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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2002

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

AMAZON.COM, INC.

(Exact name of registrant as specified in its charter)

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
(Address of principal executive offices, zip code)

(206) 266-1000
(Registrant's telephone number, including area code)

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 ☐

381,465,499 shares of \$0.01 par value common stock outstanding as of October 14, 2002

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AMAZON.COM, INC.
FORM 10-Q
For the Three Months Ended September 30, 2002

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

AMAZON.COM, INC.

CONSOLIDATED BALANCE SHEETS (in thousands, except per share data) (Unaudited)

	September 30, 2002	December 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 327,564	\$ 540,282
Marketable securities	538,238	456,303
Inventories	151,514	143,722
Prepaid expenses and other current assets	102,291	67,613
Total current assets	1,119,607	1,207,920
Fixed assets, net	239,238	271,751
Goodwill, net	70,811	45,367
Other intangibles, net	4,373	34,382
Investments in equity-method investees	1,136	10,387
Other equity investments	15,362	17,972
Other assets	46,878	49,768
Total assets	\$ 1,497,405	\$ 1,637,547
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	\$ 347,519	\$ 444,748
Accrued expenses and other current liabilities	241,674	305,064
Unearned revenue	65,878	87,978
Interest payable	42,793	68,632
Current portion of long-term debt and other	13,134	14,992
Total current liabilities	710,998	921,414
Long-term debt and other	2,264,846	2,156,133
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, \$0.01 par value:		
Authorized shares—500,000		
Issued and outstanding shares—none	—	—
Common stock, \$0.01 par value:		
Authorized shares—5,000,000		
Issued and outstanding shares—381,216 and 373,218 shares, respectively	3,812	3,732
Additional paid-in capital	1,550,118	1,462,769
Deferred stock-based compensation	(7,775)	(9,853)
Accumulated other comprehensive loss	(12,233)	(36,070)
Accumulated deficit	(3,012,361)	(2,860,578)
Total stockholders' deficit	(1,478,439)	(1,440,000)
Total liabilities and stockholders' deficit	\$ 1,497,405	\$ 1,637,547

See accompanying notes to consolidated financial statements.

AMAZON.COM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net sales	\$ 851,299	\$ 639,281	\$ 2,504,326	\$ 2,007,262
Cost of sales	635,132	477,089	1,846,867	1,482,753
Gross profit	216,167	162,192	657,459	524,509
Operating expenses:				
Fulfillment	90,342	81,400	265,908	265,231
Marketing	26,728	32,537	87,804	103,833
Technology and content	52,907	53,846	166,569	188,840
General and administrative	18,698	21,481	59,034	70,287
Stock-based compensation (1)	(832)	(2,567)	33,247	2,700
Amortization of goodwill and other intangibles	1,212	41,835	4,565	143,496
Restructuring-related and other	36,757	3,994	46,731	176,904
Total operating expenses	225,812	232,526	663,858	951,291
Loss from operations	(9,645)	(70,334)	(6,399)	(426,782)
Interest income	5,600	6,316	16,902	23,073
Interest expense	(35,922)	(35,046)	(106,817)	(103,942)
Other income (expense), net	3,183	(2,203)	2,876	(7,265)
Other gains (losses), net	2,261	(63,625)	(55,677)	(18,453)
Total non-operating expenses, net	(24,878)	(94,558)	(142,716)	(106,587)
Loss before equity in losses of equity-method investees	(34,523)	(164,892)	(149,115)	(533,369)
Equity in losses of equity-method investees, net	(557)	(4,982)	(3,469)	(28,472)
Loss before change in accounting principle	(35,080)	(169,874)	(152,584)	(561,841)
Cumulative effect of change in accounting principle	—	—	801	(10,523)
Net loss	\$ (35,080)	\$ (169,874)	\$ (151,783)	\$ (572,364)
Basic and diluted loss per share:				
Prior to cumulative effect of change in accounting principle	\$ (0.09)	\$ (0.46)	\$ (0.41)	\$ (1.55)
Cumulative effect of change in accounting principle	—	—	0.01	(0.03)
	\$ (0.09)	\$ (0.46)	\$ (0.40)	\$ (1.58)
Shares used in computation of loss per share:				
Basic and diluted	379,650	368,052	376,564	361,782
(1) Components of stock-based compensation:				
Fulfillment	\$ (98)	\$ (575)	\$ 5,512	\$ 206
Marketing	115	(110)	2,419	370
Technology and content	(765)	(948)	17,305	1,708
General and administrative	(84)	(934)	8,011	416
	\$ (832)	\$ (2,567)	\$ 33,247	\$ 2,700

See accompanying notes to consolidated financial statements.

AMAZON.COM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	\$ 270,438	\$ 462,949	\$ 540,282	\$ 822,435
OPERATING ACTIVITIES:				
Net loss	(35,080)	(169,874)	(151,783)	(572,364)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Depreciation of fixed assets and other amortization	20,501	19,795	62,411	63,662
Stock-based compensation	(832)	(2,567)	33,247	2,700
Equity in losses of equity-method investees, net	557	4,982	3,469	28,472
Amortization of goodwill and other intangibles	1,212	41,835	4,565	143,496
Non-cash restructuring-related and other	2,370	1,881	2,370	70,410
Gain on sale of marketable securities, net	(3,020)	(1,351)	(3,833)	(1,137)
Other losses (gains), net	(2,261)	63,625	55,677	18,453
Non-cash interest expense and other	7,911	6,834	22,436	20,119
Cumulative effect of change in accounting principle	—	—	(801)	10,523
Changes in operating assets and liabilities:				
Inventories	(24,029)	(659)	(2,935)	44,441
Prepaid expenses and other current assets	(14,670)	2,960	(31,420)	18,091
Accounts payable	49,408	(22,594)	(106,296)	(253,984)
Accrued expenses and other current liabilities	40,895	(9,721)	(37,455)	(15,212)
Unearned revenue	26,237	33,443	75,641	76,640
Amortization of previously unearned revenue	(29,487)	(30,100)	(97,741)	(95,400)
Interest payable	(1,604)	(2,892)	(25,840)	(27,812)
Net cash provided by (used in) operating activities	38,108	(64,403)	(198,288)	(468,902)
INVESTING ACTIVITIES:				
Sales and maturities of marketable securities and other investments	50,621	141,724	400,532	303,061
Purchases of marketable securities	(28,186)	(223,817)	(462,290)	(280,938)
Purchases of fixed assets, including internal-use software and Web site development	(11,353)	(12,925)	(23,647)	(42,787)
Net cash provided by (used in) investing activities	11,082	(95,018)	(85,405)	(20,664)
FINANCING ACTIVITIES:				
Proceeds from exercise of stock options and other	6,038	1,101	56,313	14,578
Proceeds from issuance of common stock, net of issuance costs	—	99,831	—	99,831
Proceeds from long-term debt and other	—	—	—	10,000
Repayment of capital lease obligations and other	(4,126)	(6,466)	(12,121)	(15,135)
Net cash provided by financing activities	1,912	94,466	44,192	109,274
Effect of exchange-rate changes on cash and cash equivalents	6,024	34,313	26,783	(9,836)
Net increase (decrease) in cash and cash equivalents	57,126	(30,642)	(212,718)	(390,128)
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 327,564	\$ 432,307	\$ 327,564	\$ 432,307
SUPPLEMENTAL CASH FLOW INFORMATION:				
Fixed assets acquired under capital leases	\$ 162	\$ 2,014	\$ 2,297	\$ 4,483
Equity securities received for commercial agreements	—	—	—	331
Cash paid for interest	29,898	30,275	110,947	110,990

See accompanying notes to consolidated financial statements.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2002

Note 1. ACCOUNTING POLICIES

Unaudited Interim Financial Information

The accompanying consolidated financial statements have been prepared by Amazon.com, Inc. ("Amazon.com" or the "Company") 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 the opinion of management, include all adjustments, consisting of normal recurring adjustments and accruals, as well as the accounting changes to adopt Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets," necessary for a fair presentation of the consolidated balance sheets, operating results, and cash flows for the periods presented. Operating results for the three and nine months ended September 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002 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 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 the Company's Annual Report on Form 10-K for the year ended December 31, 2001. Certain prior period amounts have been reclassified to conform to the current period presentation.

Loss Per Share

The weighted average number of shares used in calculating loss per share for the three month and nine month periods ended September 30, 2002 and 2001 was reduced by 1 million for each period. These reductions reflect the weighted average number of outstanding shares subject to repurchase or forfeiture for the corresponding periods. The effects of outstanding stock options are antidilutive and, accordingly, are excluded from diluted loss per share.

Revenues

Product sales, net of promotional gift certificates and return allowances, are recorded when the products are shipped and title passes to customers. Retail items sold to customers are made pursuant to a sales contract that provides for transfer of both title and risk of loss upon the Company's delivery to the carrier (commonly referred to as "F.O.B. Shipping Point"). Return allowances (which reduce product revenue by the Company's best estimate of expected product returns) are estimated using historical experience.

Amounts billed to customers for outbound shipping charges are included in net sales and were \$73 million and \$74 million for the three months ended September 30, 2002 and 2001, respectively, and \$244 million and \$232 million for the nine months ended September 30, 2002 and 2001, respectively.

Technology and Content

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

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

*Accounting Changes**Change in Accounting for Inventory Costing*

Effective January 1, 2002, the Company prospectively changed its inventory costing method to the first-in first-out (“FIFO”) method of accounting. This change resulted in a cumulative increase in inventory of \$0.8 million, with a corresponding amount recorded to “Cumulative effect of change in accounting principle” on the consolidated statements of operations. The Company has evaluated the effect of the change on each quarter of 2001 and determined such effect to be less than \$1.2 million individually and in the aggregate. The Company has determined this change to be preferable under accounting principles generally accepted in the United States since, among other reasons, it facilitates the Company’s record keeping process, significantly improves its ability to provide cost-efficient fulfillment services to third-party companies as part of its services offering, and results in increased consistency with others in the industry. The Company has received a letter of preferability for this change in inventory costing from its independent auditors.

In accordance with Accounting Principles Board Opinion No. 20, Accounting Changes, the effect of this accounting change is reflected prospectively. Supplemental comparative disclosure, as if the change had been retroactively applied to the prior year periods, is as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net loss:				
Reported net loss	\$ (35,080)	\$ (169,874)	\$ (151,783)	\$ (572,364)
Inventory costing change	—	1,162	(801)	913
Adjusted net loss	\$ (35,080)	\$ (168,712)	\$ (152,584)	\$ (571,451)
Basic and diluted loss per share:				
Reported loss per share	\$ (0.09)	\$ (0.46)	\$ (0.40)	\$ (1.58)
Inventory costing change	—	—	(0.01)	—
Adjusted basic and diluted loss per share	\$ (0.09)	\$ (0.46)	\$ (0.41)	\$ (1.58)

Change in Accounting for Goodwill and Certain Other Intangibles

Effective July 1, 2001, the Company adopted certain provisions of SFAS No. 141, and effective January 1, 2002, the Company adopted the full provisions of SFAS No. 141 and SFAS No. 142. SFAS No. 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting, and broadens the criteria for recording intangible assets apart from goodwill. The Company evaluated its goodwill and intangibles acquired prior to June 30, 2001 using the criteria of SFAS No. 141, which resulted in \$25 million of other intangibles (comprised entirely of assembled workforce intangibles) being subsumed into goodwill at January 1, 2002. SFAS No. 142 requires that purchased goodwill and certain indefinite-lived intangibles no longer be amortized, but instead be tested for impairment at least annually. The Company evaluated its intangible assets, as noted below, and determined that all such assets have determinable lives.

SFAS No. 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment; while the second phase (if necessary) measures the impairment. The Company completed its first

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

phase impairment analysis during the first quarter of 2002 and found no instances of impairment of its recorded goodwill; accordingly, the second testing phase was not necessary. No subsequent indicators of impairment have been noted by the Company.

In accordance with SFAS No. 142, the effect of this accounting change is reflected prospectively. Supplemental comparative disclosure, as if the change had been retroactively applied to the prior year periods, is as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net loss:				
Reported net loss	\$ (35,080)	\$ (169,874)	\$ (151,783)	\$ (572,364)
Goodwill amortization (1)	—	39,692	—	136,932
Adjusted net loss	\$ (35,080)	\$ (130,182)	\$ (151,783)	\$ (435,432)
Basic and diluted loss per share:				
Reported loss per share	\$ (0.09)	\$ (0.46)	\$ (0.40)	\$ (1.58)
Goodwill amortization (1)	—	0.11	—	0.38
Adjusted basic and diluted loss per share	\$ (0.09)	\$ (0.35)	\$ (0.40)	\$ (1.20)

- (1) Includes \$13 million and \$41 million, or \$0.04 and \$0.11 per share, for the three months and nine months ended September 30, 2001, respectively, related to amortization of other intangibles that are classified as goodwill effective January 1, 2002.

For the three months and nine months ended September 30, 2002, no goodwill or other intangibles were acquired, impaired, or disposed.

Other intangibles consisted of the following (in thousands):

	September 30, 2002			December 31, 2001		
	Gross Carrying Amount	Accumulated Amortization	Other Intangibles, Net	Gross Carrying Amount	Accumulated Amortization	Other Intangibles, Net
Contract-based	\$ 16,584	\$ (13,711)	\$ 2,873	\$ 16,584	\$ (11,170)	\$ 5,414
Marketing-related	5,617	(4,930)	687	5,617	(3,793)	1,824
Technology-based	4,386	(4,324)	62	4,386	(3,808)	578
Customer-related	2,021	(1,270)	751	2,021	(899)	1,122
Assembled workforce (1)	—	—	—	193,271	(167,827)	25,444
Other intangibles	\$ 28,608	\$ (24,235)	\$ 4,373	\$ 221,879	\$ (187,497)	\$ 34,382

- (1) As of January 1, 2002, in accordance with SFAS No. 142, the Company reclassified its assembled workforce intangibles into goodwill.

The net carrying amount of intangible assets at September 30, 2002 is scheduled to be fully amortized by the end of fiscal 2004. Amortization expense for the net carrying amount of intangible assets at September 30, 2002

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

is estimated to be \$1 million for the remainder of fiscal 2002, \$3 million in fiscal 2003, and less than \$1 million in fiscal 2004.

Change in Accounting for Derivative Instruments

Effective January 1, 2001, the Company adopted SFAS No. 133, which requires that all derivative instruments be recorded on the balance sheet at fair value. Changes in the fair value of derivatives are recorded each period in current results of operations or other comprehensive income (loss) depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction.

The adoption of SFAS No. 133 resulted in the reporting of cumulative transition losses of \$11 million in the results of operations and \$12 million as a stockholders' deficit adjustment during the first quarter 2001.

