
Net Sales:				
North America	\$ 960	\$ 791	\$1,987	\$1,639
International	793	596	1,668	1,279
Consolidated	\$ 1,753	\$ 1,387	\$3,655	\$2,918
Year-over-year Percentage Growth:				
North America	21.2%	12.8%	21.2%	16.5%
International	33.2	49.8	30.4	64.7
Consolidated	26.3	26.1	25.3	33.6
Year-over-year Percentage Growth, excluding effect of exchange rates:				
North America	21.0%	12.7%	21.1%	16.3%
International	29.3	38.1	26.3	47.7
Consolidated	24.6	21.9	23.4	27.5
Net Sales Mix:				
North America	54.8%	57.1%	54.4%	56.2%
International	45.2	42.9	45.6	43.8
Consolidated	100.0	100.0	100.0	100.0

Revenue growth is due primarily to increased demand driven by increased selection, lower prices, including from our free shipping offers, and improved features and services available on our websites. Revenue growth is also affected by general economic conditions and by changes in exchange rates — see “Effect of Exchange Rates” below. The year-over-year growth rates for 2004 periods were affected by the Q2 2003 release of *Harry Potter and the Order of the Phoenix*, for which we sold over 1.4 million copies.

North America revenue growth rates for Q2 2005 and the first half of 2005 were higher than the comparable periods in 2004, which reflects several current-year factors such as our continued efforts to reduce prices for our customers, including from our free shipping offers, additions to our product categories and selection available on our websites, and increases in our marketing and promotional-related revenues including from our co-branded credit card agreement, as well as the prior year effect on growth rates of the Q2 2003 release of *Harry Potter and the Order of the Phoenix*.

International revenue growth rates for Q2 2005 and the first half of 2005 were lower than the comparable periods in 2004. This primarily reflects the increasing size of our International business, which creates a larger revenue base against which future growth is measured, offset partially by our customer experience initiatives including new category introductions; increased selection; third-party offerings; and our efforts to reduce prices for our customers, including from our free shipping offers.

The relative mix of worldwide net sales attributed to our International segment continues to increase, and we expect that, over time, our International segment will represent 50% or more of our consolidated total. Additionally, as we continue to offer increased selection, lower prices, and additional product lines in our Electronics and other general merchandise category, we expect to see the relative mix of sales from this category increase.

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Gross profit information is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(in millions)			
<b>Gross Profit:</b>				
North America	\$ 278	\$ 220	\$ 557	\$ 446
International	172	121	352	256
<b>Consolidated</b>	<b>\$ 450</b>	<b>\$ 341</b>	<b>\$ 909</b>	<b>\$ 702</b>
<b>Year-over-year Percentage Growth:</b>				
North America	26.6%	15.6%	25.0%	18.2%
International	41.7	44.7	37.2	52.9
Consolidated	32.0	24.5	29.5	28.9
<b>Gross Margin:</b>				
North America	29.0%	27.7%	28.0%	27.2%
International	21.7	20.4	21.1	20.0
Consolidated	25.7	24.6	24.9	24.1

The increase in gross profit in absolute terms during Q2 2005 and the first half of 2005 compared to comparable periods in 2004 corresponds with increases in sales, including increases in sales by third-party sellers, increases in amounts earned from our co-branded credit card agreement, and increases in amounts earned from our Merchant.com program, offset by our free shipping offers and lower prices for customers. Generally, our gross margins fluctuate based on several factors, including our product, service, and geographic mix of sales; sales volumes by third-party sellers; changes in vendor pricing; lowering prices for customers, including from competitive pricing decisions; improvements in product sourcing and inventory management; and the extent to which our customers accept our free shipping offers. Free shipping offers reduce shipping revenue and reduce our gross margins on retail sales. We view our shipping offers as an effective worldwide marketing tool and intend to continue offering them indefinitely. Additionally, in Q1 2005 we introduced a new shipping membership program, Amazon Prime, in which members receive free two-day shipping and discounted overnight shipping.

Sales of products by third-party sellers on our websites continue to increase, representing 28% and 24% of unit sales in Q2 2005 and Q2 2004, and 28% and 24% in the first half of 2005 and 2004. Since revenues from these sales are recorded as a net amount, they generally result in lower revenues but higher gross margin per unit. If product sales by third-party sellers continue to increase, the higher gross margin attributes of these sales will offset decreases in our gross margins due to lowering prices for customers over time by offering price reductions, free shipping offers, and promotions.

Gross profit growth is also affected by changes in exchange rates—see “Effect of Exchange Rates” below.

North America segment gross margins in Q2 2005 and the first half of 2005 improved by 125 basis points and 85 basis points over the comparable periods in 2004 resulting primarily from increases in sales by third-party sellers, increases in amounts earned from our co-branded credit card agreement, and increases in amounts earned from our Merchant.com program. Gross margins are also affected by the extent to which we receive discounts and allowances from our product suppliers, which are generally offset by our efforts to continue reducing prices for customers, including from our year-round free shipping offers.

International segment gross margins in Q2 2005 and the first half of 2005 improved by 130 basis points and 104 basis points over the comparable periods in 2004 resulting from several factors including increasing sales by third-party sellers and increases in discounts we receive from our product suppliers, offset partially by changes in mix of product sales and our efforts to continue reducing prices for customers, including from our year-round free shipping offers.

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**Supplemental Information**

Supplemental information about shipping results is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
	(in millions)			
Shipping Activity:				
Shipping revenue (1)	\$ 103	\$ 84	\$ 211	\$ 178
Outbound shipping costs	(148)	(119)	(311)	(255)
Net shipping cost	<u>\$ (45)</u>	<u>\$ (35)</u>	<u>\$ (100)</u>	<u>\$ (77)</u>
Year-over-year Percentage Growth:				
Shipping revenue	22.1%	5.2%	18.5%	12.3%
Outbound shipping costs	24.8	11.7	21.9	20.5
Net shipping cost	31.2	31.5	29.8	44.8
Percent of Net Sales:				
Shipping revenue	5.9%	6.1%	5.8%	6.1%
Outbound shipping costs	(8.5)	(8.6)	(8.6)	(8.8)
Net shipping cost	<u>(2.6)</u>	<u>(2.5)</u>	<u>(2.8)</u>	<u>(2.7)</u>

(1) Outbound shipping charges to customers do not include amounts earned on shipping by third-party sellers where we do not provide the fulfillment service.

We believe that offering low prices to our customers is fundamental to our future success. One way we offer lower prices is through free-shipping offers that result in a net cost to us in delivering products, as well as through membership in Amazon Prime. We seek to partially mitigate the costs of lowering prices over time through achieving higher sales volumes, negotiating better terms with our suppliers, and achieving better operating efficiencies, including by reducing split-shipments. In addition, we anticipate that the costs of lowering prices over time will be partially mitigated to the extent product sales by third-party sellers continue to increase.

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Supplemental information about our net sales is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
(in millions)				
Net Sales:				
North America				
Media	\$ 632	\$ 541	\$ 1,331	\$ 1,141
Electronics and other general merchandise	278	226	559	450
Other (1)	50	24	97	48
Total North America	\$ 960	\$ 791	\$ 1,987	\$ 1,639
International				
Media	\$ 614	\$ 496	\$ 1,289	\$ 1,072
Electronics and other general merchandise	178	99	377	206
Other (1)	1	1	2	1
Total International	\$ 793	\$ 596	\$ 1,668	\$ 1,279
Consolidated				
Media	\$ 1,246	\$ 1,037	\$ 2,620	\$ 2,213
Electronics and other general merchandise	456	325	936	656
Other (1)	51	25	99	49
Total consolidated	\$ 1,753	\$ 1,387	\$ 3,655	\$ 2,918
Year-over-year Percentage Growth:				
North America				
Media	16.7%	8.6%	16.7%	12.2%
Electronics and other general merchandise	22.9	27.3	24.1	30.3
Other	104.7	(5.8)	100.2	6.4
Total North America	21.2	12.8	21.2	16.5
International				
Media	23.8%	35.4%	20.3%	48.5%
Electronics and other general merchandise	80.2	218.3	83.2	281.7
Other	34.6	176.3	49.4	119.9
Total International	33.2	49.8	30.4	64.7
Consolidated				
Media	20.1%	19.9%	18.4%	27.3%
Electronics and other general merchandise	40.3	55.7	42.7	64.2
Other	102.7	(4.0)	99.0	7.7
Total consolidated	26.3	26.1	25.3	33.6
Consolidated Net Sales Mix:				
Media	71.1%	74.8%	71.7%	75.8%
Electronics and other general merchandise	26.0	23.4	25.6	22.5
Other	2.9	1.8	2.7	1.7
Total consolidated	100.0%	100.0%	100.0%	100.0%
North America	54.8%	57.1%	54.4%	56.2%
International	45.2	42.9	45.6	43.8
Total consolidated	100.0%	100.0%	100.0%	100.0%

(1) Includes non-retail activities, such as our Merchant.com program, and miscellaneous marketing and promotional activities, such as our co-branded credit card program.



