

[Table of Contents](#)

**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 June 30, 2004

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
(206) 266-1000

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

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value \$.01 per share

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

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

406,861,396 shares of common stock, par value \$0.01 per share outstanding as of July 19, 2004

[Table of Contents](#)

AMAZON.COM, INC.
FORM 10-Q
For the Three Months Ended June 30, 2004

INDEX

	Page
	<hr/>
<u>PART I. FINANCIAL INFORMATION</u>	
Item 1.	Financial Statements
	Consolidated Statements of Cash Flows — Three months and six months ended June 30, 2004 and 2003
	Consolidated Statements of Cash Flows — Twelve months ended June 30, 2004 and 2003
	Consolidated Statements of Operations — Three months and six months ended June 30, 2004 and 2003
	Consolidated Balance Sheets — June 30, 2004 and December 31, 2003
	Notes to Consolidated Financial Statements — June 30, 2004
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations
Item 3.	Quantitative and Qualitative Disclosures About Market Risk
Item 4.	Controls and Procedures
<u>PART II. OTHER INFORMATION</u>	
Item 1.	Legal Proceedings
Item 2.	Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities
Item 3.	Defaults Upon Senior Securities
Item 4.	Submission of Matters to a Vote of Security Holders
Item 5.	Other Information
Item 6.	Exhibits and Reports on Form 8-K
	Signatures

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	\$ 768,587	\$ 495,773	\$ 1,102,273	\$ 738,254
OPERATING ACTIVITIES:				
Net income (loss)	76,480	(43,314)	187,616	(53,435)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Depreciation of fixed assets, including internal-use software and website development, and other amortization	18,129	19,003	35,810	38,753
Stock-based compensation	21,692	24,453	28,799	51,776
Other operating expense (income)	(7,150)	913	(7,692)	1,825
Losses (gains) on sales of marketable securities, net	77	(5,272)	(1,010)	(9,252)
Remeasurements and other	(16,302)	60,216	(36,662)	82,450
Non-cash interest expense and other	1,113	3,532	2,262	11,409
Changes in operating assets and liabilities:				
Inventories	(4,716)	(2,479)	8,454	28,146
Accounts receivable, net and other current assets	(3,272)	5,914	7,026	33,147
Accounts payable	22,612	45,486	(233,382)	(181,119)
Accrued expenses and other current liabilities	6,861	(7,138)	(66,908)	(94,203)
Additions to unearned revenue	27,495	25,752	50,762	48,720
Amortization of previously unearned revenue	(25,058)	(29,998)	(49,125)	(57,903)
Interest payable	25,075	28,956	(33,602)	(26,072)
Net cash provided by (used in) operating activities	143,036	126,024	(107,652)	(125,758)
INVESTING ACTIVITIES:				
Sales and maturities of marketable securities and other investments	42,556	350,068	612,324	559,023
Purchases of marketable securities	(250,702)	(109,259)	(755,381)	(342,314)
Purchases of fixed assets, including internal-use software and website development	(14,143)	(7,141)	(23,656)	(13,535)
Net cash provided by (used in) investing activities	(222,289)	233,668	(166,713)	203,174
FINANCING ACTIVITIES:				
Proceeds from exercises of stock options and other	20,077	53,042	34,891	91,597
Repayments of long-term debt, capital lease obligations, and other	(645)	(280,918)	(156,292)	(284,139)
Net cash provided by (used in) financing activities	19,432	(227,876)	(121,401)	(192,542)
Foreign-currency effect on cash and cash equivalents	(7,616)	14,139	(5,357)	18,600
Net increase (decrease) in cash and cash equivalents	(67,437)	145,955	(401,123)	(96,526)
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 701,150	\$ 641,728	\$ 701,150	\$ 641,728
SUPPLEMENTAL CASH FLOW INFORMATION:				
Fixed assets acquired under capital leases and other financing arrangements	\$ 31	\$ 415	\$ 523	\$ 1,076
Cash paid for interest	45	2,601	86,068	86,816
Cash paid for income taxes	561	307	1,008	609

See accompanying notes to consolidated financial statements.

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

	Twelve Months Ended June 30,	
	2004	2003
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	\$ 641,728	\$ 270,438
OPERATING ACTIVITIES:		
Net income (loss)	276,333	(85,864)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation of fixed assets, including internal-use software and website development, and other amortization	72,615	79,117
Stock-based compensation	64,774	86,624
Other operating expense (income)	(6,765)	7,420
Gains on sales of marketable securities, net	(1,356)	(14,139)
Remeasurements and other	10,985	122,042
Non-cash interest expense and other	3,771	26,470
Changes in operating assets and liabilities:		
Inventories	(96,478)	(44,251)
Accounts receivable, net and other current assets	(25,816)	16,949
Accounts payable	115,469	131,127
Accrued expenses and other current liabilities	1,555	(11,362)
Additions to unearned revenue	103,683	94,720
Amortization of previously unearned revenue	(102,962)	(125,115)
Interest payable	(5,680)	1,191
Net cash provided by operating activities	410,128	284,929
INVESTING ACTIVITIES:		
Sales and maturities of marketable securities and other investments	866,485	762,401
Purchases of marketable securities	(948,709)	(544,020)
Purchases of fixed assets, including internal-use software and website development	(56,084)	(40,404)
Proceeds from sale of subsidiary and other	5,072	—
Net cash provided by (used in) investing activities	(133,236)	177,977
FINANCING ACTIVITIES:		
Proceeds from exercises of stock options and other	106,616	163,011
Repayments of long-term debt, capital lease obligations, and other	(367,461)	(290,939)
Net cash used in financing activities	(260,845)	(127,928)
Foreign-currency effect on cash and cash equivalents	43,375	36,312
Net increase (decrease) in cash and cash equivalents	59,422	371,290
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 701,150	\$ 641,728
SUPPLEMENTAL CASH FLOW INFORMATION:		
Fixed assets acquired under capital leases and other financing arrangements	\$ 2,124	\$ 1,964
Cash paid for interest	119,199	117,356
Cash paid for income taxes	2,224	1,291

See accompanying notes to consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net sales	\$ 1,387,341	\$ 1,099,912	\$ 2,917,690	\$ 2,183,471
Cost of sales	1,046,295	825,984	2,215,810	1,638,961
Gross profit	341,046	273,928	701,880	544,510
Operating expenses:				
Fulfillment	122,717	107,455	250,422	211,160
Marketing	31,839	25,326	65,475	53,553
Technology and content	58,475	52,135	113,551	102,223
General and administrative	27,199	21,823	54,616	42,925
Stock-based compensation (1)	21,692	24,453	28,799	51,776
Other operating expense (income)	(7,150)	913	(7,692)	1,825
Total operating expenses	254,772	232,105	505,171	463,462
Income from operations	86,274	41,823	196,709	81,048
Interest income	5,311	5,761	10,866	12,301
Interest expense	(26,055)	(34,367)	(53,786)	(70,878)
Other income (expense), net	(5,352)	3,685	(2,835)	6,544
Remeasurements and other	16,302	(60,216)	36,662	(82,450)
Total non-operating expense, net	(9,794)	(85,137)	(9,093)	(134,483)
Net income (loss)	\$ 76,480	\$ (43,314)	\$ 187,616	\$ (53,435)
Basic earnings (loss) per share	\$ 0.19	\$ (0.11)	\$ 0.46	\$ (0.14)
Diluted earnings (loss) per share	\$ 0.18	\$ (0.11)	\$ 0.44	\$ (0.14)
Weighted average shares used in computation of earnings (loss) per share:				
Basic	405,268	393,876	404,399	391,223
Diluted	424,678	393,876	424,592	391,223
(1) Components of stock-based compensation:				
Fulfillment	\$ 3,287	\$ 4,862	\$ 4,293	\$ 11,847
Marketing	2,095	1,606	2,703	2,585
Technology and content	12,834	13,578	16,133	27,794
General and administrative	3,476	4,407	5,670	9,550
	\$ 21,692	\$ 24,453	\$ 28,799	\$ 51,776

See accompanying notes to consolidated financial statements.

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

	June 30, 2004	December 31, 2003
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 701,150	\$ 1,102,273
Marketable securities	450,201	292,550
Inventories	284,194	293,917
Accounts receivable, net and other current assets	125,647	132,069
Total current assets	1,561,192	1,820,809
Fixed assets, net	215,871	224,285
Goodwill	69,121	69,121
Other assets	41,926	47,818
Total assets	\$ 1,888,110	\$ 2,162,033
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	\$ 585,124	\$ 819,811
Accrued expenses and other current liabilities	249,843	317,730
Unearned revenue	39,487	37,844
Interest payable	39,498	73,100
Current portion of long-term debt and other	2,402	4,216
Total current liabilities	916,354	1,252,701
Long-term debt and other	1,762,614	1,945,439
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 — 406,711 and 403,354 shares	4,067	4,034
Additional paid-in capital	1,964,342	1,899,398
Deferred stock-based compensation	(1,872)	(2,850)
Accumulated other comprehensive income	29,417	37,739
Accumulated deficit	(2,786,812)	(2,974,428)
Total stockholders' deficit	(790,858)	(1,036,107)
Total liabilities and stockholders' deficit	\$ 1,888,110	\$ 2,162,033

See accompanying notes to consolidated financial statements.

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

Note 1 — Accounting Policies

Unaudited Interim Financial Information

We have prepared the accompanying consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. As used herein, “Amazon.com,” the “Company,” “we,” “our” and similar terms include Amazon.com, Inc. and its wholly-owned subsidiaries, unless the context indicates otherwise. These consolidated financial statements are unaudited and, in our opinion, include all adjustments, consisting of normal recurring adjustments and accruals necessary for a fair presentation of the consolidated balance sheets, operating results, and cash flows for the periods presented. Operating results for the periods presented are not necessarily indicative of the results that may be expected for the year ending December 31, 2004 due to seasonal and other factors. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2003. Certain prior period amounts have been reclassified to conform to the current period presentation.

Principles of Consolidation

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

Use of Estimates

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

Inventories

Inventories, consisting of products available for sale, are accounted for using the first-in first-out (“FIFO”) method, and are valued at the lower of cost or market value. This valuation requires us to make judgments, based on currently-available information, about the likely method of disposition, such as through sales to individual customers, returns to product vendors, or liquidations, and expected recoverable values of each disposition category. Based on this evaluation, we record a valuation allowance to adjust the carrying amount of our inventories to lower of cost or market value. We provide fulfillment-related services in connection with certain of our Merchants@ and Merchant.com programs. In those arrangements, as well as other product sales by third parties, the third party maintains ownership of the related products.

Goodwill

We have elected to perform our annual analysis of goodwill during the fourth quarter of each year. Based on our 2003 analysis, no impairments were present, and no indicators of impairment were identified during the six months ended June 30, 2004.

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

Other Assets

Included in “Other assets” on our consolidated balance sheets are amounts primarily related to deferred issuance charges on our long-term debt, which are amortized over the life of the debt; other equity investments; and intangibles assets, net of amortization. At June 30, 2004 and December 31, 2003, deferred issuance charges were \$21 million and \$25 million, and other equity investments were \$12 million and \$15 million.

Revenue

Product sales, net of promotional discounts, rebates, and return allowances, are recorded when the products are shipped and title passes to customers. Retail sales 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, which is commonly referred to as “F.O.B. Shipping Point.” Return allowances, which reduce product revenue, are estimated using historical experience.

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

Outbound shipping charges to customers are included in “Net sales” and amounted to \$84 million and \$80 million for the three months ended June 30, 2004 and 2003, and \$178 million and \$158 million for the six months ended June 30, 2004 and 2003.

Cost of Sales

Cost of sales consists of the purchase price of consumer products sold by us, inbound and outbound shipping charges to us, packaging supplies, and costs incurred in operating and staffing our fulfillment and customer service centers on behalf of other businesses, such as Toysrus.com and Target. All credit card fees and bad debt costs, including those associated with our guarantee for certain third-party seller transactions, are classified in “Fulfillment” on the consolidated statements of operations.

Outbound shipping-related costs totaled \$119 million and \$106 million for the three months ended June 30, 2004 and 2003, and \$255 million and \$212 million for the six months ended June 30, 2004 and 2003.

Vendor Agreements

We have agreements to receive cash consideration from certain of our vendors, including rebates and cooperative marketing reimbursements. We generally presume amounts received from our vendors are a reduction of the prices we pay for their products, and therefore, we reflect such amounts as either a reduction of “Cost of sales” on our consolidated statements of operations, or, if the product inventory is still on hand at the reporting date, it is reflected as a reduction of “Inventories” on our consolidated balance sheets. When we receive direct reimbursements for costs incurred by us in advertising the vendor’s product or service, the amount we receive is recorded as an offset to “Marketing” on our consolidated statements of operations.

Vendor rebates are typically dependent upon reaching minimum purchase thresholds. We evaluate the likelihood of reaching purchase thresholds using past experience and current year forecasts. When rebates can be reasonably estimated, we record a portion of the rebate as we make progress towards the purchase threshold.

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

Depreciation of Fixed Assets

Fixed assets are depreciated on a straight-line basis over the estimated useful lives of the assets (generally two to ten years). Depreciation expense is classified within the corresponding operating expense categories on the consolidated statements of operations. Depreciation expense on fixed assets, including internal-use software and website development, was \$18 million and \$35 million for the three months and six months ended June 30, 2004, and \$17 million and \$35 million for the three months and six months ended June 30, 2003.