Note 2. MARKETABLE SECURITIES

Marketable securities, at fair value, consist of the following (in thousands):

	September 30, 2002	December 31, 2001
Certificates of deposit	\$ 20,727	\$ 18,159
Commercial paper and short-term obligations	37,281	28,622
Corporate notes and bonds	16,963	37,602
Asset-backed and agency securities	327,561	232,821
Treasury notes and bonds	132,557	125,947
Equity securities	3,149	13,152
	<u>\$ 538,238</u>	<u>\$ 456,303</u>

The Company has pledged a portion of its marketable securities as collateral for certain of its contractual obligations. See Note 8 of these "Notes to Consolidated Financial Statements."

Note 3. UNEARNED REVENUE

During the nine months ended September 30, 2002, activity in unearned revenue was as follows (in thousands):

Balance, December 31, 2001	\$ 87,978
Cash received or accounts receivable	75,641
Amortization to revenue	(97,741)
Balance, September 30, 2002	<u>\$ 65,878</u>

All amounts recorded as accounts receivable, including amounts associated with unearned or deferred revenue, are legally due and contractually enforceable. At September 30, 2002 and December 31, 2001, accounts receivable (included in "Prepaid expenses and other current assets" on the consolidated balance sheets) associated with unearned revenue were \$6 million and \$1 million, respectively.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

Note 4. STOCK-BASED COMPENSATION

During the first quarter of 2001, the Company offered a limited non-compulsory exchange of employee stock options. The exchange resulted in the voluntary cancellation of employee stock options to purchase 31 million shares of common stock with varying exercise prices in exchange for 12 million employee stock options with an exercise price of \$13.375. The option exchange offer resulted in variable accounting treatment for, at the time of the exchange, approximately 15 million stock options, which includes options granted under the exchange offer and 3 million options, with a weighted average exercise price of \$52.41, that were subject to the exchange offer but were not exchanged. Variable accounting will continue until all options subject to variable accounting treatment are exercised, cancelled, or expired. At September 30, 2002, approximately 8 million shares remain under variable accounting treatment, which includes 7 million options granted under the exchange offer and 1 million options, with a weighted average exercise price of \$42.68, that were subject to the exchange offer but were not exchanged. Variable accounting treatment will result in unpredictable charges or credits, recorded to "Stock-based compensation," dependent on fluctuations in quoted prices for the Company's common stock.

Stock-based compensation includes stock-based charges resulting from variable accounting treatment, option-related deferred compensation recorded at the Company's initial public offering, as well as certain other compensation and severance arrangements. Stock-based compensation also includes the portion of acquisition-related consideration conditioned on the continued tenure of key employees of certain acquired businesses, which must be classified as compensation expense rather than as a component of purchase price under accounting principles generally accepted in the United States. Additionally, stock-based compensation will include amounts associated with the Company's planned restricted stock unit program. Under this program, the Company will, commencing in the fourth quarter of 2002, award restricted stock units as its primary vehicle for employee equity compensation. Restricted stock units are measured at fair value on the date of grant based on the number of shares granted and the quoted price of the Company's common stock. Such value is recognized as an expense ratably over the corresponding service period. To the extent restricted stock units are forfeited prior to vesting, the corresponding previously recognized expense is reversed as an offset to "Stock-based compensation."

Stock-based compensation was a credit of \$1 million and a credit of \$3 million for the three months ended September 30, 2002 and 2001, respectively, and an expense of \$33 million and an expense of \$3 million for the nine months ended September 30, 2002 and 2001, respectively. As the quoted price of the Company's common stock at September 30, 2002 was below the quoted price at June 30, 2002, previously recorded variable accounting charges were partially reversed. However, these reversed charges were partially offset by costs associated with exercises of vested options and costs associated with incremental vesting during the period. As of September 30, 2002, cumulative compensation expense associated with variable accounting treatment was \$29 million, of which \$12 million was associated with options exercised.

The number of shares of common stock subject to outstanding vested and unvested employee stock options was approximately 48 million and 66 million, or 13% and 18% of the Company's outstanding common stock, at September 30, 2002 and December 31, 2001, respectively.

Note 5. RESTRUCTURING-RELATED AND OTHER

Restructuring-related and other expenses were \$37 million and \$4 million for the three months ended September 30, 2002 and 2001, respectively, and \$47 million and \$177 million for the nine months ended September 30, 2002 and 2001, respectively. In the first quarter of 2001, the Company announced and began implementation of its operational restructuring plan to reduce operating costs, streamline its organizational

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

structure, consolidate certain of its fulfillment and customer service operations, and migrate a large portion of its technology infrastructure to a new operating platform. This initiative involved the reduction of employee staff by 1,327 positions throughout the Company in managerial, professional, clerical, technical, and fulfillment roles; consolidation of its Seattle, Washington corporate office locations; closure of its McDonough, Georgia fulfillment center; seasonal operation of its Seattle, Washington fulfillment center; closure of its customer service centers in Seattle, Washington and The Hague, Netherlands; and migration of a large portion of the Company's technology infrastructure to a new operating platform, which entails ongoing lease obligations for technology infrastructure no longer being utilized. Actual employee termination benefits paid were \$12 million. Each component of the restructuring plan is complete, however, as discussed below, the Company may adjust its restructuring-related estimates, if necessary (See Note 8—"Commitments and Contingencies").

In the third quarter of 2002, related to its January 2001 operational restructuring, the Company recorded an additional restructuring-related expense of \$37 million associated with ongoing lease obligations relating to vacated office and fulfillment center space and other costs, including revised sublease income estimates to reflect current information and higher-than-expected tenant improvement costs necessary to sublease vacated space. The Company revised its restructuring-related expense estimate due to a number of factors, primarily related to weakness in the real estate markets in Seattle, Washington and Atlanta, Georgia. In addition, during the first quarter 2002, the Company permanently closed its fulfillment center in Seattle, Washington and revised its sublease income estimates for office space vacated as part of the restructuring, resulting in additional restructuring-related expenses of \$10 million primarily associated with ongoing lease obligations.

Restructuring-related charges were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Asset impairments	\$ —	\$ 1,852	\$ —	\$ 67,825
Continuing lease obligations	36,757	1,275	45,835	85,280
Termination benefits	—	694	—	15,455
Broker commissions, professional fees, and other miscellaneous restructuring costs	—	173	896	8,344
	<u>\$ 36,757</u>	<u>\$ 3,994</u>	<u>\$ 46,731</u>	<u>\$ 176,904</u>

At September 30, 2002, the accrued liability associated with restructuring-related and other charges was \$74 million and consisted of the following (in thousands):

	Balance at December 31, 2001	Subsequent Accruals, Net	Payments	Balance at September 30, 2002	Due Within 12 Months	Due After 12 Months
Lease obligations, net of estimated sublease income (See Note 8)	\$ 53,187	\$ 45,835	\$(30,935)	\$ 68,087	\$ 19,005	\$ 49,082
Termination benefits	61	—	(61)	—	—	—
Broker commissions, professional fees, and other miscellaneous restructuring costs	8,190	896	(3,393)	5,693	—	5,693
	<u>\$ 61,438</u>	<u>\$ 46,731</u>	<u>\$(34,389)</u>	<u>\$ 73,780</u>	<u>\$ 19,005</u>	<u>\$ 54,775</u>

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)
September 30, 2002

Note 6. OTHER INCOME (EXPENSE), NET

Other income (expense), net consisted of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Gains (losses) on sale of marketable securities, net	\$ 3,020	\$ 1,351	\$ 3,833	\$ 1,137
Foreign-currency transaction gains (losses), net	(360)	(1,150)	(411)	(2,532)
Gains (losses) on disposal of fixed assets, net	47	4	(567)	(83)
Miscellaneous state, foreign, and other taxes	(274)	(1,338)	(617)	(5,834)
Other miscellaneous gains (losses), net	750	(1,070)	638	47
	<u>\$ 3,183</u>	<u>\$ (2,203)</u>	<u>\$ 2,876</u>	<u>\$ (7,265)</u>

Note 7. OTHER GAINS (LOSSES), NET

Other gains (losses), net consisted of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Foreign-currency gains (losses) on 6.875% PEACS	\$ 123	\$ (39,572)	\$ (64,637)	\$ 29,118
Gains (losses) on sale of Euro-denominated investments, net	—	(16,332)	2,227	(22,548)
Other-than-temporary impairment losses on equity investments	—	(2,382)	(5,362)	(43,408)
Gains (losses) on sale of equity investments, net	2,236	—	12,339	—
Contract termination, Kozmo.com	—	—	—	22,400
Warrant remeasurements and other	(98)	(5,339)	(244)	(4,015)
	<u>\$ 2,261</u>	<u>\$ (63,625)</u>	<u>\$ (55,677)</u>	<u>\$ (18,453)</u>

Currency gains and losses arising from the remeasurement of the 6.875% Convertible Subordinated Notes due 2010 (“6.875% PEACS”) principal from Euros to U.S. dollars each period are recorded to “Other gains (losses), net.”

The Company holds warrants to purchase equity securities of other companies. Warrants that can be exercised and settled by delivery of net shares such that the Company pays no cash upon exercise are deemed derivative financial instruments under the provisions of SFAS No. 133. Such warrants are not designated as hedging instruments; accordingly, gains or losses resulting from changes in fair value are recognized on the consolidated statements of operations in the period of change.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

Note 8. COMMITMENTS AND CONTINGENCIES

Commitments

The Company currently leases office and fulfillment center facilities and fixed assets under non-cancelable operating and capital leases. Rental expense under operating lease agreements was \$13 million and \$16 million for the three months ended September 30, 2002 and 2001, respectively, and \$43 million and \$66 million for the nine months ended September 30, 2002 and 2001, respectively.

Contractual commitments associated with the Company's operational restructuring, indebtedness, lease obligations, and marketing agreements are as follows (in thousands):

	Three Months Ending December 31, 2002	Year Ending December 31,					Total
		2003	2004	2005	2006	Thereafter	
Restructuring-related commitments:							
Operating leases, net of estimated sublease income	\$ 6,235	\$ 16,170	\$ 14,581	\$ 7,903	\$ 5,326	\$ 17,872	\$ 68,087
Other	—	1,580	1,000	3,113	—	—	5,693
Restructuring-related commitments	6,235	17,750	15,581	11,016	5,326	17,872	73,780
Other commitments:							
Debt principal and other (1)	1,196	4,962	2,004	74	—	2,188,229	2,196,465
Debt interest (1)	—	124,871	138,074	138,074	138,074	397,234	936,327
Capital leases	2,559	7,555	624	—	—	—	10,738
Operating leases	17,767	54,640	44,765	38,188	38,457	177,050	370,867
Marketing agreements	5,311	4,942	45	—	—	—	10,298
Other commitments	26,833	196,970	185,512	176,336	176,531	2,762,513	3,524,695
Total commitments	\$ 33,068	\$ 214,720	\$ 201,093	\$ 187,352	\$ 181,857	\$ 2,780,385	\$ 3,598,475

- (1) Principal and interest payments due under the Company's 6.875% PEACS, excluding those payments with a fixed exchange ratio under the currency swap hedge arrangement, will fluctuate based on the Euro/U.S. dollar exchange ratio.

Long-term capital lease obligations are as follows (in thousands):

	September 30, 2002
Gross capital lease obligations	\$ 10,738
Less imputed interest	(814)
Present value of net minimum lease payments	9,924
Less current portion	(8,613)
Long-term capital lease obligations	\$ 1,311

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

Restructuring-related lease obligations are as follows (in thousands):

	Three Months Ending December 31, 2002	Years Ending December 31,					Total
		2003	2004	2005	2006	Thereafter	
Gross lease obligations	\$ 6,614	\$17,868	\$18,050	\$14,781	\$13,677	\$ 50,382	\$121,372
Estimated sublease income (1)	(379)	(1,698)	(3,469)	(6,878)	(8,351)	(32,510)	(53,285)
Lease obligations, net	\$ 6,235	\$16,170	\$14,581	\$ 7,903	\$ 5,326	\$ 17,872	\$ 68,087

(1) At September 30, 2002, the Company had signed contractual sublease agreements covering \$11 million in future payments.

Pledged Securities

The Company has pledged a portion of its marketable securities as collateral for standby letters of credit that guarantee certain of its contractual obligations, a majority of which relates to property leases; the swap agreement that hedges the foreign-exchange rate risk on a portion of its 6.875% PEACS; and some of its real estate lease agreements. The amount of marketable securities the Company is required to pledge pursuant to the swap agreement fluctuates with the fair market value of the swap obligation. The change in the amount of collateral pledged under these agreements was as follows (in thousands):

	Standby Letters of Credit	Swap Agreement	Real Estate Leases	Total
Balance at December 31, 2001	\$ 77,635	\$ 48,498	\$ 40,657	\$166,790
Net change in collateral pledged	(19,402)	(12,153)	(578)	(32,133)
Balance at September 30, 2002	\$ 58,233	\$ 36,345	\$ 40,079	\$134,657

Legal Proceedings

On April 12, 2001, the Company received a request from the SEC staff for the voluntary production of documents and information concerning, among other things, previously reported sales of the Company's common stock by its Chairman and Chief Executive Officer, Jeffrey Bezos, on February 2 and 5, 2001. The Company is cooperating with the SEC staff's continuing inquiry.

A number of purported class action complaints were filed by holders of Amazon.com equity and debt securities against the Company, its directors and certain of its 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 October 5, 2001, plaintiffs in the 1934 Act cases filed a consolidated amended complaint alleging that the Company, together with certain of its officers and directors and certain third-parties, made false or misleading statements during the period from October 29, 1998 through July 23, 2001 concerning the Company's 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 the Company's February 2000 offering of the 6.875% PEACS. The complaints seek rescissory and/or compensatory damages and injunctive relief against all defendants. The Company disputes the allegations of wrongdoing in these complaints and intends to vigorously defend itself in these matters.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

On August 28, 2002, the Trustee for the Creditors' Trust for Living.com instituted an adversary proceeding against a subsidiary of the Company in the United States Bankruptcy Court for the Western District of Texas. The plaintiff alleges that Living.com's creditors are entitled to a contractual recovery of approximately \$58 million in fees that Living.com had previously paid in 2000 primarily by issuing Living.com stock to the Company. The Company disputes the plaintiff's allegations and intends to vigorously defend itself in this matter.

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

From time to time, the Company is subject to other legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights, patents, and other intellectual property rights. The Company currently is not aware of any such legal proceedings or claims that management believes will have, individually or in the aggregate, a material adverse effect on the Company's business, financial condition or operating results.

Inventory Suppliers

During the nine months ended September 30, 2002, approximately 20% of all inventory purchases were made from two major vendors, of which Ingram Book Group accounted for over 10% of all inventory purchases. No other vendor exceeded 10% of all inventory purchases during this period. The Company does not have long-term contracts or arrangements with most of its vendors to guarantee the availability of merchandise, particular payment terms, or the extension of credit limits.