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### ***Operating Expenses***

#### ***Fulfillment***

The increase in fulfillment costs in absolute dollars in comparison with the prior year relates primarily to variable costs corresponding with sales volume; our mix of product sales; costs associated with credit card fees; bad debt costs, including costs of our guarantee for certain third-party seller transactions; expanding fulfillment capacity; and stock-based compensation. Additionally, fulfillment for the first half of 2005 includes a loss of \$5 million relating to certain North America fulfillment assets removed from service in Q1 2005. Fulfillment includes stock-based compensation of \$5 million and \$3 million for Q2 2005 and Q2 2004, and \$8 million and \$4 million for the first half of 2005 and 2004. See “Supplemental Information about Stock-Based Compensation” below.

Fulfillment costs as a percentage of net sales may vary due to several factors, such as costs associated with bad debt, including costs of our guarantee for certain third-party seller transactions, our level of productivity and accuracy, changes in volume of units received and fulfilled, the extent we utilize fulfillment services provided by third parties, and our ability to reduce customer service contacts per unit by implementing improvements in our operations and enhancements to our customer self-service features. The mix of product sales affects fulfillment costs per shipment based on variations in shape and weight of products we sell. Additionally, since credit card fees associated with third-party seller transactions are based on the gross purchase price of underlying transactions, and bad debt costs associated with these transactions are higher as a percentage of revenue versus our retail sales, our increasing third-party sales have higher fulfillment costs as a percent of net sales.

We expanded our fulfillment capacity in 2004 and the first half of 2005 through gains in efficiencies as well as increases in leased warehouse space. We plan to continue expanding our world-wide fulfillment capacity in order to meet anticipated shipment volumes from sales of our own products as well as sales by third parties where we provide the fulfillment. We expect absolute amounts spent in fulfillment and fulfillment-related cost of sales to increase over time.

#### ***Marketing***

We direct customers to our websites primarily through a number of targeted online marketing channels, such as our Associates and Syndicated Stores programs, sponsored search, portal advertising, e-mail campaigns, and other initiatives. Our marketing expenses are largely variable, based on growth in sales and changes in rates. To the extent there is increased or decreased competition for these traffic sources, or to the extent our mix of these channels shifts, we would expect to see a corresponding change in our marketing expense. Marketing includes stock-based compensation of \$2 million for each of Q2 2005 and Q2 2004, and \$3 million for each of the first half 2005 and 2004. See “Supplemental Information about Stock-Based Compensation” below.

Marketing costs increased in absolute terms in Q2 2005 and the first half of 2005 compared to comparable prior year periods. These increases correspond with revenue growth as we utilized variable online marketing channels, such as our Associates program, sponsored search, and other variable marketing initiatives.

While costs associated with free shipping are not included in marketing expense, we view free shipping offers as an effective worldwide marketing tool, and intend to continue offering them indefinitely. We expect absolute amounts spent in marketing to increase over time.

#### ***Technology and Content***

Our spending in technology and content has primarily increased because we are adding computer scientists and software engineers to continue to enhance the customer experience on our websites and those websites powered by us, to improve our process efficiency, and to continue to invest in several areas of technology including seller platforms, search, web services, and digital initiatives. We intend to continue investing in areas of technology and content, and expect absolute amounts spent in technology and content to increase over time as

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we continue to add computer scientists and software engineers to our staff. Technology and content includes stock-based compensation of \$13 million for each of Q2 2005 and Q2 2004, and \$23 million and \$16 million for the first half of 2005 and 2004. See “Supplemental Information about Stock-Based Compensation” below.

A significant majority of our technology costs are incurred in the U.S. and most of them are allocated to our North America segment.

### ***General and Administrative***

The increase in spending in general and administrative in Q2 2005 versus Q2 2004 is primarily due to increases in payroll and related expenses, and the increase in the first half of 2005 over the comparable prior year period is primarily due to increases in payroll and related expenses, professional fees, and legal costs. In Q1 2005 we recorded a charge of \$8 million related to possible settlements of outstanding litigation, and in Q2 2005 the favorable resolution of one of these matters resulted in a \$3 million expense reduction. General and administrative includes stock-based compensation of \$6 million and \$4 million for Q2 2005 and Q2 2004, and \$11 million and \$6 million in the first half of 2005 and 2004. See “Supplemental Information about Stock-Based Compensation” below. We expect absolute amounts spent in general and administrative to increase over time.

### ***Supplemental Information about Stock-Based Compensation***

Prior to January 1, 2005, we accounted for stock-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. The intrinsic value method of accounting resulted in compensation expense for restricted stock and restricted stock units at fair value on date of grant based on the number of shares granted and the quoted price of our common stock, and for stock options to the extent option exercise prices were set below market prices on the date of grant. Also, to the extent we granted stock options subsequent to December 31, 2002 or stock awards were subject to an exchange offer, other modifications, or performance criteria, such awards were subject to variable accounting treatment. To the extent stock awards were forfeited prior to vesting, the corresponding previously recognized expense was reversed as an offset to operating expenses.

As of January 1, 2005, we adopted SFAS No. 123(R) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The fair value of restricted stock and restricted stock units is determined based on the number of shares granted and the quoted price of our common stock, and the fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under SFAS No. 123, *Accounting for Stock Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*. Such value is recognized as expense over the service period, net of estimated forfeitures, using the accelerated method under SFAS 123(R). Because we implemented SFAS 123(R), we no longer have employee stock awards subject to variable accounting treatment.

The adoption of SFAS 123(R) resulted in a cumulative benefit from accounting change of \$26 million in Q1 2005, which reflects the net cumulative impact of estimating forfeitures in the determination of period expense, rather than recording forfeitures when they occur as previously permitted.

Tax benefits resulting from stock-based compensation deductions in excess of amounts reported for financial reporting purposes were \$1 million and \$2 million for Q2 2005 and the first half of 2005. Prior to the adoption of SFAS 123(R), cash retained as a result of tax deductions relating to stock-based compensation was presented in operating cash flows, along with other tax cash flows, in accordance with the provisions of EITF 00-15, “*Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option*.” SFAS 123(R) supersedes EITF 00-15, amends SFAS 95, “*Statement of Cash Flows*,” and requires tax benefits relating to excess stock-based compensation deductions to be prospectively presented in the statement of cash flows as financing cash inflows.

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On March 29, 2005, the SEC published SAB 107, which provides the Staff's views on a variety of matters relating to stock-based payments. SAB 107 requires stock-based compensation be classified in the same expense line items as cash compensation. We have reclassified stock-based compensation from prior periods to correspond to current period presentation within the same operating expense categories as cash compensation paid to employees.

Information about operating expenses with and without stock-based compensation was as follows:

	Three months ended June 30, 2005			Three months ended June 30, 2004		
	As Reported	Stock-Based Compensation	Net	As Reported	Stock-Based Compensation	Net
<b>Operating Expenses:</b>						
Fulfillment	\$ 158	\$ (5)	\$ 153	\$ 126	\$ (3)	\$ 123
Marketing	42	(2)	40	34	(2)	32
Technology and content	106	(13)	93	71	(13)	58
General and administrative	38	(6)	32	31	(4)	27
Other operating expense (income)	2	—	2	(7)	—	(7)
Total operating expenses	\$ 346	\$ (26)	\$ 320	\$ 255	\$ (22)	\$ 233
<b>Year-over-year Percentage Growth:</b>						
Fulfillment	25.0%		24.5%	12.2%		14.2%
Marketing	23.5		25.9	26.0		25.7
Technology and content	48.7		59.4	8.5		12.2
General and administrative	24.6		18.9	16.9		24.6
<b>Percent of Net Sales:</b>						
Fulfillment	9.0%		8.7%	9.1%		8.8%
Marketing	2.4		2.3	2.4		2.3
Technology and content	6.0		5.3	5.1		4.2
General and administrative	2.2		1.8	2.2		2.0
	Six months ended June 30, 2005			Six months ended June 30, 2004		
	As Reported	Stock-Based Compensation	Net	As Reported	Stock-Based Compensation	Net
<b>Operating Expenses:</b>						
Fulfillment	\$ 324	\$ (8)	\$ 316	\$ 255	\$ (4)	\$ 251
Marketing	87	(3)	84	68	(3)	65
Technology and content	198	(23)	175	130	(16)	114
General and administrative	85	(11)	74	60	(6)	54
Other operating expense (income)	3	—	3	(8)	—	(8)
Total operating expenses	\$ 697	\$ (45)	\$ 652	\$ 505	\$ (29)	\$ 476
<b>Year-over-year Percentage Growth:</b>						
Fulfillment	27.2%		26.1%	14.2%		18.6%
Marketing	26.9		27.0	21.4		22.3
Technology and content	52.6		54.4	(0.3)		11.1
General and administrative	40.4		35.8	14.9		27.2
<b>Percent of Net Sales:</b>						
Fulfillment	8.9%		8.6%	8.7%		8.6%
Marketing	2.4		2.3	2.3		2.2
Technology and content	5.4		4.8	4.4		3.9
General and administrative	2.3		2.0	2.1		1.9

See Item 1 of Part I, "Financial Statements — Note 1 — Accounting Policies — Stock-Based Compensation."

