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

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**Form 10-Q**

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(Mark One)

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

For the quarterly period ended September 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

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**Amazon.com, Inc.**

(Exact Name of Registrant as Specified in its Charter)

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**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

**1200 12th Avenue South, Suite 1200, Seattle, Washington 98144-2734**  
**(206) 266-1000**  
(Address and Telephone Number, Including Area Code, of Registrant's Principal Executive Offices)

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

None

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

Common Stock, par value \$.01 per share

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

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

408,051,981 shares of common stock, par value \$0.01 per share outstanding as of October 14, 2004

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

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## PART I. FINANCIAL INFORMATION

### Item 1. Financial Statements

#### AMAZON.COM, INC.

#### CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD . . . . .	\$ 701,150	\$641,728	\$ 1,102,273	\$ 738,254
OPERATING ACTIVITIES:				
Net income (loss) . . . . .	54,147	15,563	241,763	(37,872)
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 . . . . .	19,083	18,338	54,893	57,091
Stock-based compensation . . . . .	9,274	20,936	38,073	72,712
Other operating expense (income) . . . . .	4,505	786	(3,187)	2,611
Losses (gains) on sales of marketable securities, net . . . . .	220	(141)	(790)	(9,393)
Remeasurements and other . . . . .	5,441	11,142	(31,221)	93,592
Non-cash interest expense and other . . . . .	1,140	1,343	3,402	12,752
Changes in operating assets and liabilities:				
Inventories . . . . .	(69,626)	(62,147)	(61,172)	(34,001)
Accounts receivable, net and other current assets . . . . .	(22,868)	(14,844)	(15,842)	18,303
Accounts payable . . . . .	95,529	49,535	(137,853)	(131,584)
Accrued expenses and other current liabilities . . . . .	8,668	(5,109)	(58,240)	(99,312)
Additions to unearned revenue . . . . .	33,707	29,932	84,469	78,652
Amortization of previously unearned revenue . . . . .	(27,029)	(27,816)	(76,154)	(85,719)
Interest payable . . . . .	4,454	(701)	(29,148)	(26,773)
Net cash provided by (used in) operating activities . . . . .	116,645	36,817	8,993	(88,941)
INVESTING ACTIVITIES:				
Sales and maturities of marketable securities and other investments . . . . .	395,087	21,988	1,007,411	581,011
Purchases of marketable securities . . . . .	(380,651)	(71,880)	(1,136,032)	(414,194)
Purchases of fixed assets, including internal-use software and website development . . . . .	(28,722)	(15,192)	(52,378)	(28,727)
Proceeds from sale of subsidiary and other . . . . .	—	5,072	—	5,072
Acquisition, net of cash acquired . . . . .	(71,195)	—	(71,195)	—
Net cash provided by (used in) investing activities . . . . .	(85,481)	(60,012)	(252,194)	143,162
FINANCING ACTIVITIES:				
Proceeds from exercises of stock options and other . . . . .	7,727	41,235	42,618	132,832
Repayments of long-term debt, capital lease obligations, and other . . . . .	(550)	(3,437)	(156,842)	(287,576)
Net cash provided by (used in) financing activities . . . . .	7,177	37,798	(114,224)	(154,744)
Foreign-currency effect on cash and cash equivalents . . . . .	6,117	10,087	760	28,687
Net increase (decrease) in cash and cash equivalents . . . . .	44,458	24,690	(356,665)	(71,836)
CASH AND CASH EQUIVALENTS, END OF PERIOD . . . . .	<u>\$ 745,608</u>	<u>\$666,418</u>	<u>\$ 745,608</u>	<u>\$ 666,418</u>
SUPPLEMENTAL CASH FLOW INFORMATION:				
Fixed assets acquired under capital leases and other financing arrangements . . . . .	\$ 135	\$ 1,572	\$ 658	\$ 2,648
Cash paid for interest . . . . .	21,497	30,019	107,565	116,835
Cash paid for income taxes . . . . .	1,651	1,019	2,659	1,628

See accompanying notes to consolidated financial statements.