Note 9. COMPREHENSIVE LOSS

The components of comprehensive loss were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net loss	\$ (35,080)	\$ (169,874)	\$ (151,783)	\$ (572,364)
Other comprehensive income (loss):				
Foreign currency translation gains (losses), net	1,408	1,292	9,831	(89)
Net unrealized gains on available-for-sale securities	1,613	56,740	12,462	7,780
Net unrealized gains (losses) on Euro-based currency swap	(7,658)	(10,620)	1,544	(19,644)
Reclassification of currency gains on 6.875% PEACS	—	—	—	(9,811)
Cumulative effect of accounting change to adopt SFAS No. 133	—	—	—	(12,294)
Other comprehensive income (loss)	(4,637)	47,412	23,837	(34,058)
Comprehensive loss	\$ (39,717)	\$ (122,462)	\$ (127,946)	\$ (606,422)

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

Activity in other comprehensive income (loss) relating to the Euro-based currency swap was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Remeasurement of swap to fair value	\$ (7,673)	\$ (5,794)	\$ 9,426	\$ (22,040)
Reclassification of losses (gains) to offset currency gains and losses on hedged portion of 6.875% PEACS included in net loss	15	(4,826)	(7,882)	2,396
	<u>\$ (7,658)</u>	<u>\$ (10,620)</u>	<u>\$ 1,544</u>	<u>\$ (19,644)</u>

The Company is not able to predict future gains or losses due to the remeasurement of the hedged portion of the 6.875% PEACS and equivalent reclassifications of losses or gains on the swap contract from accumulated other comprehensive loss to earnings.

Note 10. SEGMENT INFORMATION

The Company presents information to its chief operating decision maker in four segments: North America Books, Music, and DVD/Video (“BMVD”); North America Electronics, Tools, and Kitchen (“ETK”); International; and Services. Accordingly, the Company discloses its segment financial information along these lines.

BMVD Segment

The BMVD segment includes revenues, direct costs, and cost allocations associated with retail sales from *www.amazon.com* and *www.amazon.ca* for books, music, and DVD/video products and for magazine subscription commissions. This segment also includes commissions from sales of these products through Amazon Marketplace, and revenues from stores offering these products through the Company’s Syndicated Stores Program (where the Company operates a co-branded e-commerce Web site under a third-party seller’s name and URL, which utilizes the Company’s e-commerce features and technology and sells the Company’s products), such as *www.borders.com*. This segment also includes amounts earned from offerings of these products by third-party sellers (such as magazine subscriptions) through the Company’s Merchant@amazon.com Program (where a third-party seller offers its products for sale on the Company’s Web site in the Company’s retail stores or in a co-branded store, or both).

ETK Segment

The ETK segment includes revenues, direct costs, and cost allocations associated with *www.amazon.com* retail sales of electronics, home improvement, and home and garden products, as well as the Company’s catalog sales of tools and toys. This segment also includes commissions earned from sales of these products through Amazon Marketplace on *www.amazon.com* and amounts earned from offerings of these products by third-party sellers under our Merchant@amazon.com Program, including J&R Electronics, and will include revenues from stores offering these products, if any, through the Syndicated Stores Program.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

International Segment

The International segment includes all revenues, direct costs, and cost allocations associated with the retail sales of the following internationally-focused Web sites of the Company: *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr* and *www.amazon.co.jp*. These international sites share a common Amazon experience, but are localized in terms of language, products, customer service, and fulfillment. To the extent available on these sites, this segment includes commissions and other amounts earned from sales of products through Amazon Marketplace and revenues from stores offering products through the Company's internationally-focused Syndicated Stores Program, such as *www.waterstones.co.uk*, and will include other amounts earned from sales of products by third-party sellers through the Company's Merchant@amazon.com Program. Export sales from *www.amazon.com*, and *www.amazon.ca* are not included in the International segment. Operating results for the International segment are affected by movements in currency exchange rates. During the three months and nine months ended September 30, 2002, International segment revenues improved \$22 million and \$12 million, respectively, and operating results improved \$1 million for each respective period in comparison to the prior year due to changes in currency exchange rates. If currency rates had remained constant with the same period in the prior year, the International segment's very slight operating profit would have been a very slight operating loss for the three months ended September 30, 2002.

Services Segment

The Services segment includes revenues, direct costs, and cost allocations associated with the Company's business-to-business commercial agreements, including the Merchant Program (where the Company operates a third-party seller's e-commerce Web site under the third-party seller's name and URL, which utilizes the Company's e-commerce services, features and technology, and sells the third-party seller's products), such as *www.target.com*, and to the extent full product categories are not also offered by the Company through its online retail stores, the Merchant@amazon.com Program, as well as miscellaneous marketing, promotional, and other agreements.

Included in Services segment revenues are equity-based service revenues of \$2 million and \$5 million for the three months ended September 30, 2002 and 2001, respectively, and \$12 million and \$22 million for the nine months ended September 30, 2002 and 2001, respectively.

Stock-based compensation, amortization of goodwill and other intangibles, and restructuring-related and other costs are not allocated to segment results. All other centrally-incurred operating costs are fully allocated to segment results. There are no internal transactions between the Company's reporting segments.

The Company measures the results of operations of its reportable segments using a pro forma measure. Pro forma results from operations, which exclude stock-based compensation, amortization of goodwill and other intangibles, and restructuring-related and other charges, are not in conformity with accounting principles generally accepted in the United States.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

Information on reportable segments and reconciliation to consolidated net loss is as follows:

Three Months Ended September 30, 2002:

	North America					
	Books, Music, and DVD/Video	Electronics, Tools, and Kitchen	Total	International	Services	Consolidated
Net sales	\$ 412,428	\$ 128,516	\$540,944	\$ 263,540	\$46,815	\$ 851,299
Gross profit	116,458	13,027	129,485	60,728	25,954	216,167
Pro forma income (loss) from operations	43,102	(24,071)	19,031	819	7,642	27,492
Stock-based compensation						832
Amortization of other intangibles						(1,212)
Restructuring-related and other						(36,757)
Total non-operating expenses, net						(24,878)
Equity in losses of equity-method investees, net						(557)
Net loss						\$ (35,080)

Three Months Ended September 30, 2001:

	North America					
	Books, Music, and DVD/Video	Electronics, Tools, and Kitchen	Total	International	Services	Consolidated
Net sales	\$ 351,431	\$ 103,112	\$454,543	\$ 138,491	\$46,247	\$ 639,281
Gross profit	93,354	13,327	106,681	28,163	27,348	162,192
Pro forma income (loss) from operations	26,223	(33,107)	(6,884)	(28,000)	7,812	(27,072)
Stock-based compensation						2,567
Amortization of goodwill and other intangibles						(41,835)
Restructuring-related and other						(3,994)
Total non-operating expenses, net						(94,558)
Equity in losses of equity-method investees, net						(4,982)
Net loss						\$ (169,874)

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AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

September 30, 2002

Nine Months Ended September 30, 2002:

	North America					
	Books, Music, and DVD/Video	Electronics, Tools, and Kitchen	Total	International	Services	Consolidated
Net sales	\$ 1,267,193	\$ 383,150	\$1,650,343	\$ 707,517	\$146,466	\$ 2,504,326
Gross profit	363,266	50,968	414,234	157,101	86,124	657,459
Pro forma income (loss) from operations	138,558	(63,325)	75,233	(20,632)	23,543	78,144
Stock-based compensation						(33,247)
Amortization of other intangibles						(4,565)
Restructuring-related and other						(46,731)
Total non-operating expenses, net						(142,716)
Equity in losses of equity-method investees, net						(3,469)
Cumulative effect of change in accounting principle						801
Net loss						\$ (151,783)

Nine Months Ended September 30, 2001:

	North America					
	Books, Music, and DVD/Video	Electronics, Tools, and Kitchen	Total	International	Services	Consolidated
Net sales	\$ 1,150,740	\$ 330,576	\$1,481,316	\$ 398,942	\$127,004	\$ 2,007,262
Gross profit	313,317	43,706	357,023	85,578	81,908	524,509
Pro forma income (loss) from operations	92,815	(120,262)	(27,447)	(92,562)	16,327	(103,682)
Stock-based compensation						(2,700)
Amortization of goodwill and other intangibles						(143,496)
Restructuring-related and other						(176,904)
Total non-operating expenses, net						(106,587)
Equity in losses of equity-method investees, net						(28,472)
Cumulative effect of change in accounting principle						(10,523)
Net loss						\$ (572,364)

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 industry prospects and 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 help identify forward-looking statements. Forward-looking statements reflect management's current expectations and are inherently uncertain. Our actual results may differ significantly from management's expectations. The following discussion includes forward-looking statements regarding expectations of future pro forma operating and net income, net sales and free cash flow, each of which are inherently difficult to predict. Actual results could differ materially for a variety of reasons, including, among others, the rate of growth of the economy in general, the Internet and online commerce, customer spending patterns, the amount that we invest 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, risks of inventory management, the degree to which we enter into, maintain, and develop relationships with third party sellers and other strategic transactions, fluctuations in the value of securities and non-cash payments we receive in connection with such transactions, foreign currency risks, seasonality, international growth and expansion, 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 the section entitled "Additional Factors That May Affect Future Results," which, along with the following discussion, describes some, but not all, of the factors that could cause actual results to differ significantly from management's expectations.

Critical Accounting Judgments

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 U.S. Securities and Exchange Commission ("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 the company 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 Note 1 "Accounting Policies" in Item 1 of Part I, "Financial Statements" of this Form 10-Q, and Note 1 "Description of Business and Accounting Policies" in Item 8 of Part II, "Financial Statements and Supplementary Data," of our Annual Report on Form 10-K for the year ended December 31, 2001. 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.

Significant Accounting Policies

Inventories

Inventories, consisting of products available for sale, are valued at the lower of cost or market value, which requires us to make judgments, based on currently-available information, about the likely method of disposition (whether through sales to individual customers, returns to product vendors, or liquidations), and expected recoverable values of each disposition category. Based on this evaluation, which is applied consistently from period to period, we record a valuation allowance to adjust the carrying amount of our inventories to lower of cost or market value.

Revenue Recognition

We generally 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.

We evaluate the criteria outlined in Emerging Issues Task Force ("EITF") Issue No. 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 obligor 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 as a principal. If we are not the primary obligor and amounts earned are determined using a fixed percentage, a fixed-payment schedule, or a combination of the two, we generally record the net amounts as commissions earned.

Product sales, net of promotional gift certificates and return allowances, are recorded when the products are shipped and title passes to customers. Retail items sold to customers are made pursuant to a sales contract that provides for transfer of both title and risk of loss upon our delivery to the carrier (commonly referred to as "F.O.B. Shipping Point"). Return allowances (which reduce product revenue by our best estimate of expected product returns) are estimated using historical experience.

Commissions received on sales of products through Amazon Marketplace, as well as commissions earned through our Merchant@amazon.com Program (as defined below), are recorded as a net amount since we are acting as an agent in such transactions. In addition, we recognize amounts earned through our Merchant Program (as defined below) as a net amount. Amounts earned are recognized as net sales when the item is sold by the third-party seller and our collectibility is reasonably assured. We record an allowance for refunds on such commissions using historical experience.

We earn revenues from services primarily by entering into business-to-business commercial agreements, including providing our technology services such as search, browse, and personalization; permitting third parties to offer products or services through our Web sites; and powering third-party Web sites, providing fulfillment services, or both. These commercial agreements also include miscellaneous marketing and promotional agreements. As compensation for the services we provide under these agreements, we receive cash, equity securities, or a combination thereof. Generally, the fair value of the equity consideration received is measured when the agreement is executed, but to the extent that the equity consideration is subject to forfeiture or vesting provisions and no significant performance commitment exists upon execution of the agreement, the fair value of the equity consideration and corresponding revenue is determined as of the date that the forfeiture provision lapses or as the vesting provision lapses. Subsequent to initial measurement of fair value, appreciation or decline in the fair value of such securities will affect our ultimate realization of equity securities received as compensation; however, any such change does not affect the amount of revenue to be recognized over the term of the agreement. We generally recognize revenue from these marketing and promotional services on a straight-line basis over the period during which we perform services under these agreements, commencing at the launch date of the service. If we receive non-refundable advance payments, such amounts are deferred for revenue recognition purposes until service commences.

Included in Services segment revenues are equity-based service revenues of \$2 million and \$5 million for the three months ended September 30, 2002 and 2001, respectively, and \$12 million and \$22 million for the nine months ended September 30, 2002 and 2001, respectively.

We have in the past, and may in the future, amend our agreements with certain of the companies with which we have commercial agreements to modify future cash proceeds to be received by us, modify the service term of our commercial agreements, or both. Although these amendments do not affect the amount of unearned revenue previously recorded by us (if any), the timing of future revenue recognition changes to correspond with the terms

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of amended agreements. These amendments or future amendments will affect the timing and amount of revenues recognized in connection with these commercial 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.

Fair Value of Equity Securities Received as Compensation Under Commercial Agreements

For equity securities of public companies received as compensation under commercial agreements, we generally determine fair value based on the quoted market price at the time we enter into the underlying commercial agreement, and adjust such market price appropriately if significant restrictions on marketability exist. Because an observable market price does not exist for equity securities of private companies, our estimates of fair value of such securities are more subjective than for the securities of public companies. For significant transactions involving equity securities in private companies, we obtain and consider independent, third-party valuations where appropriate. Such valuations use a variety of methodologies to estimate fair value, including comparing the security with securities of publicly traded companies in similar lines of business, applying price multiples to estimated future operating results for the private company, and utilizing estimated discounted cash flows for that company. These valuations also reduce the otherwise fair value by a factor that is intended to account for restrictions on control and marketability where appropriate. Using these valuations and other information available to us, such as our knowledge of the industry and the company itself, we determine the estimated fair value of the securities received.

Accounting for Goodwill and Certain Other Intangibles

Effective July 1, 2001, we adopted certain provisions of SFAS No. 141, and effective January 1, 2002, we adopted the full provisions of SFAS No. 141 and SFAS No. 142. SFAS No. 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting, and broadens the criteria for recording intangible assets apart from goodwill. We evaluated our goodwill and intangibles acquired prior to June 30, 2001 using the criteria of SFAS No. 141, which resulted in \$25 million of other intangibles (comprised entirely of assembled workforce intangibles) being subsumed into goodwill at January 1, 2002. SFAS No. 142 requires that purchased goodwill and certain indefinite-lived intangibles no longer be amortized, but instead be tested for impairment at least annually. We evaluated our intangible assets and determined that all such assets have determinable lives.

SFAS No. 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment, while the second phase (if necessary) measures the impairment. We completed our first phase impairment analysis and found no instances of impairment of our recorded goodwill; accordingly, the second testing phase was not necessary during 2002. No subsequent indicators of impairment have been noted.