Stock-Based Compensation

Stock-based compensation consisted of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Stock awards — variable accounting (1)	\$ 8,923	\$ 14,747	\$ 6,371	\$ 35,722
Fixed accounting (2):				
Restricted stock units	11,880	7,993	19,760	13,169
Restricted stock (3)	889	1,713	2,668	2,885
Total stock-based compensation	\$ 21,692	\$ 24,453	\$ 28,799	\$ 51,776

- (1) Variable accounting treatment results in expense or contra-expense recognition using the cumulative expense method, calculated based on the quoted price of our common stock and vesting schedules of underlying awards.
- (2) The fair value of awards is determined at grant date and recognized as expense over the service period.
- (3) Includes expense associated with matching contributions of 12,288 and 36,250 shares of our common stock under our 401(k) savings plan during the three and six months ended June 30, 2004, and 15,125 shares of our common stock during the second quarter of 2003. No similar contributions were made in the first quarter of 2003.

We granted stock awards, primarily restricted stock units, representing 1.9 million and 1.6 million shares of common stock during the three months ended June 30, 2004 and 2003, and 2.0 million and 1.8 million shares of common stock during the six months ended June 30, 2004 and 2003. The per share weighted average fair value of stock awards, including restricted stock units, granted was \$46.62 and \$26.46 during the three months ended June 30, 2004 and 2003, and \$46.63 and \$25.78 during the six months ended June 30, 2004 and 2003. Stock-based awards generally fully vest over service periods of between three and six years.

Common shares outstanding (which includes restricted stock), plus shares underlying outstanding stock options and restricted stock units totaled 434 million and 433 million at June 30, 2004 and 2003. Common shares outstanding increased by 1.8 million shares during the three months ended June 30, 2004, and 3.3 million shares during the six months ended June 30, 2004, due to exercises of stock options and vesting of restricted stock units.

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

Outstanding stock awards were as follows:

	June 30,	
	2004	2003
	(in thousands)	
Stock options (1)(2)	21,237	31,923
Restricted stock units (3)	5,888	4,454
Outstanding stock awards, excluded from common stock outstanding	27,125	36,377
Restricted stock (4)	490	831
Total outstanding stock awards	27,615	37,208

- (1) The weighted average per share exercise price was \$12.82 and \$12.31 at June 30, 2004 and 2003.
(2) Includes 1.1 million and 1.4 million options at June 30, 2004 and 2003 subject to variable accounting treatment.
(3) Includes 0.4 million and 0.3 million restricted stock units subject to variable accounting treatment at June 30, 2004 and 2003.
(4) Included in issued and outstanding common stock.

The following table summarizes relevant information as if the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*, had been applied to all stock-based awards (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net income (loss) — as reported	\$ 76,480	\$ (43,314)	\$ 187,616	\$ (53,435)
Add: Stock-based compensation, as reported	21,692	24,453	28,799	51,776
Deduct: Total stock-based compensation determined under fair value based method for all awards	(20,405)	(22,608)	(38,463)	(50,075)
Net income (loss) — SFAS No. 123 adjusted	\$ 77,767	\$ (41,469)	\$ 177,952	\$ (51,734)
Basic earnings (loss) per share — as reported	\$ 0.19	\$ (0.11)	\$ 0.46	\$ (0.14)
Diluted earnings (loss) per share — as reported	0.18	(0.11)	0.44	(0.14)
Basic earnings (loss) per share — SFAS No. 123 adjusted	0.19	(0.11)	0.44	(0.13)
Diluted earnings (loss) per share — SFAS No. 123 adjusted	0.18	(0.11)	0.42	(0.13)

The fair value for restricted stock and restricted stock units is based on the intrinsic value of those awards at grant date. The fair value for option awards is estimated at the date of grant using a Black-Scholes option-pricing model, assuming no dividends and the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Average risk-free interest rate	2.9%	2.2%	2.5%	2.4%
Average expected life (in years)	3.3	3.3	3.3	3.3
Volatility	57.7%	76.3%	60.3%	76.3%

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

Restructuring Estimates

Restructuring-related liabilities include estimates for, among other things, anticipated disposition of lease obligations. Key variables in determining such estimates include anticipated 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. Additionally, we may determine that certain of the office space previously vacated as part of our 2001 restructuring, which we have been unable to sublease due to poor real estate market conditions, may be necessary for our future needs. To the extent we elect to utilize this office space, in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, we will adjust our restructuring-related liability and classify future payments to the corresponding operating expense categories on the consolidated statements of operations. See “Note 6 — Other Operating Expense (Income).”

Foreign Currency

A provision of SFAS No. 52, *Foreign Currency Translation*, requires that gains and losses arising from intercompany foreign currency transactions considered long-term investments, where settlement is not planned or anticipated in the foreseeable future, be excluded in the determination of net income. Our international operations are financed, in part, by the U.S. parent company. In periods ending prior to the fourth quarter of 2003, currency adjustments for these intercompany balances were recorded to stockholders’ deficit as translation adjustments and not included in the determination of net income because we intended to permanently invest such amounts. During the fourth quarter of 2003, we made the decision that these amounts would be repaid among the entities and, accordingly, upon consolidation, any exchange gain or loss arising from remeasurements of intercompany balances is required to be recorded in the determination of net income. In connection with the remeasurement of intercompany balances, we recorded a loss of \$7 million for the three months ended June 30, 2004, and a loss of \$10 million for the six months ended June 30, 2004. During the six months ended June 30, 2004, \$135 million was repaid among the entities.

Earnings (Loss) per Share

In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 128, *Earnings per Share*, the weighted-average number of shares used to calculate basic earnings (loss) per share excludes shares of restricted stock since they are subject to repurchase or forfeiture.

For periods when we have net income, the dilutive effect of outstanding stock awards, including restricted stock, is included in the calculation of diluted earnings per share using the treasury stock method for assumed proceeds, if any. For periods when we have a net loss, the effect of outstanding stock awards, including restricted stock, is antidilutive and therefore excluded from the calculation of diluted loss per share.

Stock issuable upon conversion of our convertible debt instruments is excluded from the calculation of diluted earnings per share as its effect is antidilutive. See “Note 3 — Long-Term Debt and Other.”

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

Note 2 — Cash, Cash Equivalents, and Marketable Securities

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

	June 30, 2004	December 31, 2003
	(in thousands)	
Cash	\$ 203,773	\$ 427,306
Commercial paper and short-term securities (1)	497,377	674,967
Cash and cash equivalents	701,150	1,102,273
Certificates of deposit	148,314	27,395
Commercial paper and short-term securities	93	94
Corporate notes and bonds	1,525	24,997
Asset-backed and agency securities	75,550	85,692
U.S. Treasury notes and bonds	219,359	145,778
Equity securities	5,360	8,594
Marketable securities (1)	450,201	292,550
Total cash, cash equivalents, and marketable securities (2)	\$ 1,151,351	\$ 1,394,823

(1) At June 30, 2004, gross unrealized losses were not significant.

(2) Includes amounts held in foreign currencies of \$645 million and \$764 million, at June 30, 2004 and December 31, 2003. Amounts held in foreign currencies at June 30, 2004 were primarily Euros and British Pounds, and amounts held in foreign currencies at December 31, 2003 were primarily Euros, British Pounds, and Yen.

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

Note 3 — Long-Term Debt and Other

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

	June 30, 2004	December 31, 2003
	(in thousands)	
4.75% Convertible Subordinated Notes due February 2009 (1)(2)	\$ 899,760	\$ 1,049,760
6.875% PEACS due February 2010 (3)	841,317	869,711
Long-term restructuring liabilities (see Note 6)	14,261	20,066
Capital lease obligations	2,171	2,717
Other long-term debt	7,507	7,401
	1,765,016	1,949,655
Less current portion of capital lease obligations	(1,306)	(1,558)
Less current portion of other long-term debt	(1,096)	(2,658)
Total long-term debt and other	\$ 1,762,614	\$ 1,945,439

(1) During the twelve months ended June 30, 2004, we redeemed an aggregate principal amount of \$350 million of our outstanding 4.75% Convertible Subordinated Notes due February 2009 (“4.75% Convertible Subordinated Notes”). Included in this amount, on February 26, 2004, we redeemed an aggregate principal amount of \$150 million, and as provided in the underlying indenture, the redemption price of \$154 million

AMAZON.COM, INC.

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

included a \$4 million (2.375%) premium over the face amount of the redeemed notes. We recorded a charge in the first quarter of 2004, classified in "Remeasurements and other," of approximately \$6 million related to the redemption, consisting of the \$4 million premium and approximately \$2 million in unamortized deferred issuance charges. Accrued and unpaid interest of \$0.5 million, from February 1, 2004 through February 25, 2004, was also paid at redemption and recorded to "Interest expense."

- (2) The 4.75% Convertible Subordinated Notes are convertible into our common stock at the holders' option at a conversion price of \$78.0275 per share. Total common stock issuable upon conversion of our outstanding 4.75% Convertible Subordinated Notes is 11.5 million shares. We have the right to redeem the 4.75% Convertible Subordinated Notes, in whole or in part, by paying the principal and a premium of 2.375% of the principal, as of June 30, 2004, which decreases by 47.5 basis points on February 1 of each year until maturity, plus any accrued and unpaid interest.
- (3) The 6.875% Premium Adjustable Convertible Securities due February 2010 ("6.875% PEACS") are convertible into our common stock at the holders' option at a conversion price of 84.883 Euros per share (\$103.50, based on the exchange rate as of June 30, 2004). Total common stock issuable upon conversion of our outstanding 6.875% PEACS is 8.1 million shares. The U.S. Dollar equivalent principal, interest, and conversion price fluctuates based on the Euro/U.S. Dollar exchange ratio. We have the right to redeem the 6.875% PEACS, in whole or in part, by paying the principal, plus any accrued and unpaid interest. No premium payment is required for early redemption.

Note 4 — Commitments and Contingencies

Commitments

We lease office and fulfillment center facilities and fixed assets under non-cancelable operating and capital leases. Rental expense under operating lease agreements was \$13 million for both the three months ended June 30, 2004 and the three months ended June 30, 2003, and \$27 million and \$26 million for the six months ended June 30, 2004 and 2003.

The following summarizes our principal contractual commitments, excluding open orders for inventory purchases that support normal operations, as of June 30, 2004:

	Six Months Ending December 31, 2004	2005	2006	2007	2008	Thereafter	Total
				(in thousands)			
Operating and capital commitments:							
Debt principal and other (1)	\$ 464	\$ 190	\$ 235	\$ 328	\$ 345	\$ 1,756,689	\$ 1,758,251
Debt interest (1)	107,704	107,704	107,704	107,704	107,704	140,614	679,134
Capital leases	755	1,127	375	23	—	—	2,280
Operating leases	28,680	53,535	50,656	43,497	41,645	150,398	368,411
Total operating and capital commitments	137,603	162,556	158,970	151,552	149,694	2,047,701	2,808,076
Restructuring-related commitments:							
Operating leases, net of estimated sublease income	1,963	6,993	1,999	1,961	1,614	2,952	17,482
Other	113	1,201	—	—	—	—	1,314
Total restructuring-related commitments	2,076	8,194	1,999	1,961	1,614	2,952	18,796
Total commitments	\$ 139,679	\$ 170,750	\$ 160,969	\$ 153,513	\$ 151,308	\$ 2,050,653	\$ 2,826,872

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

- (1) The principal payment due in 2010 and the annual interest payments due under our 6.875% PEACS fluctuate based on the Euro/U.S. Dollar exchange ratio. At June 30, 2004, the Euro to U.S. Dollar exchange rate was 1.2193. Due to fluctuations in the Euro/U.S. Dollar exchange ratio, which we cannot predict, our principal debt obligation under this instrument since issuance in February 2000 has increased by \$161 million as of June 30, 2004.

See “Note 6 — Operating Expense (Income)” for additional information on restructuring-related lease obligations.

Pledged Securities

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

	Standby Letters of Credit (1)	Real Estate Leases (2)	Total
		(in thousands)	
Balance at December 31, 2003	\$ 60,799	\$ 25,936	\$ 86,735
Net change in collateral pledged	(3,819)	(2,900)	(6,719)
Balance at June 30, 2004	\$ 56,980	\$ 23,036	\$ 80,016

- (1) Pursuant to available standby letter-of-credit facilities totaling \$151 million.
- (2) At June 30, 2004, our market capitalization was \$22.1 billion. The required amount of collateral to be pledged increases \$5 million if our market capitalization is below \$18 billion and an additional \$6 million if our market capitalization is equal to or below \$13 billion.

Legal Proceedings

A number of purported class action complaints were filed by holders of our equity and debt securities against us, our directors, and certain of our senior officers during 2001, in the United States District Court for the Western District of Washington, alleging violations of the Securities Act of 1933 (the “1933 Act”) and/or the Securities Act of 1934 (“the 1934 Act”). On August 1, 2003, plaintiffs in the 1934 Act cases filed a second consolidated amended complaint alleging that we, together with certain of our officers and directors, made false or misleading statements during the period from October 29, 1998 through October 23, 2001 concerning our business, financial condition and results, inventories, future prospects, and strategic alliance transactions. The 1933 Act complaint alleges that the defendants made false or misleading statements in connection with our February 2000 offering of the 6.875% PEACS. The complaints seek 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 October 29, 2002, Gary Gerlinger, individually and on behalf of all other similarly situated consumers in the United States who, during the period from August 1, 2001 to the present, purchased books online from either Amazon.com or Borders.com, instituted an action against us and Borders in the United States District Court for

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

the Northern District of California. The complaint alleges that the agreement pursuant to which an affiliate of Amazon.com operates Borders.com as a co-branded site violates federal anti-trust laws, California statutory law, and the common law of unjust enrichment. The complaint seeks injunctive relief, damages, including treble damages or statutory damages where applicable, attorneys' fees, costs, and disbursements, disgorgement of all sums obtained by allegedly wrongful acts, interest, and declaratory relief. We dispute the allegations of wrongdoing in this complaint, and intend to vigorously defend ourselves in this matter.