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

	Twelve Months Ended September 30,	
	2004	2003
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD .....	\$ 666,418	\$ 327,564
OPERATING ACTIVITIES:		
Net income (loss) .....	314,917	(35,221)
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 .....	73,360	76,955
Stock-based compensation .....	53,112	108,392
Other operating expense (income) .....	(3,046)	4,624
Gains on sales of marketable securities, net .....	(995)	(11,260)
Remeasurements and other .....	5,284	134,888
Non-cash interest expense and other .....	3,568	19,902
Changes in operating assets and liabilities:		
Inventories .....	(103,957)	(82,369)
Accounts receivable, net and other current assets .....	(33,840)	16,775
Accounts payable .....	161,463	131,254
Accrued expenses and other current liabilities .....	15,332	(57,366)
Additions to unearned revenue .....	107,458	98,415
Amortization of previously unearned revenue .....	(102,175)	(123,444)
Interest payable .....	(525)	2,093
Net cash provided by operating activities .....	489,956	283,638
INVESTING ACTIVITIES:		
Sales and maturities of marketable securities and other investments .....	1,239,584	733,768
Purchases of marketable securities .....	(1,257,480)	(587,714)
Purchases of fixed assets, including internal-use software and website development ..	(69,614)	(44,243)
Proceeds from sale of subsidiary and other .....	—	5,072
Acquisition, net of cash acquired .....	(71,195)	—
Net cash provided by (used in) investing activities .....	(158,705)	106,883
FINANCING ACTIVITIES:		
Proceeds from exercises of stock options and other .....	73,108	198,208
Repayments of long-term debt, capital lease obligations, and other .....	(364,574)	(290,250)
Net cash used in financing activities .....	(291,466)	(92,042)
Foreign-currency effect on cash and cash equivalents .....	39,405	40,375
Net increase in cash and cash equivalents .....	79,190	338,854
CASH AND CASH EQUIVALENTS, END OF PERIOD .....	<u>\$ 745,608</u>	<u>\$ 666,418</u>
SUPPLEMENTAL CASH FLOW INFORMATION:		
Fixed assets acquired under capital leases and other financing arrangements .....	\$ 687	\$ 3,374
Cash paid for interest .....	110,677	117,477
Cash paid for income taxes .....	2,856	1,613

See accompanying notes to consolidated financial statements.

**AMAZON.COM, INC.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(in thousands, except per share data)**  
**(unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net sales .....	\$1,462,475	\$1,134,456	\$4,380,165	\$3,317,927
Cost of sales .....	<u>1,106,824</u>	<u>848,635</u>	<u>3,322,634</u>	<u>2,487,596</u>
Gross profit .....	355,651	285,821	1,057,531	830,331
Operating expenses:				
Fulfillment .....	135,521	107,057	385,943	318,217
Marketing .....	34,347	28,943	99,822	82,496
Technology and content .....	64,823	53,775	178,374	155,998
General and administrative .....	25,907	22,393	80,523	65,318
Stock-based compensation (1) .....	9,274	20,936	38,073	72,712
Other operating expense (income) .....	<u>4,505</u>	<u>786</u>	<u>(3,187)</u>	<u>2,611</u>
Total operating expenses .....	<u>274,377</u>	<u>233,890</u>	<u>779,548</u>	<u>697,352</u>
Income from operations .....	81,274	51,931	277,983	132,979
Interest income .....	7,553	4,324	18,419	16,625
Interest expense .....	(26,307)	(29,802)	(80,093)	(100,680)
Other income (expense), net .....	(2,932)	252	(5,767)	6,796
Remeasurements and other .....	<u>(5,441)</u>	<u>(11,142)</u>	<u>31,221</u>	<u>(93,592)</u>
Total non-operating expense, net .....	<u>(27,127)</u>	<u>(36,368)</u>	<u>(36,220)</u>	<u>(170,851)</u>
Net income (loss) .....	<u>\$ 54,147</u>	<u>\$ 15,563</u>	<u>\$ 241,763</u>	<u>\$ (37,872)</u>
Basic earnings (loss) per share .....	<u>\$ 0.13</u>	<u>\$ 0.04</u>	<u>\$ 0.60</u>	<u>\$ (0.10)</u>
Diluted earnings (loss) per share .....	<u>\$ 0.13</u>	<u>\$ 0.04</u>	<u>\$ 0.57</u>	<u>\$ (0.10)</u>
Weighted average shares used in computation of earnings (loss) per share:				
Basic .....	<u>406,647</u>	<u>397,912</u>	<u>405,153</u>	<u>393,477</u>
Diluted .....	<u>424,777</u>	<u>422,802</u>	<u>423,924</u>	<u>393,477</u>
(1) Components of stock-based compensation:				
Fulfillment .....	\$ 2,001	\$ 4,374	\$ 6,294	\$ 16,221
Marketing .....	67	1,582	2,770	4,167
Technology and content .....	4,408	12,013	20,541	39,807
General and administrative .....	<u>2,798</u>	<u>2,967</u>	<u>8,468</u>	<u>12,517</u>
	<u>\$ 9,274</u>	<u>\$ 20,936</u>	<u>\$ 38,073</u>	<u>\$ 72,712</u>