Restructuring Estimates

Restructuring-related liabilities include estimates for, among other things, anticipated disposition of lease obligations. Key variables in determining such estimates include anticipated commencement timing of sublease rentals, estimates of sublease rental payment amounts and tenant improvement costs, and estimates for brokerage and other related costs. We periodically evaluate and, if necessary, adjust our estimates based on currently-available information.

Results of Operations

Net Sales

Net sales include the selling price of consumer products sold by us, less promotional gift certificates and sales returns; outbound shipping charges billed to our customers; commissions and other amounts earned from sales of new and used products on Amazon Marketplace; amounts earned (fixed fees, sales commissions, per-unit activity fees, or some combination thereof) for sales of retail products through our Merchant@amazon.com Program (where a third party seller offers its products for sale on our Web site in our retail stores or in a co-branded store, or both), including our strategic alliances with Toysrus.com, Inc. and J&R Electronics; the selling price of consumer products sold by us through our Syndicated Stores Program (where we operate a co-branded e-commerce Web site under a third party seller's name and URL, which utilizes our e-commerce features and technology and sells our products), such as *www.borders.com*; amounts earned (fixed fees, sales commissions, per-unit activity fees, or some combination thereof) in connection with our Merchant Program (where we operate a third-party seller's e-commerce Web site under the third-party seller's name and URL, which utilizes our e-commerce services, features and technology, and sells the third-party seller's products), such as Target.com, which launched in the third quarter of 2002; amounts earned from third parties who utilize our technology services such as search, browse, and personalization; and amounts earned for miscellaneous marketing and promotional agreements.

Net sales were \$851 million and \$639 million for the three months ended September 30, 2002 and 2001, respectively, and \$2.5 billion and \$2.0 billion for the nine months ended September 30, 2002 and 2001, respectively, representing increases of 33% and 25%, respectively. The increases in net sales dollars were primarily attributable to our International segment and our North America Books, Music, and DVD/Video ("BMVD") segment, which increased \$125 million and \$61 million for the three months ended September 30, 2002, respectively, and \$309 million and \$116 million for the nine months ended September 30, 2002, respectively. During the three months and nine months ended September 30, 2002, revenues from our International segment improved \$22 million and \$12 million, respectively, in comparison to the prior year periods due to changes in currency exchange rates. In addition, as previously disclosed, we estimated that net sales for the prior year comparative periods were negatively impacted by between \$25 million and \$35 million due to the events of September 11, 2001. Year over year comparisons for the three months and nine months ended September 30, 2002 should be viewed in this context.

Net sales for our BMVD segment were \$412 million and \$351 million for the three months ended September 30, 2002 and 2001, respectively, and \$1.3 billion and \$1.2 billion for the nine months ended September 30, 2002 and 2001, respectively, representing increases of 17% and 10%, respectively. This segment includes retail sales from *www.amazon.com* and *www.amazon.ca* of books, music, and DVD/video products and for magazine subscription commissions. This segment also includes commissions from sales of these products through Amazon Marketplace and revenues from stores offering these products through our Syndicated Stores Program, such as *www.borders.com*. This segment also includes amounts earned from offerings of these products by third-party sellers (such as magazine subscriptions) under our Merchant@amazon.com Program. The increase in net sales for our BMVD segment reflects the increase in units sold (including the increase in sales through our Amazon Marketplace), offset by increases in customer discounts on books and the introduction of our new shipping offer at *www.amazon.com* that offers free shipping for certain orders.

Net sales for our North America Electronics, Tools, and Kitchen ("ETK") segment were \$129 million and \$103 million for the three months ended September 30, 2002 and 2001, respectively, and \$383 million and \$331 million for the nine months ended September 30, 2002 and 2001, respectively, representing increases of 25% and 16%, respectively. This segment includes *www.amazon.com* retail sales of electronics, home improvement, and home and garden products, as well as our catalog sales of tools and toys. This segment also includes commissions earned from sales of these products through Amazon Marketplace on *www.amazon.com* and amounts earned from offerings of these products by third-party sellers under our Merchant@amazon.com Program, including J&R Electronics, and will include revenues from stores offering these products, if any,

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through our Syndicated Stores Program. The growth in our ETK segment is attributable to an increase in units sold, offset by increases in customer discounts and the introduction of our new shipping offer at www.amazon.com that offers free shipping for certain orders.

Net sales for our International segment were \$264 million and \$138 million for the three months ended September 30, 2002 and 2001, respectively, and \$708 million and \$399 million for the nine months ended September 30, 2002 and 2001, respectively, representing increases of 90% and 77%, respectively. We anticipate that as the revenue base of our International segment increases, the percentage growth rates will likely decline over time. During the three months and nine months ended September 30, 2002, revenues improved \$22 million and \$12 million, respectively, in comparison to the prior year periods due to changes in currency exchange rates (if currency rates had remained constant with the same period in the prior year, the International segment's very slight operating profit would have been a very slight operating loss for the three months ended September 30, 2002). This segment includes all retail sales of the following internationally-focused Web sites: www.amazon.co.uk, www.amazon.de, www.amazon.fr, and www.amazon.co.jp. These international sites share a common Amazon experience, but are localized in terms of language, products, customer service, and fulfillment. To the extent available on these sites, this segment includes commissions and other amounts from sales of products through Amazon Marketplace and revenues from stores offering products through our internationally-focused Syndicated Stores Program, such as www.waterstones.co.uk, and will include other amounts earned from sales of products by third-party sellers through our Merchant@amazon.com Program. Export sales from www.amazon.com and www.amazon.ca are not included in the International segment. The increase in net sales from our International segment results from increased unit sales in each of the four internationally-focused Web sites (including from the introduction of Amazon Marketplace on www.amazon.co.uk and www.amazon.de in March 2002), offset by increases in customer discounts and free and reduced-rate shipping offers. The future growth for our International segment may fluctuate significantly with changes in foreign exchange rates. See "Additional Factors That May Affect Future Results—We Have Foreign Currency Risk."

Net sales for our Services segment were \$47 million and \$46 million for the three months ended September 30, 2002 and 2001, respectively, and \$146 million and \$127 million for the nine months ended September 30, 2002 and 2001, respectively, representing increases of 1% and 15%, respectively. This segment consists of commissions, fees and other amounts earned from our business-to-business commercial agreements, including our Merchant Program and, to the extent full product categories are not also offered by us through our online retail stores, our Merchant@amazon.com Program, such as www.target.com, as well as miscellaneous marketing, promotional, and other agreements. The increase in net sales from our Services segment results from amounts earned through our Merchant@amazon.com Program, and to a lesser extent our Merchant Program, offset by the conclusion of certain of our marketing and promotional agreements. The amount of compensation we receive under certain of these services agreements is dependent on the volume of sales that the other company makes. See "Additional Factors That May Affect Future Results—Our Business Could Suffer If We Are Unsuccessful in Making and Integrating Strategic Alliances and Other Business Relationships."

Shipping revenue, which consists of outbound shipping charges to our customers, across all segments was \$73 million and \$74 million for the three months ended September 30, 2002 and 2001, respectively, and \$244 million and \$232 million for the nine months ended September 30, 2002 and 2001, respectively. Shipping revenue does not include any commissions or other amounts earned from Amazon Marketplace. Shipping revenue generally corresponds with overall sales levels, offset by our free and reduced-fee shipping promotions. In January 2002, we introduced a new shipping option at www.amazon.com, offering free shipping for certain orders of \$99 or more. In June 2002, we introduced a long-term test at www.amazon.com and reduced the purchase threshold to \$49, which we further reduced in August 2002 to \$25. We offer or may offer a similar shipping option for our internationally-focused Web sites, and may offer other free or reduced-fee shipping options over time. The effect of these shipping offers reduces shipping revenue as a percentage of sales, and causes our gross margins on retail sales to decline.

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Fourth quarter 2002 net sales are expected to be between \$1.325 billion and \$1.425 billion, or grow between 19% and 28%. Full year 2003 net sales are expected to grow over 10%. However, any such projections are subject to substantial uncertainty. See “Additional Factors that May Affect Future Results.”

Gross Profit

Gross profit is net sales less the cost of sales, which consists of the purchase price of consumer products sold by us, inbound and outbound shipping charges to us, packaging supplies, and certain costs associated with our service revenues. Costs associated with our Services segment revenues classified as cost of services generally include fulfillment-related costs to ship products on behalf of third-party sellers, costs to provide customer service, credit card fees, and other related costs.

Effective January 1, 2002, we prospectively changed our inventory costing method to the first-in first-out (“FIFO”) method of accounting. This change resulted in a cumulative effect increase in product inventory of \$0.8 million, with a corresponding amount recorded to “Cumulative effect of change in accounting principle” on the statements of operations. We have evaluated the effect of the change on each quarter during 2001 and determined such effect to be less than \$1.2 million individually and in the aggregate. We have determined this change to be preferable under accounting principles generally accepted in the United States since, among other reasons, it facilitates our record keeping process, significantly improves our ability to provide cost-efficient fulfillment services to third-party companies as part of our services offering, and results in increased consistency with others in our industry.

Gross profit was \$216 million and \$162 million for the three months ended September 30, 2002 and 2001, respectively and \$657 million and \$525 million for the nine months ended September 30, 2002 and 2001, respectively, representing increases of 33% and 25%, respectively. Gross margin was 25% for each of the three months ended September 30, 2002 and 2001, and 26% for each of the nine months ended September 30, 2002 and 2001, respectively. Increases in the absolute dollars of gross profit primarily correspond with increases in units sold (including increased product sales through Amazon Marketplace), improvements in transportation and inventory management, and improvements in product sourcing, offset by increases in customer discounts on books and electronics, a reduction in high-margin marketing and promotional agreements, and our free and reduced-rate shipping offers. We intend to continue to focus on lowering prices for customers over time.

Gross profit for our BMVD segment was \$116 million and \$93 million for the three months ended September 30, 2002 and 2001, respectively, and \$363 million and \$313 million for the nine months ended September 30, 2002 and 2001, respectively, representing increases of 25% and 16%, respectively. Gross margin was 28% and 27% for the three months ended September 30, 2002 and 2001, respectively, and 29% and 27% for the nine months ended September 30, 2002 and 2001, respectively. The slight improvement in gross margin in comparison with the prior year periods corresponds with the increase in higher margin sales through Amazon Marketplace, improvements in transportation and inventory management, and continued improvements in product sourcing, offset by higher customer discounts and our free shipping offer.

Gross profit for our ETK segment was \$13 million for each of the three months ended September 30, 2002 and 2001, respectively, and \$51 million and \$44 million for the nine months ended September 30, 2002 and 2001, respectively, representing a slight decline and an increase of 17%, respectively. Gross margin was 10% and 13% for the three months ended September 30, 2002 and 2001, respectively, and 13% for each of the nine months ended September 30, 2002 and 2001, respectively. Gross margin for the three months ended September 30, 2002 declined in comparison to the prior year period due primarily to increases in customer discounts, rebates offered in our wireless store, and the effect of our free shipping offer, offset by improvements in product sourcing and vendor management, improvements in transportation and inventory management and increased product sales through Amazon Marketplace. Since we currently defer revenues on wireless service contracts until the cancellation period lapses, our recent rebate program on wireless phones reduced our ETK gross margins during the three months ended September 30, 2002 by approximately 140 basis points. This margin effect will be

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offset in future periods as the incremental service contract revenue is recognized, offsetting the effect of lower net revenues from product sales.

During 2002, sales of products through Amazon Marketplace increased significantly in comparison to the prior year periods. If product sales through Amazon Marketplace continue to increase, we anticipate improvement in gross margin, offset to the extent we offer additional or broader customer discounts, free shipping offers and other promotions.

Gross profit for our International segment was \$61 million and \$28 million for the three months ended September 30, 2002 and 2001, respectively, and \$157 million and \$86 million for the nine months ended September 30, 2002 and 2001, respectively, representing increases of 116% and 84%, respectively. Gross margin was 23% and 20% for the three months ended September 30, 2002 and 2001, respectively, and 22% and 21% for the nine months ended September 30, 2002 and 2001, respectively. The increase in our absolute gross profit dollars reflects increases in units sold by each of our internationally-focused Web sites (including from the introduction of Amazon Marketplace on www.amazon.co.uk and www.amazon.de in March 2002) in comparison with the same periods in the prior year.

Gross profit for our Services segment was \$26 million and \$27 million for the three months ended September 30, 2002 and 2001, respectively, and \$86 million and \$82 million for the nine months ended September 30, 2002 and 2001, respectively, representing a decrease of 5% and an increase of 5%, respectively. Costs associated with our service revenues generally include fulfillment-related costs to ship products on behalf of third-party sellers, costs to provide customer service, credit card fees and other related costs. Gross margin was 55% and 59% for the three months ended September 30, 2002 and 2001, respectively, and 59% and 64% for the nine months ended September 30, 2002 and 2001, respectively. Gross profit from our Services segment largely corresponds with revenues from our commercial agreements, which includes our Merchant Program and, to the extent product categories are not also offered by us through our online retail stores, the Merchant@amazon.com Program, as well as amounts earned through miscellaneous marketing and promotional agreements. The decline in gross margin from our Services segment relates to service costs classified in cost of sales resulting from the shift in the mix of our strategic relationships towards alliances that incorporate a broader range of services, including fulfillment. Also contributing to the decline in Services gross margin was a reduction in high-margin marketing and promotional agreements. We expect Services segment margins will continue to decline over the next year since high-margin marketing arrangements are expected to represent a lower percentage of our overall revenue mix for this segment. See "Additional Factors That May Affect Future Results—Our Business Could Suffer If We Are Unsuccessful in Making and Integrating Strategic Alliances and Other Business Relationships."

Shipping loss across all segments was \$10 million and \$2 million for the three months ended September 30, 2002 and 2001, respectively, and \$10 million and \$8 million for the nine months ended September 30, 2002 and 2001, respectively. The loss from shipping primarily reflects the free and reduced-rate shipping offers, offset in part by increases in injection shipping (where we deliver to shipping hubs large quantities of items destined for similar geographic locations). We continue to measure our shipping results relative to their effect on our overall financial results, with the viewpoint that shipping promotions are an effective marketing tool. In January 2002, we introduced a new shipping option at www.amazon.com, offering free shipping for certain orders of \$99 or more. In June 2002, we introduced a long-term test at www.amazon.com and reduced the purchase threshold to \$49, which we further reduced in August 2002 to \$25. Because the \$25 threshold for our free shipping offer at www.amazon.com will be effective throughout the fourth quarter 2002 we expect our overall gross margins to decline. We offer or may offer a similar shipping option for our internationally-focused Web sites and may offer other free or reduced-fee shipping options over time. These shipping offers reduce shipping revenue as a percentage of sales and cause gross margins on retail sales to decline.