### ***Other Operating Expense (Income)***

“Other operating expense (income)” includes amortization of intangibles and restructuring-related expenses or credits. Comparable amounts in Q2 2004 and for the first half of 2004 include gains of \$7 million and \$8 million related to the reduction of our restructure-related liability due to our occupation of certain office space previously vacated as part of our 2001 restructuring.

### ***Net Interest Expense***

The primary component of our net interest expense is the interest we incur on our long-term debt instruments, including \$900 million principal balance of our 4.75% U.S. Convertible Subordinated Notes and €490 million (\$593 million based on the exchange rate at June 30, 2005) of our 6.875% PEACS at June 30, 2005, offset partially by the effect of changes in exchange rates. Interest expense was \$22 million and \$26 million in Q2 2005 and Q2 2004, and \$48 million and \$54 million for the first half of 2005 and 2004, with declines primarily relating to principal repayments of our long-term debt.

At June 30, 2005, our total long-term debt was \$1.5 billion compared to \$1.8 billion at June 30, 2004. See Item 1 of Part I, “Financial Statements — Note 3 — Long-Term Debt and Other.”

We generally invest our excess cash in A-rated or higher short- to intermediate-term fixed income securities and AAA-rated money market mutual funds. Our interest income corresponds with the average balance of invested funds and the prevailing rates we are earning on them, which vary depending on the geographies in which they are invested.

### ***Remeasurements and Other***

Remeasurements and other consisted of the following:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(in millions)		(in millions)	
Foreign-currency gains on remeasurement of 6.875% PEACS (1)	\$ 42	\$ 8	\$ 77	\$ 28
Gain (loss) on sales of Euro-denominated investments, net	—	2	(2)	5
Loss on redemption of long-term debt (See Note 3)	—	—	(4)	(6)
Foreign-currency effect on intercompany balances (2)	(25)	(7)	(39)	(10)
Other (3)	1	13	—	19
<b>Total remeasurements and other</b>	<b>\$ 18</b>	<b>\$ 16</b>	<b>\$ 32</b>	<b>\$ 36</b>

- (1) Each period the remeasurement of our 6.875% PEACS from Euros to U.S. Dollars results in gains or losses recorded to “Remeasurements and other” on our consolidated statements of operations.
- (2) Represents the loss resulting from remeasurement of intercompany balances due to changes in foreign exchange rates.
- (3) In Q2 2005 and Q2 2004 we recorded a gain of \$3 million and \$14 million associated with the sale of one of our equity investments, and in Q1 2004, we recorded a gain of \$6 million relating to the settlement of a contractual dispute.

### ***Income Taxes***

Our effective tax rate for Q2 2005 and the first half of 2005 was higher than the 35% statutory rate associated with taxable income resulting from the Q1 2005 transfer of certain operating assets from the U.S. to

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international locations. We expect these asset transfers to result in tax expense for financial reporting purposes above the statutory rate throughout 2005 and beneficially impact our effective tax rate over time. Since we have NOLs, these asset transfers will not have a significant effect on cash taxes paid, which we expect to be approximately \$25 million in 2005, compared with \$4 million in 2004. Cash paid for income taxes was \$1 million and \$5 million in Q2 2005 and the first half of 2005, compared with \$1 million during Q2 2004 and the first half of 2004.

At June 30, 2005, approximately \$730 million of our gross deferred tax assets were related to approximately \$2.3 billion of NOLs. Our NOL deferred tax assets are reduced by a valuation allowance of approximately \$510 million due to uncertainty about their future realization. The remainder of our deferred tax assets relate to temporary timing differences between tax and financial reporting. The majority of our NOLs expire after 2016, and utilization of NOLs may be subject to certain limitations under Sections 382 and 1502 of the Internal Revenue Code, and other limitations under state and foreign tax laws.

### *Net Income*

Net income was \$52 million and \$76 million for Q2 2005 and Q2 2004, and was \$130 million and \$188 million for the first half of 2005 and 2004. The year-over-year declines in net income are primarily related to our provision for income taxes, which increased \$51 million and \$109 million for Q2 2005 and the first half of 2005 in comparison with the prior year periods. Income before income taxes was \$108 million and \$81 million for Q2 2005 and Q2 2004, and was \$216 million and \$191 million for the first half of 2005 and 2004. See "Income Taxes" above for a discussion of our tax provision.

### *Effect of Exchange Rates*

The effect on our consolidated statements of operations from changes in exchange rates versus the U.S. Dollar is as follows:

For the three months ended June 30,						
2005			2004			
At Prior Year Rates (1)	Exchange Rate Effect (2)	As Reported	At Prior Year Rates (1)	Exchange Rate Effect (2)	As Reported	
(in millions, except per share amounts)						
Net sales	\$ 1,728	\$ 25	\$ 1,753	\$ 1,340	\$ 47	\$ 1,387
Gross profit	445	5	450	331	10	341
Operating expenses	343	3	346	249	6	255
Operating income	102	2	104	82	4	86
Net interest expense and other	(14)	—	(14)	(20)	(1)	(21)
Remeasurements and other (3)	1	17	18	13	3	16
Net income	\$ 43	\$ 9	\$ 52	\$ 70	\$ 6	\$ 76
Diluted earnings per share	\$ 0.10	\$ 0.02	\$ 0.12	\$ 0.16	\$ 0.02	\$ 0.18

  

For the six months ended June 30,						
2005			2004			
At Prior Year Rates (1)	Exchange Rate Effect (2)	As Reported	At Prior Year Rates (1)	Exchange Rate Effect (2)	As Reported	
(in millions, except per share amounts)						
Net sales	\$ 3,600	\$ 55	\$ 3,655	\$ 2,784	\$ 134	\$ 2,918
Gross profit	897	12	909	675	27	702
Operating expenses	690	7	697	489	16	505
Operating income	208	4	212	186	11	197
Net interest expense and other	(32)	4	(28)	(39)	(3)	(42)
Remeasurements and other (3)	(5)	37	32	13	23	36
Net income	\$ 108	\$ 22	\$ 130	\$ 157	\$ 31	\$ 188
Diluted earnings per share	\$ 0.26	\$ 0.05	\$ 0.31	\$ 0.37	\$ 0.07	\$ 0.44

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- (1) Represents the outcome that would have resulted had currency exchange rates in the current period been the same as those in effect in the comparable prior year period.
- (2) Represents the increase (decrease) in reported amounts resulting from changes in exchange rates from those in effect in the comparable prior year period.
- (3) Includes foreign-currency gains (losses) on remeasurement of 6.875% PEACS and intercompany balances, and realized currency-related gains associated with sales of Euro-denominated investments held by a U.S. subsidiary. See Item 1 of Part I, “Financial Statements — Note 7 — Remeasurements and Other.”

### ***Non-GAAP Financial Measure: Free Cash Flow***

Regulation G, *Conditions for Use of Non-GAAP Financial Measures*, and other provisions of the 1934 Act define and prescribe the conditions for use of certain non-GAAP financial information. Our measure of “Free cash flow” meets the definition of a non-GAAP financial measure. Free cash flow is used in addition to and in conjunction with results presented in accordance with GAAP and free cash flow should not be relied upon to the exclusion of GAAP financial measures. Free cash flow reflects an additional way of viewing our liquidity that, when viewed with our GAAP results, provides a more complete understanding of factors and trends affecting our cash flows. Management strongly encourages investors to review our financial statements and publicly-filed reports in their entirety and to not rely on any single financial measure.

Free cash flow, which we reconcile to “Cash provided by (used in) operating activities,” is cash flow from operations reduced by “Purchases of fixed assets, including internal-use software and website development.” We use free cash flow, and ratios based on it, to conduct and evaluate our business because, although it is similar to cash flow from operations, we believe it is a useful measure of cash flows since purchases of fixed assets are a necessary component of ongoing operations. In limited circumstances in which proceeds from sales of fixed assets exceed purchases, free cash flow would exceed cash flow from operations. However, since we do not anticipate being a net seller of fixed assets, we expect free cash flow to be less than operating cash flows.

Free cash flow has limitations due to the fact that it does not represent the residual cash flow available for discretionary expenditures. For example, free cash flow does not incorporate payments made on capital lease obligations or cash payments for business acquisitions. Therefore, we believe it is important to view free cash flow as a complement to our entire consolidated statements of cash flows.