See accompanying notes to consolidated financial statements.

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

	September 30, 2004	December 31, 2003
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 745,608	\$ 1,102,273
Marketable securities .....	439,092	292,550
Cash, cash equivalents, and marketable securities .....	1,184,700	1,394,823
Inventories .....	357,320	293,917
Accounts receivable, net and other current assets .....	150,764	132,069
Total current assets .....	1,692,784	1,820,809
Fixed assets, net .....	226,762	224,285
Goodwill .....	137,584	69,121
Other assets .....	51,538	47,818
Total assets .....	<u>\$ 2,108,668</u>	<u>\$ 2,162,033</u>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
Current liabilities:		
Accounts payable .....	\$ 688,297	\$ 819,811
Accrued expenses and other current liabilities .....	269,178	317,730
Unearned revenue .....	46,144	37,844
Interest payable .....	43,952	73,100
Current portion of long-term debt and other .....	3,452	4,216
Total current liabilities .....	1,051,023	1,252,701
Long-term debt and other .....	1,778,722	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 — 407,464 and 403,354 shares .....	4,075	4,034
Additional paid-in capital .....	1,981,659	1,899,398
Deferred stock-based compensation .....	(2,529)	(2,850)
Accumulated other comprehensive income .....	28,383	37,739
Accumulated deficit .....	(2,732,665)	(2,974,428)
Total stockholders' deficit .....	(721,077)	(1,036,107)
Total liabilities and stockholders' deficit .....	<u>\$ 2,108,668</u>	<u>\$ 2,162,033</u>

See accompanying notes to consolidated financial statements.

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

**Note 1 — Accounting Policies**

***Unaudited Interim Financial Information***

We have prepared the accompanying consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. These consolidated financial statements are unaudited and, in our opinion, include all adjustments, consisting of normal recurring adjustments and accruals necessary for a fair presentation of the consolidated balance sheets, operating results, and cash flows for the periods presented. Operating results for the periods presented are not necessarily indicative of the results that may be expected for 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, acquired intangibles, taxes, and contingencies. Actual results could differ materially from those estimates.

***Business Acquisition***

On September 7, 2004, we acquired all of the outstanding shares of Joyo.com Limited (“Joyo.com”), a British Virgin Islands company that operates an Internet retail website in the People’s Republic of China (“PRC”) in cooperation with a PRC subsidiary and PRC affiliates, at a purchase price of \$74.2 million, including a cash payment of \$72.4 million, the assumption of employee stock options, and transaction-related costs. Acquired intangibles were \$5.9 million with estimated useful lives of between one and four years. The excess of purchase price over the fair value of the net assets acquired was \$68.4 million and is classified as “Goodwill” on the consolidated balance sheets. The results of operations of Joyo.com have been included in our consolidated results from the acquisition date forward. The effect on consolidated net sales and operating income was not significant for the third quarter of 2004.

Joyo.com does not own any capital stock of the PRC affiliates, but is the primary beneficiary of future losses or profits through contractual rights. As a result, we consolidate the results of the PRC affiliates in accordance with FIN 46R, “Consolidation of Variable Interest Entities.” The net assets and operating results for the PRC affiliates were not significant.

The intrinsic value of the unvested employee stock options that were assumed in connection with the Joyo.com acquisition is recorded to “Deferred stock-based compensation” on the consolidated balance sheets and will be expensed over the remaining service period. Amortization of these amounts is classified in “Stock-based compensation” on the consolidated statements of operations.

# AMAZON.COM, INC.

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

### *Inventories*

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

### *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 nine months ended September 30, 2004.

### *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; certain equity investments; and intangible assets, net of amortization. At September 30, 2004 and December 31, 2003, deferred issuance charges were \$20 million and \$25 million; and equity investments were \$12 million and \$15 million; and intangibles, net of amortization, were \$6 million and \$0.5 million.