Fulfillment

Fulfillment costs represent those costs incurred in operating and staffing our fulfillment and customer service centers, including costs attributable to receiving, inspecting, and warehousing inventories; picking, packaging, and preparing customers' orders for shipment; credit card fees and bad debt costs; and responding to inquiries from customers. Fulfillment costs also include amounts paid to third-party co-sourcers who assist us in fulfillment and customer service operations. Certain Services segment fulfillment-related costs incurred on behalf of third-party sellers are classified as cost of sales rather than fulfillment. Fulfillment costs were \$90 million and \$81 million for the three months ended September 30, 2002 and 2001, respectively, representing 11% and 13% of net sales, respectively. Fulfillment costs were \$266 million and \$265 million for the nine months ended September 30, 2002 and 2001, respectively, representing 11% and 13% of net sales for the corresponding periods. Excluding net sales from our Services segment, fulfillment costs represent 11% and 14% of net sales for the three months ended September 30, 2002 and 2001, respectively, and 11% and 14% for the nine months ended September 30, 2002 and 2001, respectively. The improvement in fulfillment costs as a percentage of net sales results from improvements in productivity, the increase in units fulfilled helping to leverage our fixed-cost base, a decline in customer service contacts resulting from improvements in our operations and enhancements to our customer self-service features available on our Web sites, and the closure of our fulfillment centers in McDonough, Georgia and Seattle, Washington, and customer service centers in The Hague, Netherlands and Seattle, Washington. These improvements were offset, in part, by increases in employee wages and benefits, and credit card interchange fees associated with Amazon Marketplace, which represent a higher percent of sales relative to amounts earned.

Marketing

Marketing expenses consist of advertising, promotional, and public relations expenditures, and payroll and related expenses for personnel engaged in marketing and selling activities. Marketing expenses, net of co-operative marketing reimbursements, were \$27 million and \$33 million, representing 3% and 5% of net sales, for the three months ended September 30, 2002 and 2001, respectively, and \$88 million and \$104 million, representing 4% and 5% of net sales, for the nine months ended September 30, 2002 and 2001, respectively. To the extent co-operative marketing reimbursements decline in future periods, we may incur additional expenses to continue certain promotions, or elect to reduce or discontinue them. Declines in expense for marketing-related activities in comparison to the prior year period reflect management efforts to target advertising spending in channels considered most effective at driving incremental net sales (such as targeted online advertising through various Web portals and our Associates Program) as well as reduced rates charged to us for online marketing. We expect to incur increased marketing and promotion costs during the fourth quarter 2002. In January 2002, we introduced a new shipping option at www.amazon.com, offering free shipping for certain orders of \$99 or more. In June 2002, we introduced a long-term test and reduced the purchase threshold to \$49, which we further reduced in August 2002 to \$25. We offer or may offer a similar shipping option for our internationally-focused Web sites. Although marketing expenses do not include our free and reduced shipping offers, we view such offers as an effective marketing tool.

Technology and Content

Technology and content expenses consist principally of payroll and related expenses for development, editorial, systems, and telecommunications operations personnel and consultants; systems and telecommunications infrastructure; and costs of acquired content, including freelance reviews. Technology and content expense was \$53 million and \$54 million for the three months ended September 30, 2002 and 2001, respectively, representing 6% and 8% of net sales for the corresponding periods, respectively, and \$167 million and \$189 million for the nine months ended September 30, 2002 and 2001, respectively, representing 7% and 9% of net sales for the corresponding periods, respectively. Included in technology and content expense for the three months and nine months ended September 30, 2002 were \$2 million of costs associated with the impairment of purchased software and hardware removed from service during the third quarter of 2002. Additionally, included

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in technology and content expense for the nine months ended September 30, 2002 were \$2 million of costs associated with ongoing lease payment obligations for certain networking equipment that was removed from service during the second quarter 2002. The decline in absolute dollars spent for each comparative period primarily reflects our migration to a technology platform that utilizes a less-costly technology infrastructure, as well as improved expense management and general price reductions in most expense categories. We expect to continue to invest in technology and improvements to our Web sites during the remainder of 2002, which may include, but is not limited to, hiring additional employees, offering additional Web site features and product categories to our customers and implementing additional strategic alliances, as well as potentially continuing our international expansion.

General and Administrative

General and administrative expenses consist of payroll and related expenses for executive, finance and administrative personnel, human resources, professional fees, and other general corporate expenses. General and administrative expenses were \$19 million and \$21 million for the three months ended September 30, 2002 and 2001, respectively, representing 2% and 3% of net sales for the corresponding periods, respectively, and \$59 million and \$70 million for the nine months ended September 30, 2002 and 2001, respectively, representing 2% and 4% of net sales for the corresponding periods, respectively. The decline in absolute dollars of general and administrative costs for each comparative period is attributable to a decline in facility and depreciation costs due to our operational restructuring plan that consolidated our corporate office locations, and continued efforts to improve efficiency.

Stock-Based Compensation

Stock-based compensation includes stock-based charges resulting from variable accounting treatment of certain stock options, option-related deferred compensation recorded at our initial public offering, as well as certain other compensation and severance arrangements. Stock-based compensation also includes the portion of acquisition-related consideration conditioned on the continued tenure of key employees of certain acquired businesses, which must be classified as compensation expense rather than as a component of purchase price under accounting principles generally accepted in the United States. Additionally, stock-based compensation will include amounts associated with our planned restricted stock unit program. Under this program, we will, commencing in the fourth quarter of 2002, award restricted stock units as our primary vehicle for employee equity compensation. Restricted stock units are measured at fair value on the date of grant based on the number of shares granted and the quoted price of the Company's common stock. Such value is recognized as an expense ratably over the corresponding service period. To the extent restricted stock units are forfeited prior to vesting, the corresponding previously recognized expense is reversed as an offset to "Stock-based compensation."

Stock-based compensation was a credit of \$1 million and a credit of \$3 million for the three months ended September 30, 2002 and 2001, respectively, and an expense of \$33 million and an expense of \$3 million for the nine months ended September 30, 2002 and 2001, respectively. As the quoted price of our common stock at September 30, 2002 was below the quoted price of our common stock at June 30, 2002, previously recorded variable accounting charges were partially reversed. However, these reversed charges were partially offset by costs associated with exercises of vested options and costs associated with incremental vesting during the period.

The number of shares of common stock subject to outstanding vested and unvested employee stock options was approximately 48 million and 66 million, or 13% and 18% of our outstanding common stock, at September 30, 2002 and December 31, 2001, respectively.

Variable accounting treatment will result in unpredictable and potentially significant charges or credits recorded to "Stock-based compensation," dependent on fluctuations in quoted prices for our common stock. We have quantified the hypothetical effect on "Stock-based compensation" associated with increases in the quoted price of our common stock using a sensitivity analysis for our outstanding stock options subject to variable

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accounting at September 30, 2002. We have provided this information to provide additional insight into the potential volatility we may experience in the future in our results of operations to the extent that the quoted price for our common stock is above \$13.375. This sensitivity analysis is not a prediction of future performance of the quoted prices of our common stock. Using the following hypothetical market prices of our common stock above \$13.375 (including the actual expense associated with options exercised and no longer subject to future variability), our hypothetical cumulative compensation expense at September 30, 2002 resulting from variable accounting treatment would have been as follows (in thousands, except percentages and per share amounts):

Hypothetical Increase Over \$13.375	Hypothetical Market Price per Share	Hypothetical Cumulative Compensation Expense	Hypothetical vs. Cumulative Compensation Expense September 30, 2002
5%	\$14.04	\$17,051	(\$12,424)
10%	\$14.71	\$21,618	(\$ 7,857)
15%	\$15.38	\$26,185	(\$ 3,290)
25%	\$16.72	\$35,319	\$ 5,844
50%	\$20.06	\$58,155	\$28,680

As of September 30, 2002, cumulative compensation expense associated with variable accounting treatment was \$29 million, of which \$12 million is associated with options exercised.

Actual variable-accounting related compensation could differ significantly from the above illustration in instances where options are exercised during a period at prices that differ from the closing stock price for the reporting period.

If at the end of any fiscal quarter the quoted price of our common stock is lower than the quoted price at the end of the previous fiscal quarter, or to the extent previously-recorded amounts relate to unvested portions of options that were cancelled, compensation expense associated with variable accounting will be recalculated using the cumulative expense method and may result in a net benefit to our results of operations.

We expect that, by the beginning of 2003, we will expense our future stock-based awards, either due to a change in accounting policy, the issuance of alternative forms of equity compensation (such as our planned restricted stock unit program), or both.

Amortization of Goodwill and Other Intangibles

Amortization of goodwill and other intangibles was \$1 million and \$42 million for the three months ended September 30, 2002 and 2001, respectively, and \$5 million and \$143 million for the nine months ended September 30, 2002 and 2001, respectively. The decline in amortization of goodwill and intangibles primarily results from our adoption of SFAS No. 141, which resulted in \$25 million of intangible assets, comprised of assembled workforce intangibles, being subsumed into goodwill, and our adoption of SFAS No. 142, which requires that goodwill no longer be amortized.

Restructuring-Related and Other

Restructuring-related and other expenses were \$37 million and \$4 million for the three months ended September 30, 2002 and 2001, respectively, and \$47 million and \$177 million for the nine months ended September 30, 2002 and 2001, respectively. In the first quarter of 2001, we announced and began implementation of our operational restructuring plan to reduce operating costs, streamline our organizational structure, consolidate certain of our fulfillment and customer service operations, and migrate a large portion of our technology infrastructure to a new operating platform. This initiative involved the reduction of employee staff by 1,327 positions throughout the Company in managerial, professional, clerical, technical, and fulfillment roles; consolidation of our Seattle, Washington corporate office locations; closure of our McDonough, Georgia

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fulfillment center; seasonal operation of our Seattle, Washington fulfillment center; closure of our customer service centers in Seattle, Washington and The Hague, Netherlands; and migration of a large portion of our technology infrastructure to a new operating platform, which entails ongoing lease obligations for technology infrastructure no longer being utilized. Actual employee termination benefits paid were \$12 million. Each component of the restructuring plan is complete, however, as discussed below, we may adjust our restructuring-related estimates, if necessary.

In the third quarter of 2002, related to our January 2001 operational restructuring, we recorded an additional restructuring-related expense of \$37 million associated with ongoing lease obligations relating to vacated office and fulfillment center space and other costs, including revised sublease income estimates to reflect current information and higher-than-expected tenant improvement costs necessary to sublease vacated space. We revised our restructuring-related expense estimate due to a number of factors, primarily related to weakness in the real estate markets in Seattle, Washington and Atlanta, Georgia. In addition, during the first quarter 2002, we permanently closed our fulfillment center in Seattle, Washington and revised our sublease income estimates for office space vacated as part of the restructuring, resulting in additional restructuring-related expenses of \$10 million primarily associated with ongoing lease obligations.

Restructuring-related charges were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Asset impairments	\$ —	\$ 1,852	\$ —	\$ 67,825
Continuing lease obligations	36,757	1,275	45,835	85,280
Termination benefits	—	694	—	15,455
Broker commissions, professional fees, and other miscellaneous restructuring costs	—	173	896	8,344
	<u>\$ 36,757</u>	<u>\$ 3,994</u>	<u>\$ 46,731</u>	<u>\$ 176,904</u>

At September 30, 2002, the accrued liability associated with restructuring-related and other charges was \$74 million and consisted of the following (in thousands):

	Balance at December 31, 2001	Subsequent Accruals, Net	Payments	Balance at September 30, 2002	Due Within 12 Months	Due After 12 Months
Lease obligations, net of estimated sublease income	\$ 53,187	\$ 45,835	\$(30,935)	\$ 68,087	\$ 19,005	\$ 49,082
Termination benefits	61	—	(61)	—	—	—
Broker commissions, professional fees, and other miscellaneous restructuring costs	8,190	896	(3,393)	5,693	—	5,693
	<u>\$ 61,438</u>	<u>\$ 46,731</u>	<u>\$(34,389)</u>	<u>\$ 73,780</u>	<u>\$ 19,005</u>	<u>\$ 54,775</u>

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Cash payments resulting from our operational restructuring were \$8 million and \$15 million for the three months ended September 30, 2002 and 2001, respectively, and \$34 million and \$35 million for the nine months ended September 30, 2002 and 2001, respectively. As a result of the continued weakness in the real estate markets in Seattle, Washington and Atlanta, Georgia, we have reduced our estimates of future sublease cash flows and have increased our estimate of cash outflows for tenant improvements and other costs necessary to secure sublease tenants. We estimate, based on these adjustments and other currently available information, the remaining net cash outflows associated with our January 2001 operational restructuring will be as follows (in thousands):

	Leases	Other	Total
Three Months Ending December 31, 2002	\$ 6,235	\$ —	\$ 6,235
Years Ending December 31, 2003	16,170	1,580	17,750
2004	14,581	1,000	15,581
2005	7,903	3,113	11,016
2006	5,326	—	5,326
Thereafter	17,872	—	17,872
Total estimated cash outflows	\$ 68,087	\$ 5,693	\$ 73,780

Restructuring-related lease obligations are as follows (in thousands):

	Three Months Ending December 31, 2002	Years Ending December 31,					
		2003	2004	2005	2006	Thereafter	Total
Gross lease obligations	\$ 6,614	\$17,868	\$18,050	\$14,781	\$13,677	\$ 50,382	\$121,372
Estimated sublease income (1)	(379)	(1,698)	(3,469)	(6,878)	(8,351)	(32,510)	(53,285)
Lease obligations, net	\$ 6,235	\$16,170	\$14,581	\$ 7,903	\$ 5,326	\$ 17,872	\$ 68,087

(1) At September 30, 2002, the Company had signed contractual sublease agreements covering \$11 million in future payments.

Income (Loss) from Operations

Our results from operations were a loss of \$10 million and loss of \$70 million for the three months ended September 30, 2002 and 2001, respectively, and a loss of \$6 million and loss of \$427 million for the nine months ended September 30, 2002 and 2001, respectively. Included in operating results for the three and nine months ended September 30, 2002 are costs associated with our January 2001 operational restructuring resulting from reduced expectations of sublease income on vacated office and fulfillment center facilities due to the continued weakness of the real estate markets in Seattle, Washington and Atlanta, Georgia. The improvement in operating results in comparison with the prior year was attributable to an increase in gross profit; a reduction in certain operating costs including marketing, technology and content, and general and administrative; as well as a decline in amortization of goodwill and other intangibles primarily due to the adoption of SFAS No. 142. We are unable to forecast the effect on our future reported results associated with variable accounting treatment on certain of our employee stock options.