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

On July 17, 2003, Pinpoint, Inc. filed a complaint for patent infringement in the United States District Court for the Northern District of Illinois against us and several other companies with which we have commercial agreements. The complaint alleges that our personalization technology infringes several patents obtained by Pinpoint and seeks injunctive relief, monetary damages in an amount no less than a reasonable royalty, prejudgment interest, and attorneys' fees against all defendants. We dispute the allegations of wrongdoing in this complaint and intend to vigorously defend ourselves in this matter.

On January 12, 2004, Soverain Software LLC filed a complaint against us for patent infringement in the United States District Court for the Eastern District of Texas. The complaint alleges that our website technology infringes several patents obtained by Soverain purporting to cover "Internet Server Access Control and Monitoring Systems" (U.S. Patent No. 5,708,780) and "Network Sales Systems" (U.S. Patent Nos. 5,715,314 and 5,909,492) and seeks injunctive relief, monetary damages in an amount no less than a reasonable royalty, treble damages for alleged willful infringement, prejudgment interest, and attorneys' fees. We dispute the allegations of wrongdoing in this complaint and intend to vigorously defend ourselves in this matter.

On January 22, 2004, IPXL Holdings, LLC brought an action against us for patent infringement in the United States District Court for the Eastern District of Virginia. The complaint alleges that aspects of our online ordering technology, including 1-Click® ordering, infringe a patent obtained by IPXL purporting to cover an "Electronic Fund Transfer or Transaction System" (U.S. Patent No. 6,149,055) and seeks injunctive relief, monetary damages in an amount no less than a reasonable royalty, prejudgment interest, and attorneys' fees. We dispute the allegations of wrongdoing in this complaint and intend to vigorously defend ourselves in this matter.

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

On May 21, 2004, Toysrus.com LLC filed a complaint against us for breach of contract in the Superior Court of New Jersey. The complaint alleges that we breached our commercial agreement with Toysrus.com LLC by selling, and by permitting other third parties to sell, products that Toysrus.com LLC alleges it has an exclusive right to sell on our website. The complaint seeks injunctive relief, declaratory judgment and either monetary

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

damages of an unspecified amount or rescission of the commercial agreement and return of specific amounts paid under the agreement totaling \$200 million. We dispute the allegations of wrongdoing in this complaint and have brought counterclaims alleging breach of contract and seeking damages and declaratory relief. We intend to vigorously defend ourselves in this matter.

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

Note 5 — Comprehensive Income (Loss)

Comprehensive income (loss) was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Net income (loss)	\$ 76,480	\$ (43,314)	\$ 187,616	\$ (53,435)
Foreign currency translation gains, net	1,605	11,616	3,443	13,363
Net unrealized losses on available-for-sale securities	(5,993)	(2,449)	(12,643)	(7,355)
Net activity of Euro Currency Swap	442	(1,114)	878	10,038
Other comprehensive income (loss)	(3,946)	8,053	(8,322)	16,046
Comprehensive income (loss)	\$ 72,534	\$ (35,261)	\$ 179,294	\$ (37,389)

Accumulated balances within other comprehensive income were as follows:

	June 30, 2004	December 31, 2003
	(in thousands)	
Net unrealized gains on foreign currency translation	\$ 33,893	\$ 30,450
Net unrealized gains on available-for-sale securities	7,684	20,327
Net unrealized losses on Euro Currency Swap	(12,160)	(13,038)
Total accumulated other comprehensive income	\$ 29,417	\$ 37,739

Due to the termination of our Euro Currency Swap in 2003, future reclassifications of cumulative losses on the Euro Currency Swap from “Accumulated other comprehensive income” to “Remeasurements and other” will be recorded using the effective interest method over the remaining life of the 6.875% PEACS.

Note 6 — Other Operating Expense (Income)

Included in “Other operating expense (income)” are restructuring-related expenses and amortization of other intangibles. Amortization of other intangibles was \$0.1 million and \$0.9 million for the three months ended June 30, 2004 and 2003, and \$0.3 million and \$1.8 million for the six months ended June 30, 2004 and 2003.

During the six months ended June 30, 2004, we determined that certain of the office space previously vacated as part of our 2001 restructuring, which we had been unable to sublease due to poor real estate market conditions, was necessary for our future needs. In accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, we have reduced our restructuring-related liability, resulting in a gain

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

of \$7 million for the three months ended June 30, 2004, and \$8 million for the six months ended June 30, 2004. Future lease payments for this office space will be expensed over the lease period and classified to the corresponding operating expense categories on the consolidated statements of operations. No restructuring-related amounts were recorded during the first half of 2003.

We plan to streamline our organizational structure in France and reduce our operating costs. These efforts are primarily focused on eliminating French-office positions in managerial, professional, clerical and technical roles. We anticipate the costs associated with these efforts will be approximately \$5 million; however, the reorganization is subject to regulatory review, which may impact the severance terms. We anticipate the number of employees affected and severance terms will be finalized in the third quarter of 2004 and corresponding costs will be recorded at that time and classified in "Other operating expense (income)" on the consolidated statements of operations.

At June 30, 2004, the accrued liability associated with restructuring-related and other charges was \$19 million and consisted of the following:

	Balance at December 31, 2003	Subsequent Accruals (Credits), net	Payments	Balance at June 30, 2004	Due Within 12 Months (1)	Due After 12 Months (1)
	(in thousands)					
Lease obligations, net of estimated sublease income	\$ 29,343	\$ (8,171)	\$ (3,690)	\$ 17,482	\$ 4,206	\$ 13,276
Broker commissions, professional fees and other miscellaneous restructuring costs	1,197	198	(81)	1,314	329	985
Total restructuring-related liability	\$ 30,540	\$ (7,973)	\$ (3,771)	\$ 18,796	\$ 4,535	\$ 14,261

- (1) Restructuring-related liabilities due within 12 months are classified in "Accrued expenses and other current liabilities" and liabilities due after 12 months are classified in "Long-term debt and other" on our consolidated balance sheets.

Restructuring-related lease obligations are as follows:

	Six Months Ended December 31, 2004	2005	2006	2007	2008	Thereafter	Total
	(in thousands)						
Gross lease obligations	\$ 3,399	\$ 10,197	\$ 6,155	\$ 6,158	\$ 5,319	\$ 11,742	\$ 42,970
Estimated sublease income (1)	(1,436)	(3,204)	(4,156)	(4,197)	(3,705)	(8,790)	(25,488)
Estimated net lease obligations	\$ 1,963	\$ 6,993	\$ 1,999	\$ 1,961	\$ 1,614	\$ 2,952	\$ 17,482

- (1) At June 30, 2004, we had signed contractual sublease agreements covering \$14 million in future payments.

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

Note 7 — Other Income (Expense), Net

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Gains (losses) on sales of marketable securities, net	\$ (77)	\$ 5,272	\$ 1,010	\$ 9,252
Foreign-currency transaction losses, net	(329)	(124)	(1,305)	(168)
Foreign, state, and other income taxes (1)	(5,115)	(1,765)	(3,394)	(2,698)
Other miscellaneous gains, net	169	302	854	158
Total other income (expense), net	\$ (5,352)	\$ 3,685	\$ (2,835)	\$ 6,544

- (1) We have provided for current and deferred foreign, state, and other income taxes for all periods presented. Current and deferred income taxes were provided with respect to jurisdictions where certain of our subsidiaries produce taxable income. Due primarily to the existence of net operating loss carryforwards, our effective tax rate is substantially less than the statutory rates in effect.

Note 8 — Remeasurements and Other

Remeasurements and other consisted of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Foreign-currency gains (losses) on remeasurement of 6.875% PEACS (1)	\$ 7,935	\$ (37,566)	\$ 28,394	\$ (62,780)
Currency-related gains on sales of Euro-denominated investments, net	2,279	2,262	5,369	5,827
Loss on redemption of long-term debt	—	(15,176)	(5,672)	(15,176)
Loss on termination of Euro Currency Swap (2)	—	(6,157)	—	(6,157)
Foreign-currency effect on intercompany balances (3)	(7,319)	—	(10,415)	—
Other-than-temporary impairments and other (4)	13,407	(3,579)	18,986	(4,164)
Total remeasurements and other	\$ 16,302	\$ (60,216)	\$ 36,662	\$ (82,450)

- (1) Each period the remeasurement of our 6.875% PEACS from Euros to U.S. Dollars results in gains or losses recorded to “Remeasurements and other” on our consolidated statements of operations.
- (2) During the second quarter of 2003, we terminated our Euro Currency Swap and, although neither party made cash payments to terminate, we recorded a loss of \$6 million to “Remeasurements and Other” representing the remaining basis in our swap asset.
- (3) Represents the loss associated with the remeasurement of intercompany balances due to changes in foreign exchange rates. See “Note 1 — Accounting Policies.”
- (4) The second quarter of 2004 includes a gain of \$14 million associated with the sale of one of our equity investments. The first quarter of 2004 includes a gain of \$6 million relating to the settlement of a contractual dispute. Also included is equity in losses of equity-method investees of less than \$1 million for the three months and six months ended June 30, 2003. There were no losses from equity method investees in the first half of 2004.

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

Note 9 — Segment Information

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

We measure operating results of our segments using an internal performance measure of direct segment operating expenses that excludes stock-based compensation, and other operating expense (income), each of which are not allocated to segment results. All other centrally-incurred operating costs are fully allocated to segment results. There are no internal revenue transactions between our reporting segments.

North America

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

International

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

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

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

Three Months Ended June 30, 2004:

	North America	International	Consolidated
		(in thousands)	
Net sales	\$ 792,132	\$ 595,209	\$ 1,387,341
Cost of sales	572,420	473,875	1,046,295
Gross profit	219,712	121,334	341,046
Direct segment operating expenses	153,791	86,439	240,230
Segment operating income	65,921	34,895	100,816
Stock-based compensation			21,692
Other operating income			(7,150)
Income from operations			86,274
Total non-operating expense, net			(9,794)
Net income			\$ 76,480

Three Months Ended June 30, 2003:

	North America	International	Consolidated
		(in thousands)	
Net sales	\$ 702,523	\$ 397,389	\$ 1,099,912
Cost of sales	512,466	313,518	825,984
Gross profit	190,057	83,871	273,928
Direct segment operating expenses	135,459	71,280	206,739
Segment operating income	54,598	12,591	67,189
Stock-based compensation			24,453
Other operating expense			913
Income from operations			41,823
Total non-operating expense, net			(85,137)
Net loss			\$ (43,314)

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

Six Months Ended June 30, 2004:

	North America	International	Consolidated
		(in thousands)	
Net sales	\$ 1,638,973	\$ 1,278,717	\$ 2,917,690
Cost of sales	1,193,386	1,022,424	2,215,810
Gross profit	445,587	256,293	701,880
Direct segment operating expenses	304,157	179,907	484,064
Segment operating income	141,430	76,386	217,816
Stock-based compensation			28,799
Other operating income			(7,692)
Income from operations			196,709
Total non-operating expense, net			(9,093)
Net income			\$ 187,616

Six Months Ended June 30, 2003:

	North America	International	Consolidated
		(in thousands)	
Net sales	\$ 1,407,235	\$ 776,236	\$ 2,183,471
Cost of sales	1,030,346	608,615	1,638,961
Gross profit	376,889	167,621	544,510
Direct segment operating expenses	270,630	139,231	409,861
Segment operating income	106,259	28,390	134,649
Stock-based compensation			51,776
Other operating expense			1,825
Income from operations			81,048
Total non-operating expense, net			(134,483)
Net loss			\$ (53,435)

[Table of Contents](#)

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

This section should be read in conjunction with "Forward-Looking Statements," "Additional Factors That May Affect Future Results," and Item 1 of Part I, "Financial Statements."

Overview

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

Our financial focus is on long-term, sustainable growth in free cash flow¹. We also seek to minimize shareholder dilution while maintaining the flexibility to issue shares for strategic purposes, such as financings and aligning employee interests with shareholders.

Free cash flow is driven primarily by increasing consolidated segment operating profit and efficiently managing working capital and capital expenditures. Increases in consolidated segment operating profit result from increases in sales through our websites and a focus on keeping costs low. To increase sales, we focus on improving all aspects of the customer experience, including lowering prices, improving availability, increasing selection, expanding product information, improving ease of use, and earning customer trust. Our price reductions take several forms: we reduce the sales prices of products we sell, we recruit third-party sellers to compete with us on product detail pages, and we reduce or eliminate the cost of shipping to the consumer.

We moved to restricted stock units as our primary vehicle for equity compensation in late 2002 because we believe they better align the interests of our shareholders and employees. Restricted stock units result in charges to our income statement based on the fair value of the awards recorded over the underlying service periods. Total shares outstanding plus outstanding stock awards are essentially unchanged as of June 30, 2004 compared to June 30, 2003.

We leverage our fixed customer experience costs and work to reduce our variable cost per unit. Our customer experience costs, specifically the costs necessary to build, enhance, and add features to our websites and build and optimize our fulfillment centers, are largely fixed. The customer experience costs that remain variable as a percentage of sales include product costs, credit-card processing fees, picking, packaging, and preparing orders for shipment, transportation, customer service support, and certain aspects of our marketing costs. To decrease our variable costs on a per unit basis and enable us to lower prices for customers, we obtain volume discounts from suppliers and focus on maintaining a lean culture, including by reducing defects in our processes.