The following is a reconciliation of free cash flow to the most comparable GAAP measure, “Cash provided by operating activities” for the trailing twelve months ended June 30, 2005 and 2004 (in millions):

	Twelve Months Ended June 30,	
	2005	2004
Net cash provided by operating activities	\$ 624	\$ 410
Purchases of fixed assets, including internal-use software and website development	(138)	(56)
Free cash flow	\$ 486	\$ 354
Net cash provided by (used in) investing activities	\$ (492)	\$ (133)
Net cash used in financing activities	\$ (223)	\$ (261)

### **Guidance**

The Company provided guidance on July 26, 2005 in its earnings release furnished on Form 8-K as follows:

#### Third Quarter 2005 Guidance

- Net sales are expected to be between \$1.76 billion and \$1.91 billion, or grow between 20% and 31%, compared with third quarter 2004.

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- Operating income is expected to be between \$60 million and \$90 million, or between (26%) decline and 11% growth, compared with third quarter 2004. This guidance includes stock-based compensation of \$35 million, including the impact from the Company's January 1, 2005 early adoption of SFAS 123(R), and assumes, among other things, that no additional intangible assets are recorded, and that there are no further revisions to restructuring-related estimates.

### Full Year 2005 Expectations

- Net sales are expected to be between \$8.275 billion and \$8.675 billion, or grow between 20% and 25%, compared with 2004.
- Operating income is expected to be between \$415 million and \$515 million, or between (6%) decline and 17% growth, compared with 2004. This expectation includes stock-based compensation of \$110 million, including the impact from the Company's January 1, 2005 early adoption of SFAS 123(R), and assumes, among other things, that no additional intangible assets are recorded and that there are no further revisions to restructuring-related estimates.

These projections are subject to substantial uncertainty. See "Additional Factors That May Affect Future Results."

### **Additional Factors That May Affect Future Results**

The following risk factors and other information included in this Quarterly Report should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the following risks occur, our business, financial condition, operating results, and cash flows could be materially adversely affected.

#### ***We Have an Accumulated Deficit and May Incur Additional Losses***

We have incurred significant net losses since we began doing business. As of June 30, 2005, we had an accumulated deficit of \$2.3 billion and our stockholders' deficit was \$64 million. We have incurred substantial operating losses since our inception, and although we earned net income for Q2 2005, we may incur losses again in the future.

#### ***We Have Significant Indebtedness***

As of June 30, 2005, we had long-term indebtedness of \$1.5 billion. We make annual or semi-annual interest payments on the indebtedness under our two convertible notes, which are due in 2009 and 2010. Although we made debt principal reduction payments, we may incur substantial additional debt in the future, and in any event a significant portion of our future cash flow from operating activities is likely to remain dedicated to the payment of interest and the repayment of principal on our indebtedness. Our indebtedness could limit our ability to obtain additional financing for working capital, capital expenditures, debt service requirements, acquisitions or other purposes in the future, as needed; to plan for, or react to, changes in technology and in our business and competition; and to react in the event of an economic downturn.

There is no guarantee that we will be able to meet our debt service obligations. If we are unable to generate sufficient cash flow or obtain funds for required payments, or if we fail to comply with covenants in our indebtedness, we will be in default. In addition, we may not be able to refinance our indebtedness on terms acceptable to us, or at all.

See Item 1 of Part I, "Financial Statements and Supplementary Data — Note 3 — Long-Term Debt and Other."

***We Face Intense Competition***

The market segments in which we compete are rapidly evolving and intensely competitive, and we have many competitors in different industries, including both the retail and e-commerce services industries.

Many of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition, and significantly greater financial, marketing, and other resources than we have. They may be able to secure merchandise from vendors on more favorable terms and may be able to adopt more aggressive pricing policies. Competitors in both the retail and e-commerce services industries also may be able to devote more resources to technology development, fulfillment, and marketing than we do.

Competition in the e-commerce channel may intensify. Other companies in the retail and e-commerce service industries may enter into business combinations or alliances that strengthen their competitive positions. As various Internet market segments obtain large, loyal customer bases, participants in those segments may expand into the market segments in which we operate. In addition, new and expanded Web technologies may further intensify the competitive nature of online retail. The nature of the Internet as an electronic marketplace facilitates competitive entry and comparison shopping and renders it inherently more competitive than conventional retailing formats. This increased competition may reduce our sales, operating profits, or both.

***Our Expansion Places a Significant Strain on our Management, Operational and Financial Resources***

We are rapidly and significantly expanding our operations both domestically and internationally and will continue to expand further to pursue growth of our product and service offerings and customer base. Such expansion increases the complexity of our business and places a significant strain on our management, operations, technical performance, financial resources, and internal financial control and reporting functions, and there can be no assurance that we will be able to manage it effectively. Our current and planned personnel, systems, procedures, and controls may not be adequate to support and effectively manage our future operations, especially as we employ personnel in multiple geographic locations. We may not be able to hire, train, retain, motivate, and manage required personnel, which may limit our growth. If any of this were to occur, it could damage our reputation, limit our growth, negatively affect our operating results and harm our business.

***Our Expansion into New Product Areas and Geographic Regions Subjects Us to Business and Competitive Risks***

We do not expect to benefit in our newer market segments, whether products, services or new geographic areas, from the first-to-market advantage that we experienced in the U.S. online book channel. Our gross profits in our newer business activities may be lower than in our older business activities. In addition, we may have limited or no experience in new product and service activities and new geographic areas, and our customers may not favorably receive our new businesses. Our newer market segments may present special technology challenges that we have not faced before. To the extent we pursue commercial agreements, acquisitions and/or strategic alliances to facilitate new product or service activities or geographic expansion, the agreements, acquisitions and/or alliances may not be successful. If any of this were to occur, it could damage our reputation, limit our growth, negatively affect our operating results and harm our business.

***We May Experience Significant Fluctuations in Our Operating Results and Rate of Growth***

Due to our limited operating history, our evolving business model, and the unpredictability of our industry, we may not be able to accurately forecast our rate of growth. We base our current and future expense levels and our investment plans on estimates of future net sales and rate of growth. Our expenses and investments are to a large extent fixed, and we may not be able to adjust our spending quickly enough if our net sales fall short of our expectations.



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Our revenue and operating profit growth depends on the continued growth of demand for the products offered by us or our sellers, and our business is affected by general economic and business conditions throughout the world. A softening of demand, whether caused by changes in consumer preferences or a weakening of the U.S. or global economies, may result in decreased revenue or growth. Terrorist attacks and armed hostilities create economic and consumer uncertainty that could adversely affect our revenue or growth. Such events could create delays in, and increase the cost of, product shipments, which may decrease demand. Revenue growth may not be sustainable and our company-wide percentage growth rate may decrease in the future.

Our net sales and operating results will also fluctuate for many other reasons, including:

- our ability to retain and increase sales to existing customers, attract new customers, and satisfy our customers' demands;
- our ability to expand our network of sellers, and to enter into, maintain, renew, and amend on favorable terms our commercial agreements and strategic alliances;
- foreign exchange rate fluctuations, particularly as international sales become an increasingly larger contributor to our revenues;
- our ability to acquire merchandise, manage inventory, and fulfill orders;
- the introduction by our current or future competitors of websites, products, services, price decreases, or improvements;
- changes in usage of the Internet and e-commerce, including in non-U.S. markets;
- timing, effectiveness, and costs of upgrades and developments in our systems and infrastructure;
- the effects of commercial agreements and strategic alliances and our ability to successfully implement the underlying relationships and integrate them into our business;
- the effects of acquisitions, and other business combinations and our ability to successfully integrate them into our business;
- the success of our geographic and product line expansions;
- the outcomes of legal proceedings and claims;
- technical difficulties, system downtime, or interruptions;
- variations in the mix of products and services we sell;
- variations in our level of merchandise and vendor returns;
- disruptions in service by shipping carriers;
- the extent to which we offer free shipping, continue to reduce product prices worldwide, and provide additional benefits to our customers which reduce our gross or operating profits;
- the extent to which we invest in technology and content, fulfillment, marketing and other expense categories;
- the extent to which we provide for and pay taxes; and
- increases in the prices of fuel and gasoline, which are used in the transportation of packages, as well as increases in the prices of other energy products, primarily natural gas and electricity, and commodities like paper and packing supplies, all of which are used in our operating facilities.

Finally, both seasonal fluctuations in Internet usage and traditional retail seasonality are likely to affect our business. Internet usage generally slows during the summer months, and sales in almost all of our product groups, particularly toys and electronics, usually increase significantly in the fourth calendar quarter of each year.

***We May Not Be Successful in Our Efforts to Expand into International Market Segments***

Our international activities have become increasingly significant to our revenues and profits and we plan, over time, to continue to expand our reach in international market segments. We have relatively little experience in purchasing, marketing, and distributing products or services for these market segments and may not benefit from any first-to-market advantages. It is costly to establish international facilities and operations, promote our brand internationally and develop localized websites, stores, and other systems. We may not succeed in these efforts. Our net sales from international market segments may not offset the expense of establishing and maintaining the related operations and, therefore, these operations may not be profitable on a sustained basis.