Net Interest Expense

Net interest expense was \$30 million and \$29 million for the three months ended September 30, 2002 and 2001, respectively, and \$90 million and \$81 million for the nine months ended September 30, 2002 and 2001, respectively. Interest income was \$6 million for each of the three months ended September 30, 2002 and 2001, respectively, and \$17 million and \$23 million for the nine months ended September 30, 2002 and 2001,

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respectively. Interest income year-over-year comparisons primarily reflect declining interest rates, offset in part by increases in the average balance of marketable securities. Interest expense was \$36 million and \$35 million for the three months ended September 30, 2002 and 2001, respectively, and \$107 million and \$104 million for the nine months ended September 30, 2002 and 2001, respectively. Interest expense is primarily related to our 6.875% Convertible Subordinated Notes due 2010 (“6.875% PEACS”), 4.75% Convertible Subordinated Notes due 2009 (“4.75% Convertible Subordinated Notes”), and our 10% Senior Discount Notes due 2008 (“Senior Discount Notes”). At September 30, 2002, our total long-term indebtedness was \$2.26 billion.

Other Income (Expense), Net

Other income (expense), net consisted of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Gains (losses) on sale of marketable securities, net	\$ 3,020	\$ 1,351	\$ 3,833	\$ 1,137
Foreign-currency transaction gains (losses), net	(360)	(1,150)	(411)	(2,532)
Gains (losses) on disposal of fixed assets, net	47	4	(567)	(83)
Miscellaneous state, foreign, and other taxes	(274)	(1,338)	(617)	(5,834)
Other miscellaneous gains (losses), net	750	(1,070)	638	47
	<u>\$ 3,183</u>	<u>\$ (2,203)</u>	<u>\$ 2,876</u>	<u>\$ (7,265)</u>

Other Gains (Losses), Net

Other gains (losses), net consisted of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Foreign-currency gains (losses) on 6.875% PEACS	\$ 123	\$ (39,572)	\$ (64,637)	\$ 29,118
Gains (losses) on sale of Euro-denominated investments, net	—	(16,332)	2,227	(22,548)
Other-than-temporary impairment losses on equity investments	—	(2,382)	(5,362)	(43,408)
Gains (losses) on sale of equity investments, net	2,236	—	12,339	—
Contract termination, Kozmo.com	—	—	—	22,400
Warrant remeasurements and other	(98)	(5,339)	(244)	(4,015)
	<u>\$ 2,261</u>	<u>\$ (63,625)</u>	<u>\$ (55,677)</u>	<u>\$ (18,453)</u>

Foreign currency gains and losses arising from the remeasurement of the 6.875% PEACS’ principal from Euros to U.S. dollars each period, which we are unable to predict, are recorded to “Other gains (losses), net.”

We hold warrants to purchase equity securities of other companies. Warrants that can be exercised and settled by delivery of net shares such that we pay no cash upon exercise are deemed derivative financial instruments under the provisions of SFAS No. 133. Such warrants are not designated as hedging instruments; accordingly, gains or losses resulting from changes in fair value are recognized on our consolidated statements of operations in the period of change.

Equity in Losses of Equity-Method Investees

Equity in losses of equity-method investees represents our share of losses of companies in which we have investments that give us the ability to exercise significant influence, but not control, over an investee. This

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influence is generally defined as an ownership interest of the voting stock of the investee of between 20% and 50%, although other factors, such as representation on our investee's Board of Directors and the effect of commercial arrangements, are considered in determining whether the equity method of accounting is appropriate. Equity-method losses were \$1 million and \$5 million for the three months ended September 30, 2002 and 2001, respectively, and \$3 million and \$28 million for the nine months ended September 30, 2002 and 2001, respectively. Equity-method losses declined in the three months and nine months ended September 30, 2002 in comparison with the comparable prior year periods because past equity-method losses have reduced many of our underlying investment balances until the recorded basis was zero. Our basis in equity-method investments was \$1 million and \$10 million at September 30, 2002 and December 31, 2001, respectively. As equity-method losses are only recorded until the underlying investments are reduced to zero, we expect, absent additional investments, equity-method losses to continue to decline.

Income Taxes

We provided for current and deferred income taxes in state and foreign jurisdictions where our subsidiaries produce taxable income. As of September 30, 2002, we have a net deferred tax asset of \$2 million, which consists primarily of state net operating losses. We have provided a full valuation allowance against the remaining portion of our deferred tax asset, consisting primarily of net operating losses, because of uncertainty regarding its future realization.

Net Loss

Net loss was \$35 million and \$170 million for the three months ended September 30, 2002 and 2001, respectively, and \$152 million and \$572 million for the nine months ended September 30, 2002 and 2001, respectively. The improvement in net loss during the three months ended September 30, 2002 in comparison with the prior year period is attributable to improvements in our results from operations and the negligible gain (versus a loss of \$40 million in the comparative prior year period) associated with the remeasurement of our 6.875% PEACS from Euros to U.S. dollars. The improvement in net loss during the nine months ended September 30, 2002 in comparison with the prior year period is attributable to improvements in our results from operations, offset by losses of \$65 million (versus a gain of \$29 million in the comparative prior year period) associated with the remeasurement of our 6.875% PEACS from Euros to U.S. dollars. We are unable to forecast the effect on our future reported results of certain items, including the gain or loss associated with our 6.875% PEACS that will result from fluctuations in foreign exchange rates and the effect on our results associated with variable accounting treatment on certain of our employee stock options.

Pro Forma Results of Operations

We provide certain pro forma information regarding our results from operations, which excludes the following line items on our consolidated statements of operations:

- stock-based compensation,
- amortization of goodwill and other intangibles, and
- restructuring-related and other charges.

We also provide certain pro forma information regarding our net loss, which excludes, in addition to the line items described above, the following line items on our consolidated statements of operations:

- other gains (losses), net,
- equity in losses of equity-method investees, net, and
- cumulative effect of change in accounting principle

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This pro forma information is not presented in accordance with accounting principles generally accepted in the United States. Pro forma results, which generally exclude non-operational, non-cash expenses and income as well as one-time charges, are provided as a complement to results provided in accordance with accounting principles generally accepted in the United States. Management uses such pro forma measures internally to evaluate the Company's performance and manage its operations. The pro forma results are derived from information recorded in our financial statements. For information about our financial results, as reported in accordance with accounting principles generally accepted in the United States, see Item 1 of Part I, "Financial Statements."

The following is a reconciliation of our pro forma results for the three months ended September 30, 2002 and 2001. Interim reconciliations are consistent with full-year presentation.

	Three Months Ended September 30, 2002			Three Months Ended September 30, 2001		
	As Reported (1)	Pro Forma Adjustments	Pro Forma	As Reported (1)	Pro Forma Adjustments	Pro Forma
		(in thousands) (unaudited)			(in thousands) (unaudited)	
Net sales	\$ 851,299	\$ —	\$851,299	\$ 639,281	\$ —	\$ 639,281
Cost of sales	635,132	—	635,132	477,089	—	477,089
Gross profit	216,167	—	216,167	162,192	—	162,192
Operating expenses:						
Fulfillment	90,342	—	90,342	81,400	—	81,400
Marketing	26,728	—	26,728	32,537	—	32,537
Technology and content	52,907	—	52,907	53,846	—	53,846
General and administrative	18,698	—	18,698	21,481	—	21,481
Stock-based compensation	(832)	832	—	(2,567)	2,567	—
Amortization of goodwill and intangibles	1,212	(1,212)	—	41,835	(41,835)	—
Restructuring-related and other	36,757	(36,757)	—	3,994	(3,994)	—
Total operating expenses	225,812	(37,137)	188,675	232,526	(43,262)	189,264
Income (loss) from operations	(9,645)	37,137	27,492	(70,334)	43,262	(27,072)
Interest income	5,600	—	5,600	6,316	—	6,316
Interest expense	(35,922)	—	(35,922)	(35,046)	—	(35,046)
Other income (expense), net	3,183	—	3,183	(2,203)	—	(2,203)
Other gains (losses), net	2,261	(2,261)	—	(63,625)	63,625	—
Total non-operating expenses, net	(24,878)	(2,261)	(27,139)	(94,558)	63,625	(30,933)
Income (loss) before equity in losses of equity-method investees	(34,523)	34,876	353	(164,892)	106,887	(58,005)
Equity in losses of equity-method investees, net	(557)	557	—	(4,982)	4,982	—
Net income (loss)	\$ (35,080)	\$ 35,433	\$ 353	\$ (169,874)	\$ 111,869	\$ (58,005)
Net cash provided by (used in) operating activities	\$ 38,108		\$ 38,108	\$ (64,403)		\$ (64,403)
Basic and diluted income (loss) per share	\$ (0.09)	\$ 0.09	\$ 0.00	\$ (0.46)	\$ 0.30	\$ (0.16)
Shares used in computation of income (loss) per share:						
Basic	379,650		379,650	368,052		368,052
Diluted	379,650		398,361	368,052		368,052

(1) In accordance with accounting principles generally accepted in the United States.

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The following is a reconciliation of our pro forma results for the nine months ended September 30, 2002 and 2001. Interim reconciliations are consistent with full-year presentation.

	Nine Months Ended September 30, 2002			Nine Months Ended September 30, 2001		
	As Reported (1)	Pro Forma Adjustments	Pro Forma	As Reported (1)	Pro Forma Adjustments	Pro Forma
		(in thousands) (unaudited)			(in thousands) (unaudited)	
Net sales	\$ 2,504,326	\$ —	\$ 2,504,326	\$ 2,007,262	\$ —	\$ 2,007,262
Cost of sales	1,846,867	—	1,846,867	1,482,753	—	1,482,753
Gross profit	657,459	—	657,459	524,509	—	524,509
Operating expenses:						
Fulfillment	265,908	—	265,908	265,231	—	265,231
Marketing	87,804	—	87,804	103,833	—	103,833
Technology and content	166,569	—	166,569	188,840	—	188,840
General and administrative	59,034	—	59,034	70,287	—	70,287
Stock-based compensation	33,247	(33,247)	—	2,700	(2,700)	—
Amortization of goodwill and intangibles	4,565	(4,565)	—	143,496	(143,496)	—
Restructuring-related and other	46,731	(46,731)	—	176,904	(176,904)	—
Total operating expenses	663,858	(84,543)	579,315	951,291	(323,100)	628,191
Income (loss) from operations	(6,399)	84,543	78,144	(426,782)	323,100	(103,682)
Interest income	16,902	—	16,902	23,073	—	23,073
Interest expense	(106,817)	—	(106,817)	(103,942)	—	(103,942)
Other income (expense), net	2,876	—	2,876	(7,265)	—	(7,265)
Other gains (losses), net	(55,677)	55,677	—	(18,453)	18,453	—
Total non-operating expenses, net	(142,716)	55,677	(87,039)	(106,587)	18,453	(88,134)
Loss before equity in losses of equity-method investees	(149,115)	140,220	(8,895)	(533,369)	341,553	(191,816)
Equity in losses of equity-method investees, net	(3,469)	3,469	—	(28,472)	28,472	—
Loss before cumulative effect of change in accounting principle	(152,584)	143,689	(8,895)	(561,841)	370,025	(191,816)
Cumulative effect of change in accounting principle	801	(801)	—	(10,523)	10,523	—
Net loss	\$ (151,783)	\$ 142,888	\$ (8,895)	\$ (572,364)	\$ 380,548	\$ (191,816)
Net cash used in operating activities	\$ (198,288)		\$ (198,288)	\$ (468,902)		\$ (468,902)
Basic and diluted loss per share:						
Prior to cumulative effect of change in accounting principle	\$ (0.41)	\$ 0.39	\$ (0.02)	\$ (1.55)	\$ 1.02	\$ (0.53)
Cumulative effect of change in accounting principle	0.01	(0.01)	—	(0.03)	0.03	—
	\$ (0.40)	\$ 0.38	\$ (0.02)	\$ (1.58)	\$ 1.05	\$ (0.53)
Shares used in computation of basic and diluted loss per share	376,564		376,564	361,782		361,782

(1) In accordance with accounting principles generally accepted in the United States.

Fourth quarter 2002 pro forma operating profit is expected to be between \$70 million and \$95 million. Full year 2003 pro forma operating profit is expected to be over \$200 million; this amount could be impacted, either positively or negatively, by the investment choices the Company makes for the long term. However, any such projections are subject to substantial uncertainty. See “Additional Factors That May Affect Future Results.”

Liquidity and Capital Resources

Our principal sources of liquidity are our cash, cash equivalents, and marketable securities. Our cash and cash equivalents balance was \$328 million and \$540 million, and our marketable securities balance was \$538 million and \$456 million at September 30, 2002 and December 31, 2001, respectively. The primary use of cash and cash equivalents during the nine months ended September 30, 2002 was, among other things, associated with funding our normal operations (including the settlement of the accounts payable associated with our 2001 holiday season), and with net purchases of marketable fixed-income securities. Combined cash, cash equivalents, and marketable securities were \$866 million and \$997 million at September 30, 2002 and December 31, 2001, respectively. Equity securities of \$3 million are included in “Marketable securities” at September 30, 2002, the value of which may fluctuate significantly. Equity securities of \$13 million were included in “Marketable securities” at December 31, 2001.

As of September 30, 2002, our principal commitments consisted of long-term indebtedness totaling \$2.26 billion related primarily to our 6.875% PEACS, 4.75% Convertible Subordinated Notes, and Senior Discount Notes; trade payables of \$348 million; and accrued expenses and other liabilities of \$242 million, which includes current restructuring-related obligations of \$19 million. Additionally, we are scheduled under certain of our long-term debt obligations to make periodic interest payments through 2010 in the aggregate of \$936 million, and are obligated under operating leases and commitments for advertising and promotional arrangements in the aggregate of \$371 million and \$10 million, respectively.

We have pledged a portion of our marketable securities as collateral for standby letters of credit that guarantee certain of our contractual obligations, a majority of which relates to property leases; the swap agreement that hedges the foreign-exchange rate risk on a portion of our 6.875% PEACS; and some of our real estate lease agreements. The amount of marketable securities we are required to pledge pursuant to the swap agreement fluctuates with the fair market value of the swap obligation. The change in the total amount of collateral pledged under these agreements was as follows (in thousands):

	Standby Letters of Credit	Swap Agreement	Real Estate Leases	Total
Balance at December 31, 2001	\$ 77,635	\$ 48,498	\$ 40,657	\$ 166,790
Net change in collateral pledged	(19,402)	(12,153)	(578)	(32,133)
Balance at September 30, 2002	\$ 58,233	\$ 36,345	\$ 40,079	\$ 134,657

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The following are our contractual commitments associated with our operational restructuring, indebtedness, lease obligations, and our marketing agreements (in thousands):

	Three Months Ending December 31, 2002	Year Ending December 31,					Total
		2003	2004	2005	2006	Thereafter	
Restructuring-related commitments:							
Operating leases, net of estimated sublease income	\$ 6,235	\$ 16,170	\$ 14,581	\$ 7,903	\$ 5,326	\$ 17,872	\$ 68,087
Other	—	1,580	1,000	3,113	—	—	5,693
Restructuring-related commitments	6,235	17,750	15,581	11,016	5,326	17,872	73,780
Other commitments:							
Debt principal and other (1)	1,196	4,962	2,004	74	—	2,188,229	2,196,465
Debt interest (1)	—	124,871	138,074	138,074	138,074	397,234	936,327
Capital leases	2,559	7,555	624	—	—	—	10,738
Operating leases	17,767	54,640	44,765	38,188	38,457	177,050	370,867
Marketing agreements	5,311	4,942	45	—	—	—	10,298
Other commitments	26,833	196,970	185,512	176,336	176,531	2,762,513	3,524,695
Total commitments	\$ 33,068	\$ 214,720	\$ 201,093	\$ 187,352	\$ 181,857	\$ 2,780,385	\$ 3,598,475

- (1) Principal and interest payments due under the Company's 6.875% PEACS, excluding those payments with a fixed exchange ratio under the currency swap hedge arrangement, will fluctuate based on the Euro/U.S. dollar exchange ratio.