Because we are able to turn our inventory quickly, we have a negative operating cycle that is a source of cash flow². On average, our high inventory velocity means we generally collect from our customers before our payments to suppliers come due. Inventory turnover³ was 18 and 20 for the three months ended June 30, 2004 and 2003. We expect some variability in inventory turnover over time since it is affected by several factors, including our product mix, our continuing focus on in-stock inventory availability, our future investment in new geographies and product lines, and the extent we choose to utilize outsource fulfillment providers. Accounts

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

² The operating cycle is number of days of sales in inventory plus number of days of sales in accounts receivable minus accounts payable days.

³ Inventory turnover is the quotient of annualized cost of sales to average inventory.

[Table of Contents](#)

payable days⁴ were 51 for the three months ended June 30, 2004 and 49 for the three months ended June 30, 2003. We expect some variability in accounts payable days over time since they are affected by several factors, including the mix of product sales, the mix of suppliers, and changes in payment terms over time, including the effect of negotiating better pricing from our suppliers in exchange for shorter payment terms.

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

We do not believe that our reported net income for the three months and six months ended June 30, 2004 should be viewed, on its own, as a material positive event or should be considered predictive of future results. The nature and volatility of the operating expenses "Remeasurements and other" and "Stock-based compensation" may create significant variation in operating results from period to period. For example, changes in currency exchange between the Euro and the U.S. Dollar creates potentially significant gains or losses on remeasurement of our 6.875% PEACS, which are inherently difficult to predict. Also, due to variable accounting treatment on certain of our stock-based awards, "Stock-based compensation" is affected by increases or decreases in the quoted price of our common stock.

In addition, as our financial reporting currency is the U.S. Dollar, our total revenue, profit, and operating and free cash flow has recently benefited significantly from weakness in the U.S. Dollar in comparison to the currencies of our international websites. While we believe that our increasing diversification beyond the U.S. economy through our fast growing international businesses benefits our shareholders, it is important to also evaluate our growth rates after the effect of currency changes. For example, our revenues increased 26% during the three months ended June 30, 2004 in comparison with the prior year, and holding currency exchange constant with the prior year our growth would have been 22%. In the future, this trend may reverse, and our consolidated U.S. Dollar revenue growth rates would be less than our local-currency growth rates.

For additional information about each line item summarized below, refer to Item 1 of Part I, "Financial Statements — Note 1 — Accounting Policies."

Critical Accounting Judgments

The preparation of financial statements in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require 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 Item 1 of Part I, "Financial Statements — Note 1 — Accounting Policies," of this Quarterly Report on Form 10-Q and Item 8 of Part II, "Financial Statements and Supplementary Data — Note 1 — Description of Business and Accounting Policies," of our Annual Report on Form 10-K for the year ended December 31, 2003. 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.

⁴ Accounts payable days, calculated as the quotient of accounts payable to cost of sales, multiplied by the number of days in the period.

Significant Accounting Policies

Revenue Recognition

We recognize revenue from product sales or services rendered when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. Additionally, revenue arrangements with multiple deliverables are divided into separate units of accounting if the deliverables in the arrangement meet the following criteria: (1) the delivered item has value to the customer on a standalone basis; (2) there is objective and reliable evidence of the fair value of undelivered items; and (3) delivery of any undelivered item is probable.

We evaluate the criteria of 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. 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 discounts, rebates, and return allowances, are recorded when the products are shipped and title passes to customers. Retail items sold to customers are made pursuant to a sales contract that provides for transfer of both title and risk of loss upon our delivery to the carrier. Return allowances, which reduce product revenue by our best estimate of expected product returns, are estimated using historical experience.

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

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

Inventories

Inventories, consisting of products available for sale, are accounted for using the FIFO method, and are valued at the lower of cost or market value. This valuation requires us to make judgments, based on currently-available information, about the likely method of disposition, such as through sales to individual customers, returns to product vendors, or liquidations, and expected recoverable values of each disposition category. Based on this evaluation, we record a valuation allowance to adjust the carrying amount of our inventories to lower of cost or market value. We provide fulfillment-related services in connection with certain of our Merchants@ and Merchant.com programs. In those arrangements, as well as other product sales by third parties, the third-party maintains ownership of the related products.

Currency Effect on Intercompany Balances

A provision of SFAS No. 52, *Foreign Currency Translation*, requires that gains and losses arising from intercompany foreign currency transactions considered long-term investments, where settlement is not planned or

[Table of Contents](#)

anticipated in the foreseeable future, be excluded in the determination of net income. Our international operations are financed, in part, by the U.S. parent company. Prior to the fourth quarter of 2003, currency adjustments for these intercompany balances were recorded to stockholders' deficit as translation adjustments and not included in the determination of net income because we intended to permanently invest such amounts. During the fourth quarter of 2003, we made the decision that these amounts would be repaid among the entities and, accordingly, upon consolidation, any exchange gain or loss arising from remeasurements of intercompany balances is required to be recorded in the determination of net income. In association with the remeasurement of intercompany balances, we recorded a loss of \$7 million for the three months ended June 30, 2004, and a loss of \$10 million for the six months ended June 30, 2004. No repayments among the entities relative to these balances were made during the three months ended June 30, 2004, although approximately \$135 million was repaid among the entities during the six months ended June 30, 2004.

Restructuring Estimates

Restructuring-related liabilities include estimates for, among other things, anticipated disposition of lease obligations. Key variables in determining such estimates include anticipated 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. Additionally, we may determine that certain of the office space previously vacated as part of our 2001 restructuring, which we have been unable to sublease due to poor real estate market conditions, may be necessary for our future needs. To the extent we elect to utilize this office space, in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, we will adjust our restructuring-related liability and classify future payments to the corresponding operating expense categories on the consolidated statements of operations. See Item 1 of Part I, "Financial Statements — Note 6 — Other Operating Expense (Income)."

Liquidity and Capital Resources

Our principal sources of liquidity are cash flows generated from operations and our cash, cash equivalents, and marketable securities, which were \$1.15 billion at June 30, 2004, and \$1.39 billion at December 31, 2003. Amounts held in foreign currencies were \$645 million and \$764 million, at June 30, 2004 and December 31, 2003. Amounts held in foreign currencies at June 30, 2004 were primarily Euros and British Pounds, and amounts held in foreign currencies at December 31, 2003 were primarily Euros, British Pounds, and Yen.

During the six months ended June 30, 2004, we paid \$154 million, which includes a redemption premium of \$4 million, to redeem a portion of our 4.75% Convertible Subordinated Notes. See Item 1 of Part I, "Financial Statements — Note 3 — Long-Term Debt and Other."

Our financial focus is on long-term, sustainable growth in free cash flow. Free cash flow was \$354 million for the twelve months ended June 30, 2004 compared to \$245 million for the twelve months ended June 30, 2003, an increase of 45%. Operating cash flows and free cash flows can be volatile and are sensitive to many factors, including changes in working capital. Working capital at any specific point in time is subject to many variables, including world events, seasonality, the timing of expense payments, discounts offered by vendors, vendor payment terms, and fluctuations in foreign exchange rates.

Cash provided by operating activities was \$143 million and \$126 million for the three months ended June 30, 2004 and 2003, and cash used in operating activities was \$108 million and \$126 million for the six months ended June 30, 2004 and 2003. Our operating cash flows result primarily from cash received from our customers and third-party sellers, offset by cash payments we make to suppliers of products and services, employee compensation, and interest payments on our long-term debt obligations. Cash received from customers and third-party sellers generally corresponds to our net sales. Because our customers primarily use credit cards to buy from us, our receivables from customers settle quickly. Cash paid to inventory and transportation suppliers generally corresponds with cost of sales, adjusted for increases or decreases in inventory and payable levels. During the three months ended June 30, 2004, payments to product merchandise suppliers, which does not include payments to transportation suppliers, totaled \$901 million, an increase of \$234 million over the same period in the prior

Table of Contents

year. The increase in payments to product merchandise suppliers corresponds with cost of sales, and our efforts to add product categories, increase selection and availability in both existing and new product categories, take advantage of additional discounts offered to us by suppliers, and is also affected by foreign exchange rates. Additionally, year-over-year comparisons of operating cash flows are affected by our second quarter 2003 sales of over 1.4 million units of *Harry Potter and the Order of the Phoenix*, for which we received customer payments on these sales before quarter end, but for which our required payments to suppliers were generally not due until after the second quarter 2003.

Cash provided by (used in) investing activities corresponds with purchases, sales, and maturities of marketable securities and purchases of fixed assets, including internal-use software and website development costs. Cash used in investing activities was \$222 million and \$167 million during the three and six months ended June 30, 2004. This compares to cash provided by investing activities of \$234 million and \$203 million during the three and six months ended June 30, 2003. Our capital expenditures, including internal-use software and website development, were \$14 million and \$24 million for the three and six months ended June 30, 2004, and \$7 million and \$14 million for the three and six months ended June 30, 2003. We expect capital expenditures to be \$80 million or less for 2004. We believe our expenditures for repairs and improvements are sufficient to keep our facilities and equipment in suitable operating condition.

Cash provided by financing activities was \$19 million during the three months ended June 30, 2004, and cash used in financing activities was \$121 million during the six months ended June 30, 2004. This compares to cash used in financing activities of \$228 million and \$193 million during the three and six months ended June 30, 2003. Cash inflows from financing activities primarily result from proceeds from exercises of employee stock options, which were \$20 million and \$35 million for the three and six months ended June 30, 2004, and \$53 million and \$92 million for the three and six months ended June 30, 2003. We expect cash proceeds from exercises of stock options to decline over time as we continue issuing restricted stock units as our primary vehicle for stock-based awards. Cash outflows from financing activities result from repayments of long-term debt and payments on capital lease obligations, which were \$0.6 million and \$156 million for the three and six months ended June 30, 2004, and \$281 million and \$284 million for the three and six months ended June 30, 2003.

Since our 6.875% PEACS, which are due in 2010, are denominated in Euros, our U.S. Dollar equivalent interest payments and principal obligations fluctuate with the Euro to U.S. Dollar exchange rate. We currently do not hedge our exposure to foreign currency effects on our interest or principal obligations relating to the 6.875% PEACS, and, as a result, any fluctuations in the exchange rate will have an effect on our interest expense and, to the extent we make principal payments, the amount of U.S. Dollar equivalents necessary for principal settlement.

The following summarizes our principal contractual commitments as of June 30, 2004:

	Six Months Ending December 31, 2004	2005	2006	2007	2008	Thereafter	Total
	(in thousands)						
Operating and capital commitments:							
Debt principal and other (1)	\$ 464	\$ 190	\$ 235	\$ 328	\$ 345	\$ 1,756,689	\$ 1,758,251
Debt interest (1)	107,704	107,704	107,704	107,704	107,704	140,614	679,134
Capital leases	755	1,127	375	23	—	—	2,280
Operating leases	28,680	53,535	50,656	43,497	41,645	150,398	368,411
Purchase obligations (2)	127,279	—	—	—	—	—	127,279
Total operating and capital commitments	264,882	162,556	158,970	151,552	149,694	2,047,701	2,935,355
Restructuring-related commitments:							
Operating leases, net of estimated sublease income (3)	1,963	6,993	1,999	1,961	1,614	2,952	17,482
Other	113	1,201	—	—	—	—	1,314
Total restructuring-related commitments	2,076	8,194	1,999	1,961	1,614	2,952	18,796
Total commitments	\$ 266,958	\$ 170,750	\$ 160,969	\$ 153,513	\$ 151,308	\$ 2,050,653	\$ 2,954,151

[Table of Contents](#)

- (1) The principal payment due in 2010 and the annual interest payments due under our 6.875% PEACS fluctuate based on the Euro/U.S. Dollar exchange ratio. At June 30, 2004, the Euro to U.S. Dollar exchange rate was 1.2193. Due to fluctuations in the Euro/U.S. Dollar exchange ratio, which we cannot predict, our principal debt obligation under this instrument since issuance in February 2000 has increased by \$161 million as of June 30, 2004.
- (2) Consists of legally-binding commitments to purchase inventory. Legally-binding commitments associated with non-inventory purchases are not significant.
- (3) Net of an estimated \$25 million in sublease rentals. At June 30, 2004, we had signed sublease agreements totaling \$14 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. However, any projections of future cash needs and cash flows are subject to substantial uncertainty. See “Additional Factors that May Affect Future Results.” We continually evaluate opportunities to sell additional equity or debt securities, obtain credit facilities from lenders, repurchase common stock, pay dividends, or repurchase, refinance, or otherwise restructure our long-term debt for strategic reasons or to further strengthen our financial position. The sale of additional equity or convertible debt securities would likely be dilutive to our shareholders. In addition, we will, from time to time, consider the acquisition of, or investment in, complementary businesses, products, services, and technologies, which might affect our liquidity requirements or cause us to issue additional equity or debt securities. We do not currently have a line-of-credit, and there can be no assurance that lines-of-credit or other financing instruments will be available in amounts or on terms acceptable to us, if at all.

Results of Operations

Segment Operating Income

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Segment Operating Income:				
North America	\$ 65,921	\$ 54,598	\$ 141,430	\$ 106,259
International	34,895	12,591	76,386	28,390
Consolidated	<u>\$ 100,816</u>	<u>\$ 67,189</u>	<u>\$ 217,816</u>	<u>\$ 134,649</u>
Operating Income Growth Rate:				
North America	21%	53%	33%	49%
International	177	N/A	169	N/A
Consolidated	50	158	62	166
Segment Operating Margin:				
North America	8%	8%	9%	8%
International	6	3	6	4
Consolidated	7	6	7	6

The key drivers in the year-over-year improvement in segment operating income are revenue growth and efficiencies in our fulfillment process, as well as a \$4 million improvement resulting from changes in foreign exchange rates. Revenue growth was driven, in part, by lowering prices, including increased adoption by our customers of our free shipping offers.