Our international sales and related operations are subject to a number of risks inherent in selling abroad, including, but not limited to, risks with respect to:

- foreign exchange rate fluctuations;
- local economic and political conditions;
- restrictive governmental actions (such as trade protection measures, including export duties and quotas and custom duties and tariffs) and restrictions on the level of foreign ownership;
- restrictions on sales of certain products or services and uncertainty regarding our liability for the products or services we offer and content provided by us or our users, including uncertainty as a result of less Internet-friendly legal systems, local laws, lack of legal precedent, and varying rules, regulations, and practices regarding the distribution of media products and enforcement of intellectual property rights;
- import, export, or other business licensing requirements;
- limitations on the repatriation of funds and foreign currency exchange restrictions;
- difficulty in obtaining distribution and support;
- nationalization or restrictions on foreign ownership;
- shorter payable and longer receivable cycles and the resultant negative impact on cash flow;
- consumer and data protection laws and restrictions on pricing or discounts;
- lower levels of adoption or use of the Internet and other technologies vital to our business and the lack of appropriate infrastructure to support widespread Internet usage;
- lower levels of consumer spending on a per capita basis and fewer opportunities for growth in certain foreign market segments compared to the U.S.;
- lower levels of credit card usage and increased payment risk;
- difficulty in staffing, developing and managing a number of unique foreign operations as a result of distance, language and cultural differences;
- different employee/employer relationships and the existence of workers' councils and labor unions;
- laws and policies of the U.S. and other jurisdictions affecting trade, foreign investment, and loans;
- tax and other laws of the U.S. and other jurisdictions; and
- geopolitical events, including war and terrorism.

As the international e-commerce channel continues to grow, competition will likely intensify. Local companies may have a substantial competitive advantage because of their greater understanding of, and focus on, the local customer, as well as their more established local brand name recognition. In addition, governments in foreign jurisdictions may regulate e-commerce or other online services in such areas as licenses, content, privacy,

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network security, copyright, encryption, taxation, or distribution. We may not be able to hire, train, retain, motivate, and manage required personnel, which may limit our growth in international market segments.

### ***If We Do Not Successfully Optimize and Operate Our Fulfillment Centers, Our Business Could Be Harmed***

If we do not successfully operate our fulfillment centers, it could significantly limit our ability to meet customer demand. Because it is difficult to predict demand, we may not manage our facilities in an optimal way, which may result in excess or insufficient inventory or warehousing, fulfillment, and distribution capacity. A failure to optimize inventory in our fulfillment network will increase our net shipping cost by requiring us to make long-zone shipments or partial shipments from one or more locations. Orders from several of our internationally-focused websites are fulfilled primarily from a single fulfillment center, and we have only a limited ability to reroute orders to third parties for drop-shipping. We and our co-sourcers may be unable to adequately staff our fulfillment and customer service centers. As we continue to add fulfillment and warehouse capability or add new businesses with different fulfillment requirements, operating our fulfillment network becomes more challenging and there can be no assurance that we will be able to operate our network effectively.

We rely on a limited number of shipping companies to deliver inventory to our fulfillment centers and completed orders to our customers. If we are not able to negotiate acceptable terms with these companies or they experience performance problems or other difficulties, it could negatively impact our operating results and customer experience. In addition, our ability to receive inbound inventory efficiently and ship completed orders to customers also may be negatively affected by inclement weather, fire, flood, power loss, earthquakes, labor disputes, acts of war or terrorism, acts of God and similar factors.

Third parties either drop-ship or otherwise fulfill an increasing portion of our customers' orders, and we are increasingly reliant on the reliability, quality, and future procurement of their services. Under some of our commercial agreements, we maintain the inventory of other companies in our fulfillment centers, thereby increasing the complexity of tracking inventory in and operating our fulfillment centers. Our failure to properly handle such inventory or the inability or failure of these other companies to accurately forecast product demand would result in unexpected costs and other harm to our business and reputation.

### ***The Seasonality of Our Business Places Increased Strain on Our Operations***

We expect a disproportionate amount of our net sales to be realized during the fourth quarter of our fiscal year. If we do not stock popular products in sufficient amounts or fail to have sources to timely restock popular products, such that we fail to meet customer demand, it could significantly affect our revenue and our future growth. If we overstock products, we may be required to take significant inventory markdowns or write-offs, which could reduce gross profits. A failure to optimize inventory in our fulfillment network will harm our shipping margins by requiring us to make long-zone shipments or partial shipments from one or more locations. Orders from several of our internationally-focused websites are fulfilled primarily from a single fulfillment center, and we have only a limited ability to reroute orders to third parties for drop-shipping. We may experience an increase in our net shipping cost due to complimentary upgrades, split-shipments, and additional long-zone shipments necessary to ensure timely delivery, especially for the holiday season. If the other businesses on whose behalf we perform inventory fulfillment services deliver product to our fulfillment centers in excess of forecasts, we may be unable to secure sufficient storage space and may be unable to optimize our fulfillment centers. If too many customers access our websites within a short period of time due to increased holiday or other demand, we may experience system interruptions that make our websites unavailable or prevent us from efficiently fulfilling orders, which may reduce the volume of goods we sell and the attractiveness of our products and services. In addition, we may be unable to adequately staff our fulfillment centers during these peak periods and third parties that provide fulfillment services to our customers may be unable to meet the seasonal demand. Finally, we, along with our customer service co-sourcers, may be unable to adequately staff customer service centers.

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We generally have payment terms with our vendors that extend beyond the amount of time necessary to collect proceeds from our customers. As a result of holiday sales, at December 31 of each year, our cash, cash equivalents, and marketable securities balances typically reach their highest level (other than as a result of cash flows provided by or used in investing and financing activities). This operating cycle results in a corresponding increase in accounts payable. Our accounts payable balance should decline during the first three months following year-end, which will result in a decline in the amount of cash, cash equivalents, and marketable securities on hand.

### ***Our Business Could Suffer if We Are Unsuccessful in Making, Integrating, and Maintaining Commercial Agreements, Strategic Alliances, and Other Business Relationships***

We may enter into commercial agreements, strategic alliances, and other business relationships with other companies. We have entered into agreements to provide e-commerce services to other businesses and we plan to enter into similar agreements in the future, including as part of our Merchants@, Syndicated Stores, and Merchant.com initiatives. Under such agreements, we may perform services such as: providing our technology services such as search, browse, and personalization; permitting other businesses and individuals to offer products or services through our websites; and powering third-party websites, either with or without providing accompanying fulfillment services. These arrangements are complex and require substantial personnel and resource commitments by us, which may constrain the number of such agreements we are able to enter into and may affect our ability to integrate and deliver services under the relevant agreements. If we fail to implement, maintain, and develop successfully the various components of such commercial relationships, which may include fulfillment, customer service, inventory management, tax collection, payment processing, licensing of third party software, hardware, and content, and engaging third parties to perform hosting and other services, these initiatives may not be viable. The amount of compensation we receive under certain of these agreements is partially dependent on the volume of sales that the other company makes. Therefore, if the other business's website or product or services offering is not successful, we may not receive all of the compensation we are otherwise due under the agreement or may not be able to maintain the agreement. Moreover, we may not be able to succeed in our plans to enter into additional commercial relationships and strategic alliances on favorable terms.

As our commercial agreements expire or otherwise terminate, we may be unable to renew or replace these agreements on comparable terms, or at all. In the past, we amended several of our commercial agreements to reduce future cash proceeds to be received by us, shorten the term of the agreements, or both. Some of our agreements involve high margin services, such as marketing and promotional agreements, and as such agreements expire they may be replaced, if at all, by agreements involving lower margin services. In addition, several past commercial agreements were with companies that experienced business failures and were unable to meet their obligations to us. We may in the future enter into further amendments of our commercial agreements or encounter other parties that have difficulty meeting their contractual obligations to us, which could adversely affect our operating results. As an example, we are currently in litigation with Toysrus.com over our commercial agreement, and Toysrus.com's parent, Toysrus, Inc., recently was acquired by a private investment group. In the event of the early termination of our commercial agreement with Toysrus.com, we would attempt to replace the product selection currently provided by Toysrus.com with owned inventory and offerings from other parties, but our operating results could be negatively impacted.

Our present and future third-party services agreements, other commercial agreements, and strategic alliances create additional risks such as:

- disruption of our ongoing business, including loss of management focus on existing businesses;
- impairment of other relationships;
- variability in revenue and income from entering into, amending, or terminating such agreements or relationships; and
- difficulty integrating under the commercial agreements.