Long-term capital lease obligations are as follows (in thousands):

	September 30, 2002
Gross capital lease obligations	\$ 10,738
Less imputed interest	(814)
Present value of net minimum lease payments	9,924
Less current portion	(8,613)
Long-term capital lease obligations	\$ 1,311

Restructuring-related lease obligations are as follows (in thousands):

	Three Months Ending December 31, 2002	Years Ending December 31,					Total
		2003	2004	2005	2006	Thereafter	
Gross lease obligations	\$ 6,614	\$ 17,868	\$ 18,050	\$ 14,781	\$ 13,677	\$ 50,382	\$ 121,372
Estimated sublease income (1)	(379)	(1,698)	(3,469)	(6,878)	(8,351)	(32,510)	(53,285)
Lease obligations, net	\$ 6,235	\$ 16,170	\$ 14,581	\$ 7,903	\$ 5,326	\$ 17,872	\$ 68,087

- (1) At September 30, 2002, the Company had signed contractual sublease agreements covering \$11 million in future payments.

Net cash provided by or used in operating activities consists of net loss offset by certain adjustments not affecting current-period cash flows, and the effect of changes in working capital. Adjustments to net income to determine cash flows from operations include depreciation and amortization, equity in losses of investees, and other items not affecting cash flows in the current period. Net cash provided by operating activities during the three months ended September 30, 2002 was \$38 million, resulting from our net loss of \$35 million, offset by

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changes in working capital of \$47 million and by adjustments not affecting third quarter 2002 cash flows of \$26 million (primarily associated with depreciation of fixed assets). Net cash used by operating activities during the three months ended September 30, 2001 was \$64 million, resulting from our net loss of \$170 million and changes in working capital of \$30 million, offset by adjustments not affecting third quarter 2001 cash flows of \$135 million (primarily associated with losses resulting from the remeasurement of our 6.875% PEACS from Euros to U.S. dollars, amortization of goodwill and intangibles, and depreciation of fixed assets). Net cash used by operating activities during the nine months ended September 30, 2002 was \$198 million, resulting from our net loss of \$152 million and changes in working capital of \$226 million, offset by adjustments not affecting 2002 year-to-date cash flows of \$180 million (primarily associated with losses resulting from the remeasurement of our 6.875% PEACS from Euros to U.S. dollars, depreciation of fixed assets, non-cash interest expense and stock-based compensation). Net cash used by operating activities during the nine months ended September 30, 2001 was \$469 million, resulting from our net loss of \$572 million and changes in working capital of \$253 million, offset by adjustments not affecting 2001 year-to-date cash flows of \$357 million (primarily associated with asset impairments resulting from our January 2001 operational restructuring, amortization of goodwill and intangibles, and depreciation of fixed assets). At June 30, 2002, prepaid expenses and other current assets were increased approximately \$20 million because a credit card service provider unintentionally failed to make a scheduled settlement. Since this receivable was settled during the three months ended September 30, 2002, it had a positive effect on the operating cash flows of this three-month period, offset in part by an increase in prepaid advertising.

Cash provided by investing activities during the three months ended September 30, 2002 was \$11 million, resulting from net sales and maturities of marketable securities of \$22 million, offset by purchases of fixed assets of \$11 million. Cash used by investing activities during the three months ended September 30, 2001 was \$95 million, consisting of purchases of marketable securities of \$82 million and purchases of fixed assets of \$13 million. Cash used in investing activities during the nine months ended September 30, 2002 was \$85 million, consisting of purchases of fixed assets of \$24 million and net purchases of marketable securities of \$62 million. Cash provided by investing activities during the nine months ended September 30, 2001 was \$21 million, consisting of purchases of fixed assets of \$43 million offset by net sales of marketable securities of \$22 million.

Net cash provided by financing activities during the three months ended September 30, 2002 was \$2 million, consisting primarily of proceeds from exercises of stock options of \$6 million, offset by repayments of long-term capital lease obligations of \$4 million. Net cash provided by financing activities during the three months ended September 30, 2001 was \$94 million, consisting primarily of proceeds from issuance of common stock of \$100 million and exercises of stock options of \$1 million, offset by repayment of long-term capital lease obligations of \$6 million. Net cash provided by financing activities during the nine months ended September 30, 2002 was \$44 million, consisting primarily of proceeds from exercises of stock options of \$56 million, offset by repayments of long-term capital lease obligations of \$12 million. Net cash provided by financing activities during the nine months ended September 30, 2001 was \$109 million, consisting primarily of proceeds from issuance of common stock of \$100 million, exercises of stock options of \$15 million and proceeds of \$10 million from long-term leases, offset by repayment of long-term capital lease obligations of \$15 million.

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. In addition, we expect to have positive free cash flow (operating cash flow less purchases of fixed assets) for fiscal year 2002. 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, or restructure our long-term debt for strategic reasons or to further strengthen our financial position. The sale of additional equity or convertible debt securities could result in additional dilution to our stockholders. In addition, we will, from time to time, consider the acquisition of or investment in complementary businesses, products, services, and technologies, and the repurchase and retirement of debt, which might affect our liquidity requirements or cause us to issue additional equity or debt securities. There can be no assurance that financing will be available in amounts or on terms acceptable to us, if at all.

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 losses since we began doing business. As of September 30, 2002, we had an accumulated deficit of \$3.0 billion and our stockholders' equity was a deficit of \$1.5 billion. We have incurred substantial operating losses since our inception and we may continue to incur such losses for the foreseeable future.

We Have Significant Indebtedness

As of September 30, 2002, we had total long-term indebtedness under our Senior Discount Notes, convertible notes, capitalized-lease obligations, and other asset financings of \$2.3 billion. We make annual or semi-annual interest payments on the indebtedness under our two tranches of convertible notes, which are due in 2009 and 2010, respectively. Beginning in November 2003, we will begin to make semi-annual interest payments on the indebtedness under our Senior Discount Notes due in 2008. We may incur substantial additional debt in the future. Our indebtedness could limit our ability to obtain necessary additional financing for working capital, capital expenditures, debt service requirements or other purposes in the future; plan for, or react to, changes in technology and in our business and competition; and react in the event of an economic downturn.

We may not 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.

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 the Internet and retail 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 and marketing than us.

Other companies in the retail and e-commerce service industries may enter into business combinations or alliances that strengthen their competitive positions. We also expect that competition in the e-commerce channel will intensify. 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 and/or operating profits.

Our Business Could Suffer if We Are Unsuccessful in Making and Integrating Strategic Alliances and Other Business Relationships

We may enter into strategic alliances and other business relationships with other companies through commercial agreements, joint ventures, investments, or business combinations. We have entered into third-party services agreements to provide services related to e-commerce to companies, and we plan to enter into similar agreements in the future. Under such agreements, we may perform services such as offering consumer products sold by us through Syndicated Stores; providing certain benefits associated with our technology services such as search, browse, and personalization; permitting third parties to offer products or services through our Web site; and powering third-party Web sites, providing fulfillment services, or both. These arrangements are complex and initially 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 deliver services under the relevant agreements. If we fail to implement, maintain, and develop successfully the various components of such arrangements, which may include fulfillment, customer service, inventory management, tax collection, and licensing of third party software, hardware and content, our strategic alliance initiatives may not be viable. The amount of compensation we receive under certain of these agreements is dependent on the volume of sales that the other company makes. Therefore if the third party Web site or product or services offering is not successful, we may not receive all of the compensation we are otherwise due under the terms of 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.

In the past, we amended several of our agreements with certain of the companies with which we have formed strategic alliances to reduce future cash proceeds to be received by us, shorten the term of our commercial agreements, or both. Certain of our commercial agreements expire or otherwise terminate in almost every quarter in the current year, and although we intend to replace or renew these agreements, we may be unable to do so on comparable terms or at all. 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 strategic alliances and 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 these agreements, or encounter third parties that have difficulty meeting their contractual obligations to us, which could adversely affect our operating results.

In addition, our present and future third-party services agreements, other commercial agreements, joint ventures, investments, and business combinations create risks such as:

- disruption of our ongoing business, including loss of management focus on existing businesses;
- impairment of relationships with existing employees, customers, and companies with which we have formed strategic alliances;
- variability in revenue and income from entering into, amending, or terminating strategic alliances;
- difficulty assimilating the operations, technology, and personnel of combined companies;
- problems retaining key technical and managerial personnel; and
- additional operating losses and expenses of acquired businesses.

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 where 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 Web site 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

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exchange for equity securities of that company. We may in the future make additional investments in companies with which we have already formed strategic alliances or companies with which we form new strategic alliances or similar arrangements. 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 strategic alliance 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 has been 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.

We hold several investments in third parties, primarily investments in companies in the Internet and e-commerce industries with which we have formed strategic alliances, that are accounted for using the equity method. Under the equity method, we are required to record our ownership percentage of the income or loss of these companies as income or loss for us. We record these amounts generally one month in arrears for private companies and three months in arrears for public companies. The losses we are required to record under the equity method with respect to a particular investment are limited to the carrying value of that investment, which, as of September 30, 2002, totaled \$1 million for all of our equity-method investments. The companies in which we have equity method investments are likely to experience large losses for the foreseeable future and may or may not be ultimately successful. Accordingly, we may record additional equity method losses in the future.

Our investments in equity securities that are not accounted for under the equity method are included in "Marketable securities" and "Other equity investments" on our 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 other of these investments have experienced an other-than-temporary decline. As of September 30, 2002, our recorded basis in equity securities was \$20 million, including \$3 million classified as "Marketable securities," \$1 million classified as "Investments in equity-method investees," and \$15 million classified as "Other equity investments."

The Seasonality of Our Business Places Increased Strain on Our Business

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 and 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 partial shipments from one or more locations. We may experience a decline in our shipping margins due to complimentary upgrades, split-shipments and additional long-zone shipments necessary to ensure timely delivery, especially for the holiday season. If the third party sellers for which we perform inventory fulfillment services on their behalf 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 Web sites within a short period of time due to increased holiday or other demand, we may experience system interruptions that make our Web sites 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

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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 outsourcers, may be unable to adequately staff customer service centers.

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 balance reaches its highest level (other than as a result of cash flows provided by investing and financing activities). This operating cycle results in a corresponding increase in accounts payable. Our accounts payable balance will decline during the first three months following year-end and will result in a decline in the amount of cash, cash equivalents and marketable securities on hand.

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. We may not be able to adjust our spending quickly if our net sales fall short of our expectations.

Our revenue and operating profit growth depends on the continued growth of demand for the products offered by us or our third party 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 create economic and consumer uncertainty that could adversely affect our revenue or growth. Such attacks and security concerns could create delays in and increase the cost of product shipments to and from us, 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 third party sellers, and to enter into, maintain, renew, and amend on favorable terms our strategic alliances;
- foreign exchange rate fluctuations;
- our ability to acquire merchandise, manage inventory and fulfill orders;
- the introduction by our competitors of Web sites, products, or services;
- changes in usage of the Internet and online services and consumer acceptance of the Internet and e-commerce;
- timing and costs of upgrades and developments in our systems and infrastructure;
- the effects of strategic alliances, acquisitions, and other business combinations, and our ability to successfully integrate them into our business;
- 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;

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- the extent to which we offer free shipping promotions; and
- an increase in the prices of fuel and gasoline, which are used in the transportation of packages, as well as an increase in the prices of other energy products, primarily natural gas and electricity, 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 Have Foreign Currency Risk

We may be adversely affected by foreign exchange rate risk. Our 6.875% PEACS are denominated in Euros, not U.S. dollars, and the exchange ratio between the Euro and the U.S. dollar is not fixed by the indenture governing the 6.875% PEACS. When we periodically remeasure the principal of the 6.875% PEACS based on fluctuations in the Euro/U.S. dollar exchange ratio, we will record non-cash gains or losses in “Other gains (losses), net” on our statements of operations. Furthermore, we have invested some of the proceeds from the 6.875% PEACS in Euro-denominated cash equivalents and marketable securities. Accordingly, if the U.S. dollar strengthens compared to the Euro, cash equivalents and marketable securities balances, when translated, may be materially less than expected and vice versa.

In addition, the results of operations of our internationally-focused Web sites are exposed to foreign exchange rate fluctuations as the financial results of the applicable subsidiaries are translated from the local currency into U.S. dollars upon consolidation. As exchange rates vary, net sales and other operating results, when translated, may differ materially from expectations.

Our Past and Planned Future Growth Will Place a Significant Strain on our Management, Operational, and Financial Resources

We have rapidly and significantly expanded our operations and will endeavor to expand further to pursue growth of our product and service offerings and customer base. Such growth will continue to place a significant strain on our management, operational, and financial resources. We also need to train and manage our employee base. Our current and planned personnel, systems, procedures, and controls may not be adequate to support and effectively manage our future operations. We may not be able to hire, train, retain, motivate, and manage required personnel, which may limit our growth.

In addition, we do not expect to benefit in our newer market segments from the first-to-market advantage that we experienced in the 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 our customers may not favorably receive our new businesses. To the extent we pursue strategic alliances to facilitate new product or service activities, the alliances may not be successful. If any of this were to occur, it could damage our reputation and negatively affect revenue growth.

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 Web sites 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 Web sites unavailable or prevent us from efficiently fulfilling orders, which may reduce our net sales and the attractiveness of our products and services. To prevent system interruptions, we continually need to add additional software and hardware, upgrade our systems and network infrastructure to accommodate both increased traffic on our Web sites and increased sales volume, and integrate our systems.

Our computer and communications systems and operations could be damaged or interrupted by fire, flood, power loss, telecommunications failure, break-ins, earthquakes, acts of war or terrorism, and similar events. We do not have backup systems or a formal disaster recovery plan, and we may have inadequate insurance coverage or insurance limits to compensate us for losses from a major interruption. Computer viruses, physical or electronic break-ins, and similar disruptions could cause system interruptions, delays, and loss or theft of critical data, and could prevent us from providing services and accepting and fulfilling customer orders. If this were to occur, it could damage our reputation and be expensive to remedy.