[Table of Contents](#)

Information about our segment operating expenses is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Segment Operating Expenses:				
North America	\$ 153,791	\$ 135,459	\$ 304,157	\$ 270,630
International	86,439	71,280	179,907	139,231
Consolidated	\$ 240,230	\$ 206,739	\$ 484,064	\$ 409,861
Percent of Net Sales:				
North America	19%	19%	19%	19%
International	15	18	14	18
Consolidated	17	19	17	19

Increases in segment operating expenses were primarily related to variable costs, including fulfillment-related costs for picking, packaging, and shipping our products to customers, credit card fees, and variable marketing programs, and to year over year increases in technology and content spending and legal costs. Year-over-year declines in our International and consolidated segment operating expenses as a percentage of net sales resulted primarily from leveraging the fixed cost portion of our operations over increased volume.

Net Sales and Gross Profit

Net sales information is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Net Sales:				
North America				
Media	\$ 541,807	\$ 499,051	\$ 1,140,489	\$ 1,016,310
Electronics and other general merchandise	225,805	177,439	450,238	345,584
Other	24,520	26,033	48,246	45,341
Total North America	792,132	702,523	1,638,973	1,407,235
International				
Media	495,526	366,034	1,071,586	721,746
Electronics and other general merchandise	98,947	31,089	205,948	53,952
Other	736	266	1,183	538
Total International	595,209	397,389	1,278,717	776,236
Consolidated				
Media	1,037,333	865,085	2,212,075	1,738,056
Electronics and other general merchandise	324,752	208,528	656,186	399,536
Other	25,256	26,299	49,429	45,879
Total consolidated	\$ 1,387,341	\$ 1,099,912	\$ 2,917,690	\$ 2,183,471

[Table of Contents](#)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net Sales Growth Rate:				
North America				
Media	9%	14%	12%	12%
Electronics and other general merchandise	27	36	30	34
Other	(6)	53	6	15
Total North America	13	20	16	17
International				
Media	35%	75%	48%	71%
Electronics and other general merchandise	218	221	282	156
Other	177	(49)	120	(47)
Total International	50	81	65	74
Consolidated				
Media	20%	33%	27%	30%
Electronics and other general merchandise	56	49	64	43
Other	(4)	50	8	14
Total Consolidated	26	37	34	32
Consolidated Net Sales Mix:				
Media	75%	79%	76%	80%
Electronics and other general merchandise	23	19	22	18
Other	2	2	2	2
Total Consolidated	100%	100%	100%	100%
North America	57%	64%	56%	64%
International	43	36	44	36
Consolidated	100%	100%	100%	100%

Revenue growth is due primarily to increased demand driven by increased selection, lower prices, including from our free shipping offers, and improved features and services available on our websites. In the second quarter of 2003, we sold over 1.4 million copies of *Harry Potter and the Order of the Phoenix*. Net sales shipped to customers outside of the U.S. represented approximately 48% and 49% of net sales for the three and six months ended June 30, 2004, compared to 42% and 41% of net sales for the three and six months ended June 30, 2003.

Gross profit information is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Gross Profit:				
North America	\$ 219,712	\$ 190,057	\$ 445,587	\$ 376,889
International	121,334	83,871	256,293	167,621
Consolidated	\$ 341,046	\$ 273,928	\$ 701,880	\$ 544,510
Gross Profit Growth Rate:				
North America	16%	12%	18%	10%
International	45	75	53	72
Consolidated	25	26	29	23
Gross Margin:				
North America	28%	27%	27%	27%
International	20	21	20	22
Consolidated	25	25	24	25

[Table of Contents](#)

The increases in gross profit in comparison with the prior year corresponds with increased revenue, offset by our year-round free shipping offers and lower prices for customers. Generally, our gross margins fluctuate based on several factors, including our product and geographic mix of sales during the year, sales volumes by third-party sellers, changes in vendor pricing and pricing to customers, including competitive pricing decisions, general efforts to reduce prices for our customers over time, and the extent to which our customers accept our free shipping offers. Free shipping offers reduce shipping revenue and reduce our gross margins on retail sales. We view our shipping offers as an effective marketing tool and intend to continue offering them.

North America segment gross margins increased slightly during the three months ended June 30, 2004 compared to the same period last year. The improvement in North America gross margin primarily results from increased sales volume by third-party sellers, offset by general efforts to reduce prices for our customers over time. Additionally, during the second quarter of 2003 we sold over 1.4 million copies of Harry Potter and the Order of the Phoenix at a discount of approximately 40% off list price. Including the effect of related shipping, these sales were fulfilled at roughly our overall cost, which had a negative effect on our gross margins for the three months ended June 30, 2003.

International segment gross margins declined slightly during the three months and six months ended June 30, 2004 compared to the same periods last year. This was primarily the result of changes in product mix, price reductions, and the lower threshold for our free shipping offer in the U.K., which was introduced in July 2003.

Sales of products by third-party sellers on our websites continue to increase. Since revenues from these sales are recorded as a net amount, they generally result in lower revenues but higher gross margins per unit. If product sales by third-party sellers continue to increase, we anticipate the higher gross margin attributes of these sales will partially offset the effect on our gross margins of our strategy to lower prices for customers over time by offering additional or broader price reductions, free shipping offers, and other promotions.

Supplemental information about shipping results is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Supplemental Information:				
Shipping Activity				
Shipping revenue	\$ 84,125	\$ 79,992	\$ 177,718	\$ 158,280
Outbound shipping costs	(118,600)	(106,209)	(255,195)	(211,778)
Net shipping cost	(34,475)	(26,217)	(77,477)	(53,498)

We believe that offering low prices to our customers is fundamental to our future success. One way we offer lower prices is through free-shipping alternatives that resulted in a net cost to us in delivering products. We seek to offset these costs over time through achieving higher sales volumes and better operating efficiencies and by negotiating better terms with our suppliers.

[Table of Contents](#)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
(in thousands, except per share amounts)				
Exchange-rate effect on (1):				
Net sales	\$ 46,758	\$ 54,870	\$ 134,110	\$ 105,645
Gross profit	9,761	11,907	26,852	23,243
Operating income	4,117	3,165	10,692	6,797
Net interest expense and other	(563)	(2,165)	(2,831)	(3,287)
Remeasurements and other (2)	2,895	(35,304)	23,348	(56,953)
Net income (loss)	6,449	(34,304)	31,209	(53,443)
Diluted earnings (loss) per share	\$ 0.02	\$ (0.09)	\$ 0.07	\$ (0.14)
Shares used in computation of diluted earnings (loss) per share	424,678	393,876	424,592	391,223

- (1) Represents the effect on reported results due to year-over-year changes in exchange rates. Absent year-over-year changes in exchange rates, reported amounts would have been lower (higher) by these amounts.
- (2) Includes foreign-currency gains (losses) on remeasurement of 6.875% PEACS and intercompany balances, and realized currency-related gains associated with sales of Euro-denominated investments held by a U.S. functional-currency subsidiary. See Item I of Part I, "Financial Statements — Note 8 — Remeasurements and Other."

Direct Segment Operating Expenses

Selected operating expense information is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
(in thousands)				
Fulfillment (1)	\$ 122,717	\$ 107,455	\$ 250,422	\$ 211,160
Percent of net sales	9%	10%	9%	10%
Year-over-year percentage change	14	25	19	20
Marketing (2)	\$ 31,839	\$ 25,326	\$ 65,475	\$ 53,553
Percent of net sales	2%	2%	2%	2%
Year-over-year percentage change	26	(12)	22	(12)
Technology and content (3)	\$ 58,475	\$ 52,135	\$ 113,551	\$ 102,223
Percent of net sales	4%	5%	4%	5%
Year-over-year percentage change	12	(10)	11	(10)
General and administrative (4)	\$ 27,199	\$ 21,823	\$ 54,616	\$ 42,925
Percent of net sales	2%	2%	2%	2%
Year-over-year percentage change	25	12	27	6

- (1) The increase in fulfillment costs in comparison with the prior year primarily relates to variable costs corresponding with sales volume and our mix of product sales. The mix of product sales affects fulfillment costs per shipment based on variations in shape and weight of products we sell. The improvement in fulfillment costs as a percentage of net sales results from improvements in productivity and accuracy, the increase in units fulfilled, which leverages the fixed-cost portion of our fulfillment network, efficiencies gained through utilization of fulfillment services provided by third parties, a decline in customer service contacts per unit resulting from improvements in our operations, and enhancements to our customer self-service features. Credit card fees associated with third-party seller transactions are based on the gross purchase price of underlying transactions, and therefore represent a larger percentage of our recorded commission revenue than credit card fees on our retail sales. Accordingly, this negatively affects fulfillment

Table of Contents

costs as a percentage of net sales. Additionally, we announced the opening of a new European fulfillment center in Scotland, which is scheduled to begin operations in the second half of 2004. The center is approximately 300,000 square feet and will employ approximately 300 associates over the first 18 months of operations.

- (2) We direct customers to our websites primarily through a number of online marketing channels, including our Syndicated Stores and Associates programs, which enable associated websites to make our products available to their audiences with fulfillment performed by us. Under these arrangements, we pay a sales commission on product sales, which is classified as "Marketing" on our consolidated statements of operations. The increase in absolute dollars spent reflects an increased investment in marketing channels considered most effective in driving incremental net sales, such as targeted online advertising through various web portals and our Associates program. We expect the absolute dollars spent in marketing to increase over time.
- (3) Our spending in technology and content has increased as we are adding computer scientists and software engineers to continue to improve our process efficiency and enhance the customer experience on our websites. We expect absolute dollars spent in technology and content to increase over time as we continue to add computer scientists and software engineers to our staff.
- (4) The increase in spending in general and administrative is primarily due to increases in legal fees. We expect absolute dollars spent in general and administrative to increase over time.

Stock-Based Compensation

Stock-based compensation was \$22 million and \$24 million for the three months ended June 30, 2004 and 2003, and \$29 million and \$52 million for the six months ended June 30, 2004 and 2003. In late 2002, we began issuing restricted stock units as our primary form of stock-based compensation. Previously, we primarily issued at-the-money stock options. In certain of our foreign jurisdictions, we continue to grant stock options. Certain of our stock awards are subject to variable accounting treatment, resulting in expense or contra-expense recognition each period, using the cumulative expense method.

At June 30, 2004, we had 28 million stock awards outstanding, including 21 million stock options that had a \$12.82 weighted average exercise price; 6 million restricted stock units; and 0.5 million shares of restricted stock. Common shares outstanding (which include restricted stock), plus shares underlying stock options and restricted stock units, totaled 434 million and 433 million at June 30, 2004 and 2003. For additional information about our stock-based compensation and awards, see Item 1 of Part I, "Financial Statements — Note 1 — Accounting Policies."

Other Operating Expense (Income)

Included in "Other operating expense (income)" are restructuring-related expenses or credits and amortization of other intangibles. Amortization of other intangibles was \$0.1 million and \$0.9 million for the three months ended June 30, 2004 and 2003, and \$0.3 million and \$1.8 million for the six months ended June 30, 2004 and 2003.

During the six months ended June 30, 2004, we determined that certain of the office space previously vacated as part of our 2001 restructuring, which we had been unable to sublease due to poor real estate market conditions, was necessary for our future needs. In accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, we have reduced our restructuring-related liability, resulting in a gain of \$7 million for the three months ended June 30, 2004, and \$8 million for the six months ended June 30, 2004. Future lease-related payments for this office space, which is approximately \$0.6 million per quarter, will be expensed over the lease period and classified to the corresponding operating expense categories on the consolidated statements of operations. No restructuring-related amounts were recorded during the first half of 2003.

[Table of Contents](#)

We plan to streamline our organizational structure in France and reduce our operating costs. These efforts are primarily focused on eliminating French-office positions in managerial, professional, clerical and technical roles. We anticipate the costs associated with these efforts will be approximately \$5 million; however, the reorganization is subject to regulatory review, which may impact the severance terms. We anticipate the number of employees affected and severance terms will be finalized in the third quarter of 2004 and corresponding costs will be recorded at that time and classified in “Other operating expense (income)” on the consolidated statements of operations.

Cash payments resulting from our January 2001 operational restructuring were \$1 million and \$4 million for the three months ended June 30, 2004 and 2003, and \$4 million and \$20 million for the six months ended June 30, 2004 and 2003. Based on currently available information, we estimate the remaining restructuring-related cash outflows will be as follows:

	Leases	Other	Total
		(in thousands)	
Six months ending December 31, 2004	\$ 1,963	\$ 113	\$ 2,076
Years ended:			
2005	6,993	1,201	8,194
2006	1,999	—	1,999
2007	1,961	—	1,961
2008	1,614	—	1,614
Thereafter	2,952	—	2,952
Total estimated cash outflows (1)	\$ 17,482	\$ 1,314	\$ 18,796

(1) Cash flows are presented net of an estimated \$25 million in sublease rentals. At June 30, 2004, we had signed sublease agreements totaling \$14 million.

For additional information about our January 2001 operational restructuring, see Item 1 of Part I, “Financial Statements — Note 6 — Other Operating Expense (Income).”