***Our Business Could Suffer if We Are Unsuccessful in Making, Integrating, and Maintaining Acquisitions and Investments***

We have acquired and invested in a number of companies, including our acquisition of Joyo.com in September 2004, and we may acquire or invest in (such as through joint ventures or other business combinations) additional companies. Acquisitions and investments create risks such as:

- disruption of our ongoing business, including loss of management focus on existing businesses;
- problems retaining key technical and managerial personnel, resulting from, among other factors, changes in compensation, responsibilities, reporting relationships, future prospects, and the direction of the business;
- additional operating losses and expenses of the businesses we acquired or in which we invested;
- the potential impairment of amounts capitalized as intangible assets as part of the acquisition;
- the potential impairment of customer and other relationships of the company we acquired or in which we invested or our own customers as a result of any integration of operations;
- the difficulty of incorporating acquired technology and rights into our offerings and unanticipated expenses related to such integration;
- the difficulty of integrating a new company's accounting, financial reporting, management, information, human resource and other administrative systems to permit effective management, and the lack of control if such integration is delayed or not implemented;
- the difficulty of implementing controls, procedures and policies appropriate for a larger public company at companies that prior to acquisition or investment had lacked such controls, procedures and policies;
- potential unknown liabilities associated with a company we acquire or in which we invest; and
- for foreign acquisitions and investments, additional risks related to the integration of operations across different cultures and languages, currency risks, and the particular economic, political, and regulatory risks associated with specific countries.

Finally, as a result of future acquisitions or mergers, we might need to issue additional equity securities, spend our cash, or incur debt, contingent liabilities, or amortization expenses related to intangible assets, any of which could reduce our profitability and harm our business.

***Our Recent Acquisition of Joyo.com Creates Risks and Uncertainties Relating to the Laws of the People's Republic of China***

In September, 2004, we acquired Joyo.com, a company organized under the laws of the British Virgin Islands. Joyo.com operates [www.joyo.com](http://www.joyo.com) and [www.joyo.com.cn](http://www.joyo.com.cn) in the People's Republic of China ("PRC") in cooperation with a PRC subsidiary and PRC affiliates and is subject to many of the risks described in "Our Business Could Suffer if We are Unsuccessful in Making, Integrating, and Maintaining Acquisitions and Investments" and "We May Not Be Successful in Our Efforts to Expand into International Market Segments." In addition, the PRC regulates Joyo.com's business through regulations and license requirements restricting (i) the scope of foreign investment in the Internet, retail and delivery sectors, (ii) Internet content and (iii) the sale of certain media products. In order to meet the PRC local ownership and regulatory licensing requirements, Joyo.com's business is operated through a PRC subsidiary which acts in cooperation with PRC companies owned by nominee shareholders who are PRC nationals. Although we believe Joyo.com's structure complies with existing PRC laws, it involves unique risks. There are substantial uncertainties regarding the interpretation of PRC laws and regulations, and it is possible that the PRC government will ultimately take a view contrary to ours. If Joyo.com or its subsidiary or affiliates were found to be in violation of any existing or future PRC laws or regulations or if interpretations of those laws and regulations were to change, the business could be subject to

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fines and other financial penalties, have its licenses revoked or be forced to shut down entirely. In addition, if Joyo.com were unable to enforce its contractual relationships with respect to management and control of its business, it might be unable to continue to operate the business.

### ***We Have Foreign Exchange Risk***

The results of operations of, and certain of our intercompany balances associated with, our internationally-focused websites are exposed to foreign exchange rate fluctuations. Upon translation, net sales and other operating results may differ materially from expectations, and we may record significant gains or losses on the remeasurement of intercompany balances. As we have expanded our international operations, our exposure to exchange rates fluctuations has become more pronounced. See Item 2 of Part I, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Results of Operations — Effect of Exchange Rates" for a table demonstrating the effect on our consolidated statements of operations from changes in exchange rates versus the U.S. Dollar.

In addition, our 6.875% PEACS are denominated in Euros, not U.S. Dollars. We remeasure the principal of the 6.875% PEACS quarterly based on fluctuations in the Euro/U.S. Dollar exchange ratio and record gains or losses in "Remeasurements and other" on our consolidated statements of operations. As a result, increases in the Euro relative to the U.S. Dollar increase the U.S. dollar amount we owe as interest and principal. Furthermore, we hold cash equivalents and/or marketable securities in Euros, British Pounds, Yen, Canadian Dollars, and Chinese Yuan. Accordingly, if the U.S. Dollar strengthens compared to these currencies, cash equivalents and marketable securities balances, when translated, may be materially less than expected and vice versa.

### ***Our Investments and the Consideration We Receive under Certain Commercial Agreements May Subject Us to a Number of Risks***

In the past, we have entered into commercial agreements with other companies, including strategic alliances whereby we perform certain e-commerce services, and in exchange for our services we received cash, equity securities of these companies, and/or additional benefits, such as website traffic. The amount of compensation we receive under certain of these agreements is dependent on the volume of sales made by the other company. In some cases, we have also made separate investments in the other company by making a cash payment in exchange for equity securities of that company. We may make similar investments in the future. To the extent we have received equity securities as compensation, fluctuations in the value of such securities will affect our ultimate realization of amounts we have received as compensation for services.

In the past, we amended several of our commercial agreements to reduce future cash proceeds to be received by us, shorten the term of our commercial agreements, or both. We may in the future enter into further amendments of our commercial agreements. Although these amendments did not affect the amount of unearned revenue previously recorded by us (if any), the timing of revenue recognition of these recorded unearned amounts was changed to correspond with the terms of the amended agreements. To the extent we believe any such amendments cause or may cause the compensation to be received under an agreement to no longer be fixed or determinable, we limit our revenue recognition to amounts received, excluding any future amounts not deemed fixed or determinable. As future amounts are subsequently received, such amounts are incorporated into our revenue recognition over the remaining term of the agreement.

Our investments in equity securities are included in "Marketable securities" and "Other assets" on our consolidated balance sheets. We regularly review all of our investments in public and private companies for other-than-temporary declines in fair value. When we determine that the decline in fair value of an investment below our accounting basis is other-than-temporary, we reduce the carrying value of the securities we hold and record a loss in the amount of any such decline. In recent years, securities of companies in the Internet and e-commerce industries have experienced significant difficulties. We may conclude in future quarters that the fair values of our investments have experienced additional other-than-temporary declines. As of June 30, 2005, our

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recorded basis in equity securities was \$25 million, including \$8 million classified as “Marketable securities” and \$18 million classified as “Other assets.”

### ***The Loss of Key Senior Management Personnel Could Negatively Affect Our Business***

We depend on the continued services and performance of our senior management and other key personnel, particularly Jeffrey P. Bezos, our President, Chief Executive Officer, and Chairman of the Board. We do not have “key person” life insurance policies. The loss of any of our executive officers or other key employees could harm our business.

### ***System Interruption and the Lack of Integration and Redundancy in Our Systems May Affect Our Sales***

Customer access to our websites directly affects the volume of goods we sell and the services we offer and thus affects our net sales. We experience occasional system interruptions that make our websites unavailable or prevent us from efficiently fulfilling orders or providing services to third parties, which may reduce our net sales and the attractiveness of our products and services. If we are unable to continually add additional software and hardware and upgrade in an effective manner our systems and network infrastructure, it could cause system interruption and adversely affect our operating results.

Our computer and communications systems and operations could be damaged or interrupted by fire, flood, power loss, telecommunications failure, earthquakes, acts of war or terrorism, acts of God, computer viruses, physical or electronic break-ins, and similar events or disruptions. Any of these events could cause system interruption, delays, and loss of critical data, and could prevent us from accepting and fulfilling customer orders. Should this occur, it would make our product offerings less attractive to our customers and our service offerings less attractive to third parties. While we do have backup systems for certain aspects of our operations, our systems are not fully redundant and our disaster recovery planning may not be sufficient for all eventualities. In addition, we may have inadequate insurance coverage or insurance limits to compensate us for losses from a major interruption. If any of this were to occur, it could damage our reputation and be expensive to remedy.

### ***We Face Significant Inventory Risk***

We are exposed to significant inventory risks as a result of seasonality, new product launches, rapid changes in product cycles and changes in consumer tastes with respect to our products. In order to be successful, we must accurately predict these trends and avoid overstocking or under-stocking products. Demand for products, however, can change significantly between the time inventory is ordered and the date of sale. In addition, when we begin selling a new product, it may be difficult to establish vendor relationships, determine appropriate product selection, and accurately forecast product demand. A failure to optimize inventory within our fulfillment network will increase our net shipping cost by requiring us to make split shipments from one or more locations, complimentary upgrades, and additional long-zone shipments necessary to ensure timely delivery.

As a result of our third-party services relationships with Toysrus.com, Babiesrus.com, Target, and other companies, these parties identify, buy, and bear the financial risk of inventory obsolescence for their corresponding stores and merchandise. As a result, if any of these parties fail to forecast product demand or optimize or maintain access to inventory, we would receive reduced service fees under the agreements and our business and reputation could be harmed.