Other intangibles consist of the following:

	September 30, 2004			December 31, 2003		
	Other Intangibles Gross	Accumulated Amortization	Other Intangibles Net (1)	Other Intangibles Gross	Accumulated Amortization	Other Intangibles Net
	(in thousands)					
Contract-based . . . . .	\$15,972	\$(13,509)	\$2,463	\$13,469	\$(13,469)	\$—
Marketing-related . . . . .	8,821	(5,626)	3,195	5,617	(5,326)	291
Technology-based . . . . .	4,607	(4,396)	211	4,386	(4,360)	26
Customer-based . . . . .	2,021	(1,984)	37	2,021	(1,820)	201
Other intangibles . . . . .	<u>\$31,421</u>	<u>\$(25,515)</u>	<u>\$5,906</u>	<u>\$25,493</u>	<u>\$(24,975)</u>	<u>\$518</u>

- (1) The net carrying amount of intangible assets at September 30, 2004 is scheduled to be fully amortized over the next four years as follows: \$0.6 million for the remainder of 2004; \$1.7 million in 2005; \$1.4 million in 2006; \$1.3 million in 2007; and \$0.9 million in 2008. The weighted-average amortization period is 3.6 years based on useful life assumptions between one and four years.

### *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 September 30, 2004, we have recorded a net deferred tax asset of \$6 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.



## AMAZON.COM, INC.

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

At September 30, 2004, we have net operating loss carryforwards (“NOLs”) of \$2.8 billion, primarily related to U.S. federal taxes. Utilization of NOLs, which begin to expire at various times starting in 2010, may be subject to certain limitations. Approximately \$1 billion of our NOLs are attributable to continuing operations and the related tax benefits, if realized, will be credited to results of operations for both financial reporting and tax reporting purposes. The remaining portion of approximately \$1.8 billion relates to tax deductible stock-based compensation in excess of amounts recognized for financial reporting purposes and the related tax benefits, if realized, will be credited to stockholders’ equity rather than to results of operations for financial reporting purposes.

Additionally, we have approximately \$228 million of capital loss carryforwards that begin to expire in 2005.

#### *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 \$87 million and \$77 million for the three months ended September 30, 2004 and 2003, and \$264 million and \$235 million for the nine months ended September 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 \$128 million and \$104 million for the three months ended September 30, 2004 and 2003, and \$383 million and \$315 million for the nine months ended September 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.

**AMAZON.COM, INC.**

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

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.

***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 \$19 million and \$54 million for the three months and nine months ended September 30, 2004, and \$18 million and \$52 million for the three months and nine months ended September 30, 2003.

***Stock-Based Compensation***

Stock-based compensation consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
Stock awards — variable accounting (1) . . . . .	\$ (5,722)	\$10,449	\$ 649	\$46,172
Fixed accounting (2):				
Restricted stock units and stock options . . . . .	14,076	9,323	33,836	22,493
Restricted stock (3) . . . . .	920	1,164	3,588	4,047
Total stock-based compensation . . . . .	<u>\$ 9,274</u>	<u>\$20,936</u>	<u>\$38,073</u>	<u>\$72,712</u>

- (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. To the extent awards are forfeited prior to vesting, the corresponding previously recognized expense is reversed as an offset to stock-based compensation.
- (3) Includes expense associated with matching contributions of 15,651 and 51,901 shares of our common stock under our 401(k) savings plan during the three and nine months ended September 30, 2004, and 11,229 and 26,354 shares of our common stock during the three and nine months ended September 30, 2003.

We granted stock awards, primarily restricted stock units, representing 0.7 million and 0.3 million shares of common stock during the three months ended September 30, 2004 and 2003, and 2.7 million and 2.0 million shares of common stock during the nine months ended September 30, 2004 and 2003. The per share weighted average fair value of stock awards, including restricted stock units, granted was \$40.12 and \$41.78 during the three months ended September 30, 2004 and 2003, and \$44.59 and \$27.90 during the nine months ended September 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 September 30, 2004 and 2003. Common shares outstanding increased by 0.8 million shares during the three months ended September 30, 2004, and 4.1 million shares during the nine months ended September 30, 2004, due to exercises of stock options, vesting of restricted stock units, and matching contributions under our 401(k) savings plan.