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

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 Web sites and 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 never be profitable.

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);
- import or export licensing requirements;
- limitations on the repatriation of funds;
- difficulty in obtaining distribution and support;
- nationalization;
- longer receivable cycles;
- consumer protection laws and restrictions on pricing or discounts;
- lower level 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 level of credit card usage and increased payment risk;
- difficulty in developing and simultaneously managing a larger number of unique foreign operations as a result of distance, language, and cultural differences;
- laws and policies of the U.S. and other jurisdictions affecting trade, foreign investment, and loans; and
- tax and other laws of the U.S. and other jurisdictions.

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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 content, privacy, 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.

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 is particularly difficult to forecast product demand accurately. A failure to optimize inventory within our fulfillment network will harm our shipping margins 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 agreements with Toysrus.com, Babiesrus.com, Target, and other companies, these parties will identify, buy, manage, 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 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.

Our ability to receive inbound inventory efficiently or ship completed orders to customers may be negatively affected by a number of factors, including dependence on a limited number of shipping companies, inclement weather, fire, flood, power loss, earthquakes, labor disputes, acts of war or terrorism, or acts of God.

Any one of the factors set forth above may require us to mark down or write off inventory, which will adversely affect our operating results.

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. Most of our fulfillment centers are highly automated, and we have had limited experience with automated fulfillment centers. Because it is difficult to predict sales volume, we may not manage our facilities in an optimal way, which may result in excess or insufficient inventory, warehousing, fulfillment, and distribution capacity. We have closed our fulfillment centers in McDonough, Georgia and Seattle, Washington. In addition, 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.

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 which 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 third party sellers or other companies 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;
- changes in Internet regulation;
- changes in our capital structure, including issuance of additional debt or equity to the public;

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- 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
- news and securities analyst reports and speculation relating to new and existing commercial agreements, general business or Internet trends, or our existing or future products or services.

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 option awards than we have historically, which could hurt our operating results or reduce the percentage ownership of our existing stockholders, or both. In the first quarter of 2001, we offered a limited non-compulsory exchange of employee stock options. This option exchange offer results in variable accounting treatment for stock options representing, at September 30, 2002, approximately 8 million shares of our common stock. Variable accounting treatment will result in unpredictable stock-based compensation expense dependent on fluctuations in quoted prices for our common stock.

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 may cover taxation, user privacy, pricing, content, copyrights, distribution, electronic contracts, consumer protection, the provision of online payment services, 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 consumer-to-consumer fixed price online markets, like zShops and certain aspects of Amazon Marketplace. This could, in turn, diminish the demand for our products and services and increase our cost of doing business.

We May Be Subject to Liability for Past Sales and Our Future Sales May Decrease

In accordance with current industry practice, we do not collect sales taxes or other taxes with respect to shipments of most of our goods into states other than Washington and North Dakota. Under some of our strategic alliance 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. We collect Value Added Tax, or VAT, for products that are ordered on www.amazon.co.uk, www.amazon.de, and www.amazon.fr and delivered in European Union member countries. We also collect Japanese consumption tax for products that are ordered on www.amazon.co.jp and delivered in Japan. In addition, Canadian consumption taxes are collected on sales of products that are ordered on www.amazon.ca and delivered in Canada. 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. One or more states or foreign countries may seek to impose sales or other tax collection obligations on out-of-jurisdiction companies which 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 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

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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 states other than Washington and North Dakota. 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.

Various countries are currently evaluating their VAT positions on e-commerce transactions. Recently, for example, the European Union enacted a directive requiring that businesses in non-EU countries selling digital products and services to EU resident consumers collect and remit VAT in the country of the consumer's residence. This directive will become effective on July 1, 2003, will result in additional VAT collection obligations and administrative burdens, and may decrease our future sales to customers in the EU. Future VAT legislation or changes to our business model may have similar impacts.

We Source a Significant Portion of Our Inventory from a Few Vendors

Although we continue to increase our direct purchasing from manufacturers, we still source a significant amount of inventory from relatively few vendors. During the nine months ended September 30, 2002, approximately 20% of all inventory purchases were made from two major vendors, of which Ingram Book Group accounted for over 10% of all inventory purchases. 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. Our current vendors may stop selling merchandise to us on acceptable terms. If that were the case, 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 our products, such as toys, tools, hardware, computers, cell phones, and kitchen and houseware products, 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. Companies with which we have formed strategic alliances also may sell products that may indirectly increase our exposure to product liability 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 suppliers do not indemnify us from product liability.

We Could Be Liable for Breaches of Security on Our Web Site and Fraudulent Activities of Users of Our Amazon Payments Program

A fundamental requirement for e-commerce is the secure transmission of confidential information over public networks. 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.

The law relating to the liability of providers of online payment services is currently unsettled. In addition, we are aware that governmental agencies are currently investigating the provision of online payment services and could require changes in the way we conduct this business. We guarantee payments made through Amazon Payments up to certain limits for both buyers and sellers, and we may be unable to prevent users of Amazon Payments from fraudulently receiving goods when payment may not be made to a seller or fraudulently collecting payments when goods may not be shipped to a buyer. Our liability risk will increase as a larger fraction of our sellers use Amazon Payments. Any costs we incur as a result of liability because of our guarantee

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of payments made through Amazon Payments or otherwise could harm our business. In addition, the functionality of Amazon Payments depends on certain third-party vendors delivering services. If these vendors are unable or unwilling to provide services, Amazon Payments will not be viable (and our businesses that use Amazon Payments may not be viable).

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 Web sites and proprietary technology obsolete.

The Internet as a Medium for Commerce Is Uncertain

Consumer use of the Internet as a medium for commerce is a recent phenomenon and is subject to a high level of 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. If use of the Internet as a medium for commerce does not continue to grow or grows at a slower rate than we anticipate, our sales would be lower than expected and our business would be harmed.

We Could Be Liable for Unlawful or Fraudulent Activities by Users of Our Merchant@, Amazon Marketplace, Auctions, and zShops Services

We may be unable to prevent users of our Merchant@, Amazon Marketplace, Auctions, and zShops services from selling unlawful goods, or from selling goods in an unlawful manner. We may face civil or criminal liability for unlawful and fraudulent activities by our users under U.S. laws and/or the laws and regulations of other countries. Any costs we incur as a result of liability relating to the sale of unlawful goods, the unlawful sale of goods, the fraudulent receipt of goods, or the fraudulent collection of payments could harm our business. In running our Merchant@, Amazon Marketplace, Auctions, and zShops services, we rely on sellers of goods to make accurate representations and provide reliable delivery, and on buyers to pay the agreed purchase price. We do not take responsibility for delivery of payment or goods and while we can suspend or terminate the accounts of users who fail to fulfill their delivery obligations to other users, we cannot require users to make payments or deliver goods. We do not compensate users who believe they have been defrauded by other users except through our guarantee program. Under the guarantee program, fraudulent activities by our users, such as the fraudulent receipt of goods and the fraudulent collection of payments, may create liability for us.

Item 3. *Quantitative and Qualitative Disclosure of 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 disclosure about market risk is set forth below and in “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 equivalents 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 AA-rated or higher short- to intermediate-term fixed income securities and 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 September 30, 2002, we have long-term indebtedness of \$2.26 billion primarily associated with our 6.875% PEACS, 4.75% Convertible Subordinated Notes, and Senior Discount Notes, which are due in 2010, 2009, and 2008, respectively. Our payment commitments associated with these debt instruments are fixed during the corresponding terms and are comprised of interest payments, principal payments, or a combination thereof. 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.

Foreign Currency Risk

Net sales from our internationally-focused Web sites (www.amazon.co.uk, www.amazon.de, www.amazon.fr, www.amazon.co.jp, and www.amazon.ca) accounted for 28% and 21% of consolidated revenues for the nine months ended September 30, 2002 and the year ended December 31, 2001, respectively. Net sales generated from these Web sites, as well as most of the related expenses incurred, are denominated in the functional currencies of the corresponding Web sites. The functional currency of our subsidiaries that either operate or support www.amazon.co.uk, www.amazon.de, www.amazon.fr, www.amazon.co.jp, and www.amazon.ca is the same as the local currency of the United Kingdom, Germany, France, Japan and Canada, respectively. Results of operations from our foreign subsidiaries and our subsidiaries that operate our internationally-focused Web sites are exposed to foreign exchange rate fluctuations as the financial results of these subsidiaries are translated into U.S. dollars upon consolidation. As exchange rates vary, net sales and other operating results, when translated, may differ materially from expectations. During the three months and nine months ended September 30, 2002, International segment revenues improved \$22 million and \$12 million, respectively, and operating results improved \$1 million for each respective period in comparison to the prior year due to changes in currency exchange rates.

At September 30, 2002, we were also exposed to foreign exchange risk related to our 6.875% PEACS and Euro-denominated cash equivalents and marketable securities (“Euro Investments”). The 6.875% PEACS have an outstanding principal balance of 690 million Euros (\$681 million, based on the exchange rate as of September 30, 2002), and our Euro Investments, classified as available-for-sale, had a balance of 59 million Euros (\$58 million, based on the exchange rate as of September 30, 2002). As the Euro/U.S. dollar exchange ratio varies, the value of our Euro Investments, when translated, will fluctuate. Debt principal of 615 million Euros is remeasured each period, which results in currency gains or losses that are recorded in “Other gains (losses), net” on our statements of operations. We hedge the exchange rate risk on debt principal of 75 million

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Euros and a portion of the interest payments using a cross-currency swap agreement. Under the swap agreement, we agreed to pay at inception and receive upon maturity 75 million Euros in exchange for receiving at inception and paying at maturity \$67 million. In addition, we agreed to receive in February of each year 27 million Euros corresponding with interest payments on 390 million Euros of the 6.875% PEACS and, simultaneously, to pay \$32 million. This agreement is cancelable, in whole or in part, at our option at no cost on or after February 20, 2003 if our common stock price (converted into Euros) is greater than or equal to 84.883 Euros, the minimum conversion price of the 6.875% PEACS. We account for the swap agreement as a cash flow hedge of the risk of exchange rate fluctuations on the debt principal and interest. Gains and losses on the swap agreement are initially recorded in "Accumulated other comprehensive loss" on our balance sheets and recognized in "Other gains (losses), net" on our statements of operations upon the recognition of the corresponding currency losses and gains on the remeasurement of the 6.875% PEACS.

Investment Risk

As of September 30, 2002, our carrying value in equity securities was \$20 million, including \$3 million classified as "Marketable securities," \$1 million classified as "Investments in equity-method investees," and \$15 million classified as "Other equity investments." We invest in the stock and/or warrants of both private and public companies primarily for strategic purposes. At September 30, 2002, our investments in securities of publicly-held companies was \$10 million, and our investments in securities of privately-held companies was \$10 million. We have also received securities, including warrant investments, from some of the companies with which we have formed strategic alliances in exchange for services provided by us to those companies. Our investments are accounted for under the equity method if we have the ability to exercise significant influence, but not control, over an investee. Some of our cost-method investments are in private companies and are accounted for at cost and others are in public companies and are accounted for as available-for-sale securities and recorded at fair value. Warrant investments are generally carried at fair value. We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that such declines in the fair value of such assets below our carrying value are other-than-temporary. During the nine months ended September 30, 2002, and the year ended December 31, 2001, we recorded impairment losses totaling \$5 million and \$44 million, respectively, to write-down certain of our equity securities to fair value. All of these investments are in companies involved in the Internet and e-commerce industries and their fair values are subject to significant fluctuations due to volatility of the stock market and changes in general economic conditions. Based on the fair value of the publicly-traded equity securities we held at September 30, 2002 of \$31 million (recorded basis of \$10 million), an assumed 15%, 30%, or 50% adverse change to market prices of these securities would result in a corresponding decline in total fair value of approximately \$5 million, \$9 million, or \$16 million, respectively.

Item 4. Controls and Procedures

Within 90 days prior to the date of this report, we carried out an evaluation, 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. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic SEC reports. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

In addition, we reviewed our internal controls, and there have been no significant changes in our internal controls or in other factors that could significantly affect those controls subsequent to the date of their last evaluation.

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

On April 12, 2001, we received a request from the SEC staff for the voluntary production of documents and information concerning, among other things, previously reported sales of our common stock by our Chairman and Chief Executive Officer, Jeffrey Bezos, on February 2 and 5, 2001. We are cooperating with the SEC staff's continuing inquiry.

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 October 5, 2001, plaintiffs in the 1934 Act cases filed a consolidated amended complaint alleging that we, together with certain of our officers and directors and certain third-parties, made false or misleading statements during the period from October 29, 1998 through July 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 rescissory and/or compensatory damages and injunctive relief against all defendants. We dispute the allegations of wrongdoing in these complaints and intend to vigorously defend ourselves in these matters.

On August 28, 2002, the Trustee for the Creditors' Trust for Living.com instituted an adversary proceeding against a subsidiary of the Company in the United States Bankruptcy Court for the Western District of Texas. The plaintiff alleges that Living.com's creditors are entitled to a contractual recovery of approximately \$58 million in fees that Living.com had previously paid in 2000 primarily by issuing Living.com stock to the Company. We dispute the plaintiff's allegations and intend to vigorously defend ourselves in this matter.

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

From time to time, we are subject to other legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights, patents, and other intellectual property rights. We currently are not aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse effect on our business, financial condition, or operating results.

Item 2. *Changes in Securities and Use of Proceeds*

None.

Item 3. *Defaults Upon Senior Securities*

None.

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

None.

Item 5. *Other Information*

None.

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Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

<u>Exhibit Number</u>	<u>Title</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
99.1	Press Release Dated October 24, 2002, Announcing the Company's Third Quarter Financial Results
99.2	Certification of Jeffrey P. Bezos, Chairman and Chief Executive Officer of Amazon.com, Inc., Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.3	Certification of Mark S. Peek, Vice President and Chief Accounting Officer of Amazon.com, Inc., Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K

On July 31, 2002, the Company filed an 8-K under Item 9 announcing that its Chief Executive Officer, Jeffrey P. Bezos, and principal financial officer, Mark S. Peek, submitted their statements under oath in response to the order of the Securities and Exchange Commission pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934 (SEC File No. 4-460).

On August 30, 2002, the Company filed an 8-K under Item 5 announcing that Thomas J. Szkutak will become its Senior Vice President and Chief Financial Officer.

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
(Principal Financial and Accounting Officer)

Dated: October 25, 2002

CERTIFICATIONS

I, Jeffrey P. Bezos, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Amazon.com, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: October 25, 2002

/s/ JEFFREY P. BEZOS

Jeffrey P. Bezos
Chairman and Chief Executive Officer
(Principal Executive Officer)

CERTIFICATIONS

I, Mark S. Peek, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Amazon.com, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: October 25, 2002

/s/ MARK S. PEEK

Mark S. Peek
Vice President and Chief Accounting Officer
(Principal Financial Officer)

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