The acquisition of certain types of inventory, or inventory from certain sources, may require significant lead-time and prepayment, and such inventory may not be returnable. We carry a broad selection and significant inventory levels of certain products, such as consumer electronics, and we may be unable to sell products in sufficient quantities or during the relevant selling seasons.

Any one of the inventory risk factors set forth above may adversely affect our operating results.

***We May Not Be Able to Adequately Protect Our Intellectual Property Rights or May Be Accused of Infringing Intellectual Property Rights of Third Parties***

We regard our trademarks, service marks, copyrights, patents, trade dress, trade secrets, proprietary technology, and similar intellectual property as critical to our success, and we rely on trademark, copyright, and patent law, trade secret protection, and confidentiality and/or license agreements with our employees, customers, partners, and others to protect our proprietary rights. Effective trademark, service mark, copyright, patent, and trade secret protection may not be available in every country in which our products and services are made available online.

We also may not be able to acquire or maintain appropriate domain names in all countries in which we do business. Furthermore, regulations governing domain names may not protect our trademarks and similar proprietary rights. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe upon, or diminish the value of our trademarks and other proprietary rights.

Policing unauthorized use of our proprietary rights is inherently difficult, and we may not be able to determine the existence or extent of any such unauthorized use. The protection of our intellectual property may require the expenditure of significant financial and managerial resources. Moreover, we cannot be certain that the steps we take to protect our intellectual property will adequately protect our rights or that others will not independently develop or otherwise acquire equivalent or superior technology or other intellectual property rights.

Third parties that license our proprietary rights may take actions that diminish the value of our proprietary rights or reputation. In addition, the steps we take to protect our proprietary rights may not be adequate and third parties may infringe or misappropriate our copyrights, trademarks, trade dress, patents, and similar proprietary rights. Other parties may claim that we infringed their proprietary rights. We have been subject to, and expect to continue to be subject to, claims and legal proceedings regarding alleged infringement by us of the patents, trademarks, and other intellectual property rights of third parties. Such claims, whether or not meritorious, may result in the expenditure of significant financial and managerial resources, injunctions against us or the imposition of damages that we must pay. We may need to obtain licenses from third parties who allege that we have infringed their rights, but such licenses may not be available on terms acceptable to us or at all. In addition, we may not be able to obtain or utilize on terms that are favorable to us, or at all, licenses or other rights with respect to intellectual property we do not own in providing e-commerce services to other businesses and individuals under commercial agreements.

***We Have a Limited Operating History and Our Stock Price Is Highly Volatile***

We have a relatively short operating history and, as an e-commerce company, we have a rapidly evolving and unpredictable business model. The trading price of our common stock fluctuates significantly. Trading prices of our common stock may fluctuate in response to a number of events and factors, such as:

- general economic conditions;
- changes in interest rates;
- conditions or trends in the Internet and the e-commerce industry;
- fluctuations in the stock market in general and market prices for Internet-related companies in particular;
- quarterly variations in operating results;
- new products, services, innovations, and strategic developments by our competitors or us, or business combinations and investments by our competitors or us;
- changes in financial estimates by us or securities analysts and recommendations by securities analysts;



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- changes in Internet regulation;
- changes in our capital structure, including issuance of additional debt or equity to the public;
- additions or departures of key personnel;
- corporate restructurings, including layoffs or closures of facilities;
- changes in the valuation methodology of, or performance by, other e-commerce companies; and
- transactions in our common stock by major investors and certain analyst reports, news, and speculation.

Any of these events may cause our stock price to rise or fall and may adversely affect our business and financing opportunities.

Future volatility in our stock price could force us to increase our cash compensation to employees or grant larger stock awards than we have historically, which could hurt our operating results or reduce the percentage ownership of our existing stockholders, or both.

### ***Government Regulation of the Internet and E-commerce Is Evolving and Unfavorable Changes Could Harm Our Business***

We are subject to general business regulations and laws, as well as regulations and laws specifically governing the Internet and e-commerce. Such existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, user privacy, data protection, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, the provision of online payment services, broadband residential Internet access, and the characteristics and quality of products and services. It is not clear how existing laws governing issues such as property ownership, sales and other taxes, libel, and personal privacy apply to the Internet and e-commerce. Unfavorable resolution of these issues may harm our business. In addition, many jurisdictions currently regulate “auctions” and “auctioneers” and may regulate online auction services. Jurisdictions may also regulate other consumer-to-consumer online markets, including certain aspects of Amazon Marketplace. This could, in turn, diminish the demand for our products and services and increase our cost of doing business.

### ***Taxation Risks Could Subject Us to Liability for Past Sales and Cause Our Future Sales to Decrease***

We do not collect sales taxes or other taxes with respect to shipments of most of our goods into most states in the U.S. Under some of our commercial agreements, the other company is the seller of record of the applicable merchandise and we are obligated to collect sales tax in most states in accordance with that company’s instructions. We may enter into additional strategic alliances requiring similar tax collection obligations. Our fulfillment center and customer service center networks, and any future expansion of those networks, along with other aspects of our evolving business, may result in additional sales and other tax obligations. We collect consumption tax (including value added tax, goods and services tax, and provincial sales tax) as applicable on goods and services sold by us that are ordered on our international sites. One or more states or foreign countries may seek to impose sales or other tax collection obligations on out-of-jurisdiction companies that engage in e-commerce. A successful assertion by one or more states or foreign countries that we should collect sales or other taxes on the sale of merchandise or services could result in substantial tax liabilities for past sales, decrease our ability to compete with traditional retailers, and otherwise harm our business.

Currently, decisions of the U.S. Supreme Court restrict the imposition of obligations to collect state and local sales and use taxes with respect to sales made over the Internet. However, a number of states, as well as the U.S. Congress, have been considering various initiatives that could limit or supersede the Supreme Court’s position regarding sales and use taxes on Internet sales. If any of these initiatives addressed the Supreme Court’s constitutional concerns and resulted in a reversal of its current position, we could be required to collect sales and use taxes in additional states. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could decrease our future sales.

***Our Vendor Relationships Subject Us to a Number of Risks***

Although we continue to increase the number of vendors that supply products to us and no vendor accounts for 10% or more of our inventory purchases, we have significant vendors that are important to our sourcing. We do not have long-term contracts or arrangements with most of our vendors to guarantee the availability of merchandise, particular payment terms, or the extension of credit limits. If our current vendors were to stop selling merchandise to us on acceptable terms, we may not be able to acquire merchandise from other suppliers in a timely and efficient manner and on acceptable terms.

***We May Be Subject to Product Liability Claims if People or Property Are Harmed by the Products We Sell***

Some of the products we sell may expose us to product liability claims relating to personal injury, death, or property damage caused by such products, and may require us to take actions such as product recalls. Certain businesses and individuals also sell products using our e-commerce platform that may increase our exposure to product liability claims, such as if these sellers do not have sufficient resources to protect themselves from such claims. Although we maintain liability insurance, we cannot be certain that our coverage will be adequate for liabilities actually incurred or that insurance will continue to be available to us on economically reasonable terms, or at all. In addition, some of our vendor agreements with our distributors, manufacturers, and third party sellers do not indemnify us from product liability.

***We Could Be Liable for Breaches of Security on Our Website***

A fundamental requirement for e-commerce is the secure storage and transmission of confidential information. Although we have developed systems and processes that are designed to protect consumer information and prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches may adversely affect our operating results.

***We Could Be Liable for Fraudulent or Unlawful Activities of Sellers***

The law relating to the liability of providers of online payment services is currently unsettled. In addition, we are aware that governmental agencies have investigated the provision of online payment services and could require changes in the way this business is conducted. Under Merchants@, Marketplace and certain other of our programs, we may be unable to prevent sellers from collecting payments, fraudulently or otherwise, when buyers never receive the products they ordered or when the products received are materially different from the sellers' descriptions. Under our A2Z Guarantee, we reimburse buyers for payments up to certain limits in these situations and as our third party sales grow, the cost of this program will increase and could negatively affect our operating results. Any costs we incur as a result of liability because of our A2Z Guarantee or otherwise could harm our business. In addition, the functionality of our payments program depends on certain third-party vendors delivering services. If these vendors are unable or unwilling to provide services, our payments program and our businesses that use it may not be viable. Finally, we may be unable to prevent sellers in our Merchants@, Marketplace, Merchant.com, and certain other programs from selling unlawful goods, from selling goods in an unlawful manner, or violating the proprietary rights of others, and could face civil or criminal liability for unlawful activities by our sellers.

***We May Not Be Able to Adapt Quickly Enough to Changing Customer Requirements and Industry Standards***

Technology in the e-commerce industry changes rapidly. We may not be able to adapt quickly enough to changing customer requirements and preferences and industry standards. Competitors often introduce new products and services with new technologies. These changes and the emergence of new industry standards and practices could render our existing websites and proprietary technology obsolete.