Income from Operations

Our income from operations was \$86 million and \$42 million for the three months ended June 30, 2004 and 2003, and \$197 million and \$81 million for the six months ended June 30, 2004 and 2003. The improvement in operating results in comparison with the prior year was attributable to increasing revenues, leveraging our direct cost structure relative to sales growth, and year-over-year reductions of \$6 million and \$29 million in stock-based compensation expense associated with variable accounting treatment.

Net Interest Expense

We generally invest our excess cash in A-rated or higher short-to-intermediate-term fixed income securities and money market mutual funds. Our interest income corresponds with the average balance of invested funds and the prevailing rates we are earning on them. The primary components of our interest expense relate to our debt instruments. The decline in interest expense compared to the same periods a year ago resulted from principal redemptions of long-term debt. At June 30, 2004 our total long-term indebtedness was \$1.76 billion compared to \$2.07 billion a year ago. See Item 1 of Part I, “Financial Statements — Note 3 — Long-Term Debt and Other.”

[Table of Contents](#)

Other Income (Expense), Net

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Gains (losses) on sales of marketable securities, net	\$ (77)	\$ 5,272	\$ 1,010	\$ 9,252
Foreign-currency transaction losses, net	(329)	(124)	(1,305)	(168)
Foreign, state, and other income taxes	(5,115)	(1,765)	(3,394)	(2,698)
Other miscellaneous gains, net	169	302	854	158
Total other income (expense), net	\$ (5,352)	\$ 3,685	\$ (2,835)	\$ 6,544

Remeasurements and Other

Remeasurements and other consisted of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(in thousands)			
Foreign-currency gains (losses) on remeasurement of 6.875% PEACS (1)	\$ 7,935	\$ (37,566)	\$ 28,394	\$ (62,780)
Currency-related gains on sales of Euro-denominated investments, net	2,279	2,262	5,369	5,827
Loss on redemption of long-term debt	—	(15,176)	(5,672)	(15,176)
Loss on termination of Euro Currency Swap (2)	—	(6,157)	—	(6,157)
Foreign-currency effect on intercompany balances (3)	(7,319)	—	(10,415)	—
Other-than-temporary impairments and other (4)	13,407	(3,579)	18,986	(4,164)
Total remeasurements and other	\$ 16,302	\$ (60,216)	\$ 36,662	\$ (82,450)

- (1) Each period the remeasurement of our 6.875% PEACS from Euros to U.S. Dollars results in gains or losses recorded to "Remeasurements and other" on our consolidated statements of operations.
- (2) During the second quarter of 2003, we terminated our Euro Currency Swap and, although neither party made cash payments to terminate, we recorded a non-cash loss of \$6 million to "Remeasurements and Other" representing the remaining basis in our swap asset.
- (3) Represents the loss associated with the remeasurement of intercompany balances due to changes in foreign exchange rates. See "Note 1 — Accounting Policies."
- (4) The second quarter of 2004 includes a gain of \$14 million associated with the sale of one of our equity investments. The first quarter of 2004 includes a gain of \$6 million relating to the settlement of a contractual dispute. Also included is equity in losses of equity-method investees of less than \$1 million for the three months and six months ended June 30, 2003. There were no losses from equity method investees in the first half of 2004.

Income Taxes

We have provided for current and deferred U.S. federal, state, and foreign income taxes for all periods presented. Current and deferred income taxes were provided with respect to jurisdictions where certain of our subsidiaries produce taxable income. As of June 30, 2004, we have recorded a net deferred tax asset of \$5 million, classified in "Other assets," which consists of certain state jurisdiction net operating loss carryforwards. We have provided a valuation allowance for the remainder of our deferred tax asset, consisting primarily of net operating loss carryforwards, because of uncertainty regarding its realization.

[Table of Contents](#)

At June 30, 2004, we had net operating loss carryforwards of approximately \$2.8 billion primarily related to U.S. federal taxes. Utilization of net operating loss carryforwards, which begin to expire at various times starting in 2010, may be subject to certain limitations under Sections 382 and 1502 of the Internal Revenue Code of 1986 and other limitations under state and foreign tax laws. Approximately \$1.8 billion of our net operating loss carryforwards relate to tax deductible stock-based compensation in excess of amounts recognized for financial reporting purposes. To the extent that net operating loss carryforwards, if realized, relate to stock-based compensation recorded for tax purposes but not financial reporting purposes, the resulting tax benefits will be recorded to stockholders' equity, rather than to results of operations.

We also have approximately \$227 million of capital loss carryforwards that begin to expire in 2005.

Net Income (Loss)

Although we reported net income for the three months and six months ended June 30, 2004, we believe that this positive net income result should not be viewed, on its own, as a material positive event and is not necessarily predictive of future results for a variety of reasons. For example, we are unable to forecast the effect on our future reported results of certain items, including the effect that fluctuations in foreign currency rates will have on the remeasurement of our 6.875% PEACS and intercompany investments. The remeasurement of our 6.875% PEACS resulted in significant gains and charges in past periods and may result in significant charges or gains in future periods. Additionally, we are unable to forecast the effect of stock-based compensation, which is based in part by the quoted price of our common stock in accordance with variable accounting treatment. Variable accounting has resulted in significant expense and contra-expense in past periods and will continue to be unpredictable going forward.

Non-GAAP Financial Measures

Regulation G, "Conditions for Use of Non-GAAP Financial Measures," and other provisions of the 1934 Act define and prescribe the conditions for use of certain non-GAAP financial information. We believe that certain of our financial measures which meet the definition of a non-GAAP financial measure are important supplemental information to investors. We provide: "consolidated segment operating income," "pro forma net income," "pro forma net earnings per share," and "free cash flow."

We use these non-GAAP financial measures for internal managerial purposes, when publicly providing guidance on possible future results, and as a means to evaluate period-to-period comparisons. These non-GAAP financial measures are used in addition to and in conjunction with results presented in accordance with GAAP. These non-GAAP financial measures should not be relied upon to the exclusion of GAAP financial measures. These non-GAAP financial measures reflect an additional way of viewing aspects of our operations that, when viewed with our GAAP results and the accompanying reconciliations to corresponding GAAP financial measures, provide a more complete understanding of factors and trends affecting our business. Management strongly encourages investors to review our financial statements and publicly-filed reports in their entirety and to not rely on any single financial measure.

Because non-GAAP financial measures are not standardized, it may not be possible to compare these financial measures with other companies' non-GAAP financial measures having the same or similar names. For example, certain companies disclose a financial measure of earnings before certain charges such as interest, taxes, depreciation, and amortization, commonly referred to as EBITDA. We considered the use of EBITDA as a supplemental performance measure to GAAP, but believe consolidated segment operating income and pro forma net income are superior for our Company as certain periodic costs associated with our invested capital, such as fixed asset depreciation expense and amortization of software development costs, and certain costs associated with our capital structure, such as interest expense, are relevant and important factors affecting our management decisions. For information about our financial results as reported in accordance with GAAP, see Item 1 of Part I, "Financial Statements." For a quantitative reconciliation of our non-GAAP financial measures to the most comparable GAAP financial measures, see "Reconciliation Tables" below.

Consolidated Segment Operating Income

We measure operating results of our segments using an internal performance measure of direct segment operating expenses that excludes:

- Stock-based compensation; and
- Other operating expense (income)

These operating expense line items are not allocated to segment results, and all other centrally-incurred operating costs are fully allocated to segment results. The sum of our individual segment results is consolidated segment operating income, which we reconcile to GAAP operating income. Pursuant to SEC staff interpretations of Regulation G, when presented in our financial statement footnotes, consolidated segment operating income is a GAAP financial measure; however, since we also present this financial measure outside the context of our financial statement footnotes, we have included this financial measure in our discussion of non-GAAP financial measures.

We use consolidated segment operating income, and ratios based on it, to manage and evaluate our business operations and overall financial performance. Our management evaluates consolidated segment income because it excludes certain cash and non-cash items that are either beyond our immediate control or that we believe are not characteristic of our underlying business operations for the period in which they are recorded, or both.

Items Excluded From Consolidated Segment Operating Income

Stock-Based Compensation

We exclude stock-based compensation for the following reasons:

- Stock-based compensation expense is excluded from our internal operating plans and measurement of financial performance, although we consider the dilutive impact to our investors when awarding stock-based compensation and value such awards accordingly;
- Stock-based compensation expense or contra-expense are non-cash; and
- The measurement of stock-based compensation is determined under a variety of methods depending on the underlying award. These methods include: (a) fixed accounting on certain stock options granted at market prices, resulting in no compensation expense, (b) variable accounting on certain stock options and restricted stock units, resulting in unpredictable charges or gains beyond our control, and (c) fixed accounting for certain restricted stock units and restricted stock awards, resulting in the estimated fair value of the award recognized over the service period.

We record the employer portion of payroll tax expense, a cash expense, resulting from exercises of stock-based awards in “Fulfillment,” “Marketing,” “Technology and content,” and “General and administrative” on our consolidated statements of operations and do not include such expenses in “Stock-based compensation.”

Other Operating Expense (Income)

We exclude other operating expense (income), including amortization of other intangibles and restructuring-related and other, which are cash and non-cash items for the following reasons:

- Amortization of other intangibles is excluded from our internal operating plans and measurement of financial performance;
- Amortization of other intangibles is a non-cash charge to current operations;
- Amortization of other intangibles has diminished, is currently immaterial, and is scheduled to fully amortize by the end of 2004; and
- Since we have not regularly had restructuring-related charges, the exclusion of such charges from prior periods provides better comparability of our results of operations as viewed by management.

[Table of Contents](#)

Impairment of Goodwill

If, in the future, we incur impairment losses on our goodwill, such charges would be excluded from consolidated segment operating income since they would be non-cash, and not in the immediate control of management. We have elected to perform our annual analysis during the fourth quarter of each year. No indicators of impairment were identified during the first half of 2004.

Limitations of Consolidated Segment Operating Income

Consolidated segment operating income has certain limitations. First, because it excludes “Stock-based compensation,” the financial measure does not include all expenses primarily related to our workforce. We compensate for this limitation by providing supplemental information about stock-based compensation on the face of our consolidated statements of operations and in the footnotes to our financial statements. We also provide supplemental information about outstanding stock-based awards, including their dilutive effect on shareholders, in the footnotes to our financial statements. See Item 1 of Part I “Financial Statements — Note 1 — Description of Business and Accounting Policies” for presentation of our stock-based compensation expense calculated on a consistent basis for all awards using the fair value method as prescribed under SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*, as well as total outstanding stock-based awards and related activity.

Second, consolidated segment operating income excludes “Other Operating Expense (Income).” For companies that periodically undergo restructuring events, excluding restructuring-related costs from performance measures could provide an incomplete summary of ongoing costs that would affect future cash flows. However, we compensate for this limitation by disclosing cash flow measures, including operating cash flow, that incorporate all ongoing cash obligations associated with our January 2001 restructuring event and by providing disclosure of future estimated cash flows and remaining commitments associated with this event. See Item 1 of Part I, “Financial Statements — Note 6 — Other Operating Expense (Income).” Since we have initiated in the second quarter of 2004 a restructuring event in Europe, we have re-evaluated our decision to exclude such charges from our consolidated segment operating income. We have determined that it continues to be appropriate since it has been over two years since our last restructuring event, and we do not anticipate another restructuring event in the next two years. There can, however, be no assurance that we will not undertake another restructuring event in the future that would affect future cash flows.

Pro Forma Net Income

Pro forma net income, including the related pro forma net earnings per share, which we reconcile to net income (loss) and net earnings (loss) per share, excludes, in addition to the line items described above as excluded from consolidated segment operating income, the following line items on our consolidated statements of operations:

- Remeasurements and other; and
- Cumulative effect of change in accounting principle.

We use pro forma net income, and ratios based on it, to manage and evaluate our business operations and overall financial performance. We use this financial measure as it excludes certain cash and non-cash items that are either beyond our immediate control or are not characteristic of our underlying business operations for the period in which they are recorded, or both.

Items Excluded From Pro Forma Net Income

See “Consolidated Segment Operating Income — Items Excluded from Consolidated Segment Operating Income” for an explanation of “Stock-based compensation,” “Other operating expense (income),” and “Impairment of goodwill.”

Remeasurements and Other

A portion of “Remeasurements and other” consists of gains or charges due to our quarterly remeasurement of the principal of our 6.875% PEACS from Euros to U.S. Dollars. We exclude the effect of these periodic

[Table of Contents](#)

remeasurements from our pro forma net income because the ultimate cash effect resulting from changes in exchange rates is inherently uncertain. These gains or charges would only affect near-term cash flows if we redeem or, in certain cases, restructure, our 6.875% PEACS in the next several years, rather than over a longer term or at maturity in 2010. Because these charges and gains vary based on exchange rates between the U.S. Dollar and Euro, these amounts are beyond our immediate control and are difficult to predict for future periods.

Additionally, we exclude gains or charges associated with remeasurements of foreign-currency denominated intercompany balances. We exclude these amounts because they are beyond our immediate control and are difficult to predict for future periods.

We exclude equity in losses of equity-method investees, net, which are included in "Remeasurements and other," because it generates potential non-cash gains or losses, based on the financial results of other companies that we do not manage or control and are difficult to predict. In addition, we believe these non-cash gains and losses are not indicative of our financial or operating performance. In recent quarters, these amounts represented insignificant charges and, absent future investments, we expect this trend to continue.

To the extent we incur gains or losses on the repurchase, redemption, or retirements of our debt instruments, such amounts will be recorded to "Remeasurements and other."

Cumulative Effect of Change in Accounting Principle

We exclude cumulative effect of change in accounting principle because it generates non-cash charges, which we believe are not indicative of our financial or operating performance.