### ***The Internet as a Medium for Commerce Is Subject to Uncertainty***

Consumer use of the Internet as a medium for commerce is subject to uncertainty. While the number of Internet users has been rising, the Internet infrastructure may not expand fast enough to meet the increased levels of demand. In addition, activity that diminishes the experience for Internet users, such as spyware, spoof emails, viruses and spam directed at Internet users, as well as viruses and “denial of service” attacks directed at Internet companies and service providers, may discourage people from using the Internet, including for commerce. Furthermore, newer users of the Internet could be less active e-commerce customers compared to our earlier customers. If use of the Internet as a medium for commerce grows at a slower rate than we anticipate, our sales would be lower than expected and our business could be harmed.

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

We are exposed to market risk for the effect of interest rate changes, foreign currency fluctuations, and changes in the market values of our investments.

Information relating to quantitative and qualitative market risks is set forth below and in Item 2 of Part I, “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources.”

#### ***Interest Rate Risk***

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio and our long-term debt. All of our cash equivalent and marketable fixed income securities are designated as available-for-sale and, accordingly, are presented at fair value on our balance sheets. We generally invest our excess cash in A-rated or higher short- to intermediate-term fixed income securities and AAA-rated money market mutual funds. Fixed rate securities may have their fair market value adversely affected due to a rise in interest rates, and we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates.

At June 30, 2005, we had long-term debt of \$1.5 billion primarily associated with our 4.75% Convertible Subordinated Notes and 6.875% PEACS, which are due in 2009 and 2010. The market value of our long-term debt will fluctuate with movements of interest rates, increasing in periods of declining rates of interest and declining in periods of increasing rates of interest. Based upon quoted market prices, the fair value of the 4.75% Convertible Subordinated Notes (outstanding principal of \$900 million) was \$863 million and \$907 million at June 30, 2005 and December 31, 2004, and the fair value of the 6.875% PEACS (outstanding principal of €490 million and €690 million) was \$599 million and \$936 million at June 30, 2005 and December 31, 2004.

#### ***Foreign Exchange Risk***

During Q2 2005, net sales from our International segment (consisting of [www.amazon.co.uk](http://www.amazon.co.uk), [www.amazon.de](http://www.amazon.de), [www.amazon.fr](http://www.amazon.fr), [www.amazon.co.jp](http://www.amazon.co.jp), and [www.joyo.com](http://www.joyo.com)) accounted for 45% of our consolidated revenues. Net sales and related expenses generated from these websites, as well as those relating to [www.amazon.ca](http://www.amazon.ca) (which is included in our North America segment), are denominated in the functional currencies of the corresponding websites and include British Pounds, Euros, Yen, Chinese Yuan, and Canadian Dollars. The functional currency of our subsidiaries that either operate or support these websites is the same as the corresponding local currency. The results of operations of, and certain of our intercompany balances associated with, our internationally-focused websites are exposed to foreign exchange rate fluctuations. Upon consolidation, as exchange rates vary, net sales and other operating results may differ materially from expectations, and we may record significant gains or losses on the remeasurement of intercompany balances. For example, as a result of fluctuations in foreign exchange rates throughout the period compared to rates in effect the prior year, International segment revenues in Q2 2005 improved \$23 million and our consolidated operating income improved \$2 million.

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We have foreign exchange risk related to foreign-denominated cash, cash equivalents, and marketable securities (“foreign funds”). Based on the balance of foreign funds at June 30, 2005 of \$679 million, an assumed 5%, 10%, and 20% negative currency movement would result in fair value declines of \$34 million, \$68 million, or \$136 million. The balance of foreign funds at June 30, 2004 was \$645 million. All investments are classified as “available for sale,” as defined by SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

We have foreign exchange risk related to our 6.875% PEACS, which have an outstanding principal balance at June 30, 2005 of €490 million (\$593 million, based on the exchange rate as of June 30, 2005). Due to fluctuations in the Euro/U.S. Dollar exchange ratio, which we cannot predict, our remaining principal debt obligation under the 6.875% PEACS since issuance in February 2000 has increased by \$110 million as of June 30, 2005. Based on the outstanding 6.875% PEACS’ principal balance, an assumed 5%, 10%, and 20% weakening of the U.S. Dollar in relation to the Euro would result in additional losses of approximately \$30 million, \$59 million, or \$119 million, recorded to “Remeasurements and other.” Additionally, we have not hedged our interest payments under our 6.875% PEACS to protect against exchange rate fluctuations. Assuming the U.S. Dollar weakens against the Euro by 5%, 10%, and 20%, we would incur \$2 million, \$4 million, or \$8 million additional annual interest expense due solely to fluctuations in foreign exchange.

See Item 2 of Part I, “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Effect of Exchange Rates” for additional information on the effect on reported results of changes in exchange rates.

### ***Investment Risk***

As of June 30, 2005, our recorded basis in equity securities (including both publicly-traded and private companies) was \$25 million, including \$8 million classified as “Marketable securities,” and \$18 million classified as “Other assets.” We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that declines in the fair value of such assets below our accounting basis are other-than-temporary. The fair values of our investments are subject to significant fluctuations due to volatility of the stock market in general, company-specific circumstances, and changes in general economic conditions. Based on the fair value of the publicly-traded equity securities we held at June 30, 2005 of \$72 million (recorded basis of \$18 million), an assumed 15%, 30%, and 50% adverse change to market prices of these securities would result in a corresponding decline in total fair value of approximately \$11 million, \$22 million, or \$36 million.

### ***Item 4. Controls and Procedures***

We carried out an evaluation required by the 1934 Act, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) of the 1934 Act, as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective in providing reasonable assurance that material information required to be included in our periodic SEC reports is made known to them in a timely manner. Management does not expect that our disclosure controls and procedures will prevent or detect all error and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected.

During the most recent fiscal quarter, there has not occurred any change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II OTHER INFORMATION

### Item 1. *Legal Proceedings*

See Item 1 of Part I, “Financial Statements — Note 4 — Commitments and Contingencies.”

### Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds*

On April 13, 2005, De Anza Properties exercised a portion of their warrant and received 970 shares of our common stock at a per share exercise price of \$6.1588. We assumed this warrant obligation in connection with a 1998 acquisition. The shares were issued in reliance on an exemption from registration under Section 4(a)(2) under the 1933 Act.

### Item 3. *Defaults Upon Senior Securities*

None.

### Item 4. *Submission of Matters to a Vote of Security Holders*

Our annual meeting of stockholders was held on May 17, 2005. The following nominees were elected as directors, each to hold office until his or her successor is elected and qualified, by the vote set forth below:

Nominee	For	Withheld
Jeffrey P. Bezos	373,536,299	5,372,965
Tom A. Alberg	374,581,183	4,328,081
John Seely Brown	374,262,454	4,646,810
L. John Doerr	370,764,481	8,144,783
William B. Gordon	374,595,336	4,313,928
Myrtle S. Potter	374,222,857	4,686,407
Thomas O. Ryder	374,364,087	4,545,177
Patricia Q. Stonesifer	374,603,217	4,306,047

The appointment of Ernst & Young LLP as our independent auditor was ratified by the vote set forth below:

	Votes
For	376,509,858
Against	321,691
Abstain	2,077,715
Broker Non-Votes	-0-

A shareholder proposal regarding the voting standard for election of directors was not adopted by the vote set forth below:

	Votes
For	62,370,567
Against	253,204,613
Abstain	2,267,768
Broker Non-Votes	61,066,316

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**Item 5. Other Information**

None.

**Item 6. Exhibits**

*Exhibits*

<u>Exhibit Number</u>	<u>Description</u>
3.1	Restated Certificate of Incorporation of the Company (incorporated by reference to the Company's Quarterly Report on Form 10-Q for the Quarterly Period Ended March 31, 2000).
3.2	Restated Bylaws of the Company (incorporated by reference to the Company's Quarterly Report on Form 10-Q for the Quarterly Period Ended March 31, 2002).
12.1	Computation of Ratio of Earnings to Fixed Charges.
31.1	Certification of Jeffrey P. Bezos, Chairman and Chief Executive Officer of Amazon.com, Inc., pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
31.2	Certification of Thomas J. Szkutak, Senior Vice President and Chief Financial Officer of Amazon.com, Inc., pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
32.1	Certification of Jeffrey P. Bezos, Chairman and Chief Executive Officer of Amazon.com, Inc., pursuant to 18 U.S.C. Section 1350.
32.2	Certification of Thomas J. Szkutak, Senior Vice President and Chief Financial Officer of Amazon.com, Inc., pursuant to 18 U.S.C. Section 1350.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AMAZON.COM, INC. (REGISTRANT)

By: /s/ MARK S. PEEK

**Mark S. Peek**  
Vice President and  
Chief Accounting Officer

Dated: July 27, 2005

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