Limitations of Pro Forma Net Income

Pro forma net income has the same limitations as consolidated segment operating income. See "Consolidated Segment Operating Income — Limitations of Consolidated Segment Operating Income" above. In addition, when the 6.875% PEACS are retired, whether by early redemption or restructuring, or at maturity in 2010, the foreign currency effect of changes in the exchange ratio between the U.S. Dollar and the Euro will result in a cash effect. We compensate for this limitation by disclosing the effect of currency movements on our 6.875% PEACS on our consolidated statements of operations and presenting the fair value of our 6.875% PEACS in the notes to our financial statements. See Item 1 of Part I, "Financial Statements — Note 3 — Long-Term Debt and Other."

During the three and six months ended June 30, 2004, our reported net income was greater than our pro forma net income.

Free Cash Flow

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

Limitations of Free Cash Flow

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

[Table of Contents](#)
Reconciliation Table

The following is a reconciliation of our non-GAAP financial measures to the most comparable GAAP measures for the three months ended June 30, 2004 and 2003 (in thousands, except per share data).

	Three Months Ended June 30, 2004			Three Months Ended June 30, 2003		
	As Reported (1)	Adjustments	Pro Forma	As Reported (1)	Adjustments	Pro Forma
Net sales	\$ 1,387,341	\$ —	\$ 1,387,341	\$ 1,099,912	\$ —	\$ 1,099,912
Cost of sales	1,046,295	—	1,046,295	825,984	—	825,984
Gross profit	341,046	—	341,046	273,928	—	273,928
Operating expenses:						
Fulfillment	122,717	—	122,717	107,455	—	107,455
Marketing	31,839	—	31,839	25,326	—	25,326
Technology and content	58,475	—	58,475	52,135	—	52,135
General and administrative	27,199	—	27,199	21,823	—	21,823
Stock-based compensation	21,692	(21,692)	—	24,453	(24,453)	—
Other operating expense (income)	(7,150)	7,150	—	913	(913)	—
Total operating expenses	254,772	(14,542)	240,230	232,105	(25,366)	206,739
Income from operations	86,274	14,542	100,816(2)	41,823	25,366	67,189(2)
Interest income	5,311	—	5,311	5,761	—	5,761
Interest expense	(26,055)	—	(26,055)	(34,367)	—	(34,367)
Other income (expense), net	(5,352)	—	(5,352)	3,685	—	3,685
Remeasurements and other	16,302	(16,302)	—	(60,216)	60,216	—
Total non-operating expense, net	(9,794)	(16,302)	(26,096)	(85,137)	60,216	(24,921)
Net income (loss)	\$ 76,480	\$ (1,760)	\$ 74,720	\$ (43,314)	\$ 85,582	\$ 42,268
Basic earnings (loss) per share	\$ 0.19	\$ (0.01)	\$ 0.18	\$ (0.11)	\$ 0.22	\$ 0.11
Diluted earnings (loss) per share	\$ 0.18	\$ —	\$ 0.18	\$ (0.11)	\$ 0.21	\$ 0.10
Weighted average shares used in computation of earnings (loss) per share:						
Basic	405,268		405,268	393,876		393,876
Diluted	424,678		424,678	393,876		418,138
Net cash provided by operating activities			\$ 143,036			\$ 126,024
Purchases of fixed assets, including internal-use software and website development			(14,143)			(7,141)
Free cash flow			\$ 128,893			\$ 118,883
Net cash provided by (used in) investing activities			\$ (222,289)			\$ 233,668
Net cash provided by (used in) financing activities			\$ 19,432			\$ (227,876)

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

(2) Consolidated segment operating income.

[Table of Contents](#)

The following is a reconciliation of our non-GAAP financial measures to the most comparable GAAP measures for the six months ended June 30, 2004 and 2003 (in thousands, except per share data).

	Six Months Ended June 30, 2004			Six Months Ended June 30, 2003		
	As Reported (1)	Adjustments	Pro Forma	As Reported (1)	Adjustments	Pro Forma
Net sales	\$ 2,917,690	\$ —	\$ 2,917,690	\$ 2,183,471	\$ —	\$ 2,183,471
Cost of sales	2,215,810	—	2,215,810	1,638,961	—	1,638,961
Gross profit	701,880	—	701,880	544,510	—	544,510
Operating expenses:						
Fulfillment	250,422	—	250,422	211,160	—	211,160
Marketing	65,475	—	65,475	53,553	—	53,553
Technology and content	113,551	—	113,551	102,223	—	102,223
General and administrative	54,616	—	54,616	42,925	—	42,925
Stock-based compensation	28,799	(28,799)	—	51,776	(51,776)	—
Other operating expense (income)	(7,692)	7,692	—	1,825	(1,825)	—
Total operating expenses	505,171	(21,107)	484,064	463,462	(53,601)	409,861
Income from operations	196,709	21,107	217,816(2)	81,048	53,601	134,649(2)
Interest income	10,866	—	10,866	12,301	—	12,301
Interest expense	(53,786)	—	(53,786)	(70,878)	—	(70,878)
Other income (expense), net	(2,835)	—	(2,835)	6,544	—	6,544
Remeasurements and other	36,662	(36,662)	—	(82,450)	82,450	—
Total non-operating expense, net	(9,093)	(36,662)	(45,755)	(134,483)	82,450	(52,033)
Net income (loss)	\$ 187,616	\$ (15,555)	\$ 172,061	\$ (53,435)	\$ 136,051	\$ 82,616
Basic earnings (loss) per share	\$ 0.46	\$ (0.03)	\$ 0.43	\$ (0.14)	\$ 0.35	\$ 0.21
Diluted earnings (loss) per share	\$ 0.44	\$ (0.03)	\$ 0.41	\$ (0.14)	\$ 0.34	\$ 0.20
Weighted average shares used in computation of earnings (loss) per share:						
Basic	404,399		404,399	391,223		391,223
Diluted	424,592		424,592	391,223		414,965
Net cash used in operating activities			\$ (107,652)			\$ (125,758)
Purchases of fixed assets, including internal-use software and website development			(23,656)			(13,535)
Free cash flow			\$ (131,308)			\$ (139,293)
Net cash provided by (used in) investing activities			\$ (166,713)			\$ 203,174
Net cash used in financing activities			\$ (121,401)			\$ (192,542)

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

(2) Consolidated segment operating income.

[Table of Contents](#)

The following is a reconciliation of our non-GAAP financial measure of free cash flow to the most comparable GAAP measure for the twelve months ended June 30, 2004 and 2003 (in thousands):

	Twelve Months Ended	
	June 30, 2004	June 30, 2003
Net cash provided by operating activities	\$ 410,128	\$ 284,929
Purchases of fixed assets, including internal-use software and website development	(56,084)	(40,404)
Free cash flow	\$ 354,044	\$ 244,525
Net cash provided by (used in) investing activities	\$ (133,236)	\$ 177,977
Net cash used in financing activities	\$ (260,845)	\$ (127,928)

Guidance

Consistent with our July 22, 2004 earnings release furnished on Form 8-K and as of the date of this filing, our third quarter 2004 and full year 2004 guidance is as follows:

Third Quarter 2004 Guidance

- Third quarter net sales are expected to be between \$1.425 billion and \$1.525 billion, or grow between 26% and 34%, compared with third quarter 2003.
- Consolidated segment operating income is expected to be between \$80 million and \$100 million, or grow between 9% and 36%, compared with third quarter 2003.
- Operating income is expected to be between \$50 million and \$70 million, assuming, among other things, that the Company does not record any further revisions to its restructuring-related estimates and that the closing price of Amazon.com common stock on September 30, 2004, is identical to the closing price of \$54.40 on June 30, 2004.

Full Year 2004 Expectations

- Net sales are expected to be between \$6.625 billion and \$6.925 billion.
- Consolidated segment operating income is expected to be between \$475 million and \$535 million.
- Operating income is expected to be between \$400 million and \$460 million, assuming, among other things, that the Company does not record any further revisions to its restructuring-related estimates and that the closing price of Amazon.com common stock on December 31, 2004, is identical to the closing price of \$54.40 on June 30, 2004.

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

Additional Factors That May Affect Future Results

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

We Have an Accumulated Deficit and May Incur Additional Losses

We have incurred significant net losses since we began doing business. As of June 30, 2004, we had an accumulated deficit of \$2.79 billion and our stockholders’ deficit was \$791 million. We have incurred substantial

[Table of Contents](#)

operating losses since our inception, and although we earned net income in the three and six months ended June 30, 2004, we may incur losses again in the future.

We Have Significant Indebtedness

As of June 30, 2004, we had long-term indebtedness of \$1.76 billion. We make annual or semi-annual interest payments on the indebtedness under our two convertible notes, which are due in 2009 and 2010. Although we made debt principal reduction payments in the three months ended March 31, 2004, we may incur substantial additional debt in the future. Our indebtedness could limit our ability to obtain additional financing for working capital, capital expenditures, debt service requirements, or other purposes in the future, as needed; to plan for, or react to, changes in technology and in our business and competition; and to react in the event of an economic downturn.

There is no guarantee that we will be able to meet our debt service obligations. If we are unable to generate sufficient cash flow or obtain funds for required payments, or if we fail to comply with covenants in our indebtedness, we will be in default.

See Item 1 of Part I, “Financial Statements — Note 3 — Long-Term Debt and Other.”

We Face Intense Competition

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

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

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

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

We may enter into commercial agreements, strategic alliances, and other business relationships with other companies. We have entered into agreements to provide e-commerce services to other businesses and we plan to enter into similar agreements in the future, including as part of our Merchants@, Syndicated Stores, and Merchant.com initiatives. Under such agreements, we may perform services such as: providing our technology services such as search, browse, and personalization; permitting other businesses and individuals to offer products or services through our websites; and powering third-party websites, either with or without providing accompanying fulfillment services. These arrangements are complex and require substantial personnel and resource commitments by us, which may constrain the number of such agreements we are able to enter into and may affect our ability to integrate and deliver services under the relevant agreements. If we fail to implement, maintain, and develop successfully the various components of such commercial relationships, which may include fulfillment, customer service, inventory management, tax collection, payment processing, licensing of third party

[Table of Contents](#)

software, hardware, and content, and engaging third parties to perform hosting and other services, these initiatives may not be viable. The amount of compensation we receive under certain of these agreements is dependent on the volume of sales that the other company makes. Therefore, if the other business's website or product or services offering is not successful, we may not receive all of the compensation we are otherwise due under the agreement or may not be able to maintain the agreement. Moreover, we may not be able to succeed in our plans to enter into additional commercial relationships and strategic alliances on favorable terms.

As our commercial agreements expire or otherwise terminate, we may be unable to renew or replace these agreements on comparable terms, or at all. In the past, we amended several of our commercial agreements to reduce future cash proceeds to be received by us, shorten the term of our commercial agreements, or both. Some of our agreements involve high margin services, such as marketing and promotional agreements, and as such agreements expire they may be replaced, if at all, by agreements involving lower margin services. In addition, several past commercial agreements were with companies that experienced business failures and were unable to meet their obligations to us. We may in the future enter into further amendments of these agreements or encounter other parties that have difficulty meeting their contractual obligations to us, which could adversely affect our operating results.

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

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

Our present and future acquisitions, business combinations, joint ventures, and investments create additional risks such as:

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

In the past, we amended several of our commercial agreements to reduce future cash proceeds to be received by us, shorten the term of our commercial agreements, or both. We may in the future enter into further amendments of our commercial agreements. Although these amendments did not affect the amount of unearned revenue previously recorded by us (if any), the timing of revenue recognition of these recorded unearned

[Table of Contents](#)

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.

Our investments in equity securities are included in “Marketable securities” and “Other assets” on our consolidated balance sheets. We regularly review all of our investments in public and private companies for other-than-temporary declines in fair value. When we determine that the decline in fair value of an investment below our accounting basis is other-than-temporary, we reduce the carrying value of the securities we hold and record a loss in the amount of any such decline. In recent years, securities of companies in the Internet and e-commerce industries have experienced significant difficulties. We may conclude in future quarters that the fair values of our investments have experienced additional other-than-temporary declines. As of June 30, 2004, our recorded basis in equity securities was \$17 million, including \$5 million classified as “Marketable securities” and \$12 million classified as “Other assets.”

The Seasonality of Our Business Places Increased Strain on Our Operations

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

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

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 enough if our net sales fall short of our expectations.

[Table of Contents](#)

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

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

- our ability to retain and increase sales to existing customers, attract new customers, and satisfy our customers' demands;
- our ability to expand our network of sellers, and to enter into, maintain, renew, and amend on favorable terms our commercial agreements and strategic alliances;
- foreign exchange rate fluctuations;
- our ability to acquire merchandise, manage inventory, and fulfill orders;
- the introduction by our competitors of websites, products, services, or improvements;
- 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 commercial agreements and strategic alliances and our ability to successfully implement the underlying relationships and integrate them into our business;
- the effects of acquisitions, and other business combinations and our ability to successfully integrate them into our business;
- technical difficulties, system downtime, or interruptions;
- variations in the mix of products and services we sell;
- variations in our level of merchandise and vendor returns;
- disruptions in service by shipping carriers;
- the extent to which we offer free shipping 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 Exchange Risk

The results of operations of, and certain of our intercompany balances associated with, our internationally-focused websites are exposed to foreign exchange rate fluctuations. Upon translation, net sales and other operating results may differ materially from expectations, and we may record significant gains or losses on the remeasurement of intercompany balances.

In addition, our 6.875% PEACS are denominated in Euros, not U.S. Dollars. We remeasure the principal of the 6.875% PEACS quarterly based on fluctuations in the Euro/U.S. Dollar exchange ratio and record gains or

[Table of Contents](#)

losses in “Remeasurements and other” on our consolidated statements of operations. Furthermore, we hold cash equivalents and marketable securities in Euros, British Pounds, and Yen. Accordingly, if the U.S. Dollar strengthens compared to these currencies, cash equivalents, and marketable securities balances, when translated, may be materially less than expected and vice versa.

Our 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 hire, 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, especially as we employ personnel in multiple geographic locations. We may not be able to hire, train, retain, motivate, and manage required personnel, which may limit our growth.

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

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

We 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

[Table of Contents](#)

may not benefit from any first-to-market advantages. It is costly to establish international facilities and operations, promote our brand internationally and develop localized websites, stores, and other systems. We may not succeed in these efforts. Our net sales from international market segments may not offset the expense of establishing and maintaining the related operations and, therefore, these operations may not be profitable on a sustained basis.

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

- foreign exchange rate fluctuations;
- local economic and political conditions;
- restrictive governmental actions (such as trade protection measures, including export duties and quotas and custom duties and tariffs);
- 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;
- tax and other laws of the U.S. and other jurisdictions; and
- geopolitical events, including war and terrorism.

As the international e-commerce channel continues to grow, competition will likely intensify. Local companies may have a substantial competitive advantage because of their greater understanding of, and focus on, the local customer, as well as their more established local brand name recognition. In addition, governments in foreign jurisdictions may regulate e-commerce or other online services in such areas as 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 increase our net shipping cost by requiring us to make split shipments from one or more locations, complimentary upgrades, and additional long-zone shipments necessary to ensure timely delivery. As a result of our third-party services relationships with Toysrus.com, Babiesrus.com, Target, and other companies, these parties identify, buy, and bear the financial risk of inventory

[Table of Contents](#)

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.

Any one of the inventory risk factors set forth above may 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. Because it is difficult to predict demand, we may not manage our facilities in an optimal way, which may result in excess or insufficient inventory, and warehousing, fulfillment, and distribution capacity. A failure to optimize inventory in our fulfillment network will increase our net shipping cost by requiring us to make long-zone shipments or partial shipments from one or more locations. Orders from each of our internationally-focused websites are fulfilled primarily from a single fulfillment center, and we have only a limited ability to reroute orders to third parties for drop-shipping. We and our co-sourcers may be unable to adequately staff our fulfillment and customer service centers. Finally, 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.

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.

[Table of Contents](#)

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

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

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

- general economic conditions;
- changes in interest rates;
- conditions or trends in the Internet and the e-commerce industry;
- fluctuations in the stock market in general and market prices for Internet-related companies in particular;
- quarterly variations in operating results;
- new products, services, innovations, and strategic developments by our competitors or us, or business combinations and investments by our competitors or us;
- changes in financial estimates by us or securities analysts and recommendations by securities analysts;
- changes in Internet regulation;
- changes in our capital structure, including issuance of additional debt or equity to the public;
- additions or departures of key personnel;
- corporate restructurings, including layoffs or closures of facilities;
- changes in the valuation methodology of, or performance by, other e-commerce companies; and
- certain analyst reports, news, and speculation.

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

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

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

We are subject to general business regulations and laws, as well as regulations and laws specifically governing the Internet and e-commerce. Such existing and future laws and regulations may impede the growth of

[Table of Contents](#)

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

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, North Dakota, and Kansas. Under some of our commercial agreements, the other company is the seller of record of the applicable merchandise and we are obligated to collect sales tax in most states in accordance with that company’s instructions. We may enter into additional strategic alliances requiring similar tax collection obligations. 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, or EU, member countries. We also collect VAT with respect to certain of our “electronically supplied services,” including digital downloads and marketplace services, provided to certain EU residents. 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 that engage in e-commerce. A successful assertion by one or more states or foreign countries that we should collect sales or other taxes on the sale of merchandise or services could result in substantial tax liabilities for past sales, decrease our ability to compete with traditional retailers, and otherwise harm our business.

Currently, decisions of the U.S. Supreme Court restrict the imposition of obligations to collect state and local sales and use taxes with respect to sales made over the Internet. However, a number of states, as well as the U.S. Congress, have been considering various initiatives that could limit or supersede the Supreme Court’s position regarding sales and use taxes on Internet sales. If any of these initiatives addressed the Supreme Court’s constitutional concerns and resulted in a reversal of its current position, we could be required to collect sales and use taxes in states other than Washington, North Dakota, and Kansas. 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.

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

Although we continue to increase our direct purchasing from manufacturers, we source a significant amount of inventory from relatively few vendors. However, no vendor accounts for 10% or more of our 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. If our current vendors were to stop selling merchandise to us on acceptable terms, we may not be able to acquire merchandise from other suppliers in a timely and efficient manner and on acceptable terms.

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

Some of the products we sell may expose us to product liability claims relating to personal injury, death, or property damage caused by such products, and may require us to take actions such as product recalls. Certain

[Table of Contents](#)

businesses and individuals also sell products using our e-commerce platform that may increase our exposure to product liability claims, such as if these sellers do not have sufficient resources to protect themselves from such claims. Although we maintain liability insurance, we cannot be certain that our coverage will be adequate for liabilities actually incurred or that insurance will continue to be available to us on economically reasonable terms, or at all. In addition, some of our vendor agreements with our suppliers and third party sellers do not indemnify us from product liability.

We Could Be Liable for Breaches of Security on Our Website and Fraudulent Activities of Users of Our 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 have investigated the provision of online payment services and could require changes in the way this business is conducted. We guarantee payments made through our payments program available to sellers on Marketplace and certain other programs up to certain limits for buyers, and we may be unable to prevent users from fraudulently collecting payments when goods may not be shipped to a buyer. As our payments program grows, our liability risk will increase. Any costs we incur as a result of liability because of our payments program's guarantee or otherwise could harm our business. In addition, the functionality of our payments program depends on certain third-party vendors delivering services. If these vendors are unable or unwilling to provide services, our payments program and our businesses that use it may not be viable.

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

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

The Internet as a Medium for Commerce Is a Relatively Recent Phenomenon

Consumer use of the Internet as a medium for commerce is a relatively 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 Merchants@, Marketplace, Merchant.com, and Certain Other Programs

We may be unable to prevent users of our Merchants@, Marketplace, Merchant.com, and certain other programs 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 the laws and regulations of other countries. In addition, if we are unsuccessful in preventing our users from providing content that is either illegal or that violates the proprietary rights of others, it may result in liability to us. 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 Merchants@,

[Table of Contents](#)

Marketplace, Merchant.com, and other programs, we rely on sellers to make accurate representations and provide reliable delivery, and on buyers to pay the agreed purchase price. To the extent we expand our guarantee program, this may create additional liability for us.

Forward-Looking Statements

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact, including statements regarding guidance, industry prospects or future results of operations or financial position, made in this Quarterly Report on Form 10-Q are forward-looking. We use words such as anticipates, believes, expects, future, intends, and similar expressions to identify forward-looking statements. Forward-looking statements reflect management's current expectations and are inherently uncertain. Actual results could differ materially for a variety of reasons, including, among others, the rate of growth of the economy in general and of the Internet and online commerce, customer spending patterns, world events, 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 commercial agreements and strategic transactions and maintain and develop commercial relationships, foreign exchange 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 "Additional Factors That May Affect Future Results," which, along with the previous discussion, describes some, but not all, of the factors that could cause actual results to differ significantly from management's expectations.

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

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

Information relating to quantitative and qualitative disclosure about market risk is set forth below and in Item 2 of Part I, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources."

Interest Rate Risk

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

At June 30, 2004, we had long-term debt of \$1.76 billion primarily associated with our 4.75% Convertible Subordinated Notes and 6.875% PEACS, which are due in 2009 and 2010. The market value of our long-term debt will fluctuate with movements of interest rates, increasing in periods of declining rates of interest and declining in periods of increasing rates of interest. Based upon quoted market prices, the fair value of the 6.875% PEACS was \$847 million and \$870 million at June 30, 2004 and December 31, 2003, and the fair value of the 4.75% Convertible Subordinated Notes was \$899 million (outstanding principal of \$900 million) and \$1.06 billion (outstanding principal of \$1.05 billion) at June 30, 2004 and December 31, 2003.

Foreign Exchange Risk

During the three months ended June 30, 2004, net sales from our International segment (consisting of www.amazon.co.uk, www.amazon.de, www.amazon.fr, and www.amazon.co.jp) accounted for 43% of our

[Table of Contents](#)

consolidated revenues. Net sales and related expenses generated from these websites, as well as those relating to *www.amazon.ca*, are denominated in the functional currencies of the corresponding websites and include Euros, British Pounds, Yen, and Canadian Dollars. The functional currency of our subsidiaries that either operate or support these websites is the same as the corresponding local currency. The results of operations of, and certain of our intercompany balances associated with, our internationally-focused websites are exposed to foreign exchange rate fluctuations. Upon translation, net sales and other operating results may differ materially from expectations, and we may record significant gains or losses on the remeasurement of intercompany balances. As exchange rates vary, net sales and other operating results, when translated, may differ materially from expectations. As a result of fluctuations in foreign exchange rates during the three months ended June 30, 2004, International segment revenues improved \$46 million and our operating results improved \$4 million in comparison with the prior year.

We have foreign exchange risk related to foreign-denominated cash, cash equivalents, and marketable securities ("foreign funds"). Based on the balance of foreign funds at June 30, 2004 of \$645 million, an assumed 5%, 10%, and 20% negative currency movement would result in fair value declines of \$32 million, \$65 million, and \$129 million. All investments are classified as "available for sale," as defined by SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

We have foreign exchange risk related to our 6.875% PEACS, which have an outstanding principal balance of 690 million Euros (\$841 million, based on the exchange rate as of June 30, 2004). Based on the outstanding 6.875% PEACS' principal balance, an assumed 5%, 10%, and 20% weakening of the U.S. Dollar in relation to the Euro would result in losses of approximately \$42 million, \$84 million, and \$168 million, recorded to "Remeasurements and other." We are not hedged on interest payments under our 6.875% PEACS. Assuming the U.S. Dollar weakens against the Euro by 5%, 10%, and 20% in 2004, we would incur \$3 million, \$6 million, and \$12 million additional, annual interest expense due solely to fluctuations in foreign exchange.

Investment Risk

As of June 30, 2004, our recorded basis in equity securities was \$17 million, including \$5 million classified as "Marketable securities," and \$12 million classified as "Other assets." We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that such declines in the fair value of such assets below our accounting basis are other-than-temporary. The fair values of our investments are subject to significant fluctuations due to volatility of the stock market and changes in general economic conditions. Based on the fair value of the publicly-traded equity securities we held at June 30, 2004 of \$55 million (recorded basis of \$10 million), an assumed 15%, 30%, and 50% adverse change to market prices of these securities would result in a corresponding decline in total fair value of approximately \$8 million, \$16 million, and \$27 million.

Item 4. Controls and Procedures

We carried out an evaluation required by the 1934 Act, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic SEC reports. It should be noted that any system of controls is based in part upon certain assumptions designed to obtain reasonable (and not absolute) assurance as to its effectiveness, and there can be no assurance that any design will succeed in achieving its stated goals.

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

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

None.

Item 3. Defaults Upon Senior Securities

None.

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

Our annual meeting of stockholders was held on May 25, 2004. The following nominees were elected as directors, each to hold office until his or her successor is elected and qualified, by the vote set forth below:

<u>Nominee</u>	<u>For</u>	<u>Withheld</u>
Jeffrey P. Bezos	372,651,726	2,215,955
Tom A. Alberg	371,002,868	3,864,813
L. John Doerr	373,106,513	1,761,168
William B. Gordon	374,156,210	711,471
Myrtle S. Potter	372,945,811	1,921,870
Thomas O. Ryder	371,002,991	3,864,690
Patricia Q. Stonesifer	372,249,065	2,618,616

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

	<u>Votes</u>
For	370,786,643
Against	3,953,323
Abstain	127,715
Broker Non-Votes	0

A shareholder proposal regarding the use of a performance and time-based restricted share program for executives was not adopted by the margins indicated:

	<u>Votes</u>
For	11,122,355
Against	300,149,225
Abstain	1,754,391
Broker Non-Votes	61,841,710

Item 5. Other Information

None.

[Table of Contents](#)

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.
31.1	Certification of Jeffrey P. Bezos, Chairman and Chief Executive Officer of Amazon.com, Inc., Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
31.2	Certification of Thomas J. Szkutak, Senior Vice President and Chief Financial Officer of Amazon.com, Inc., Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
32.1	Certification of Jeffrey P. Bezos, Chairman and Chief Executive Officer of Amazon.com, Inc., Pursuant to 18 U.S.C. Section 1350.
32.2	Certification of Thomas J. Szkutak, Senior Vice President and Chief Financial Officer of Amazon.com, Inc., Pursuant to 18 U.S.C. Section 1350.

(b) Reports on Form 8-K

On April 12, 2004, we furnished a Form 8-K announcing the election of Myrtle S. Potter to our Board of Directors.

On April 12, 2004, we furnished a Form 8-K disclosing our Letter to Shareholders which accompanied our Annual Report for the Year Ended December 31, 2003.

On April 22, 2004, we filed a Form 8-K announcing our first quarter 2004 financial results.

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/ THOMAS J. SZKUTAK

Thomas J. Szkutak
Senior Vice President and
Chief Financial Officer
(Principal Financial Officer)

Dated: July 22, 2004

EXHIBIT INDEX

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