**AMAZON.COM, INC.**

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

Outstanding stock awards were as follows:

	<u>September 30,</u>	
	<u>2004</u>	<u>2003</u>
	(in thousands)	
Stock options (1)(2) . . . . .	20,319	27,841
Restricted stock units (3) . . . . .	<u>6,368</u>	<u>4,694</u>
Outstanding stock awards, excluded from common stock outstanding . . . . .	26,687	32,535
Restricted stock (4) . . . . .	<u>490</u>	<u>831</u>
Total outstanding stock awards . . . . .	<u><u>27,177</u></u>	<u><u>33,366</u></u>

- (1) The weighted average per share exercise price was \$12.90 and \$12.37 at September 30, 2004 and 2003.  
(2) Includes 1.0 million and 0.9 million options at September 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 September 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 Statement of Financial Accounting Standards ("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):

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Net income (loss) — as reported . . . . .	\$ 54,147	\$ 15,563	\$241,763	\$ (37,872)
Add: Stock-based compensation, as reported . . . . .	9,274	20,936	38,073	72,712
Deduct: Total stock-based compensation determined under fair value based method for all awards . . . . .	<u>(21,995)</u>	<u>(22,449)</u>	<u>(60,450)</u>	<u>(72,525)</u>
Net income (loss) — SFAS No. 123 adjusted . . . . .	<u>\$ 41,426</u>	<u>\$ 14,050</u>	<u>\$219,386</u>	<u>\$ (37,685)</u>
Basic earnings (loss) per share — as reported . . . . .	\$ 0.13	\$ 0.04	\$ 0.60	\$ (0.10)
Diluted earnings (loss) per share — as reported . . . . .	0.13	0.04	0.57	(0.10)
Basic earnings (loss) per share — SFAS No. 123 adjusted . . . . .	0.10	0.04	0.54	(0.10)
Diluted earnings (loss) per share — SFAS No. 123 adjusted . . . . .	0.10	0.03	0.52	(0.10)

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:

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Average risk-free interest rate . . . . .	2.9%	2.1%	2.6%	2.5%
Average expected life (in years) . . . . .	3.3	3.3	3.3	3.3
Volatility . . . . .	53.3%	73.2%	58.0%	78.3%

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 accordance with SFAS No. 52, currency adjustments arising before the fourth quarter of 2003 continue to be included as a component of “Accumulated other comprehensive income” on our consolidated balance sheets. In connection with the remeasurement of intercompany balances, we recorded a gain of \$7 million for the three months ended September 30, 2004, and a loss of \$3 million for the nine months ended September 30, 2004. During the nine months ended September 30, 2004, \$192 million was repaid among the entities.

***Earnings (Loss) per Share***

In accordance with 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:

	September 30, 2004	December 31, 2003
	(in thousands)	
Cash .....	\$ 195,172	\$ 427,306
Cash equivalents pledged as collateral (See Note 4) .....	8,536	—
Commercial paper and short-term securities (1) .....	541,900	674,967
Cash and cash equivalents .....	745,608	1,102,273
U.S. Treasury notes and bonds .....	186,819	145,778
Asset-backed and agency securities .....	116,196	85,692
Certificates of deposit .....	98,614	27,395
Corporate notes and bonds .....	27,378	24,997
Commercial paper and short-term securities .....	2,076	94
Equity securities .....	8,009	8,594
Marketable securities (1) .....	439,092	292,550
Total cash, cash equivalents, and marketable securities (2) ...	<u>\$1,184,700</u>	<u>\$1,394,823</u>

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

(2) Includes amounts held in foreign currencies of \$693 million and \$764 million at September 30, 2004 and December 31, 2003. Amounts held in foreign currencies at September 30, 2004 and 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:

	September 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) .....	858,084	869,711
Long-term restructuring liabilities (see Note 6) .....	10,750	20,066
Capital lease obligations .....	1,907	2,717
Other long-term debt .....	11,673	7,401
	1,782,174	1,949,655
Less current portion of capital lease obligations .....	(1,238)	(1,558)
Less current portion of other long-term debt .....	(2,214)	(2,658)
Total long-term debt and other .....	<u>\$1,778,722</u>	<u>\$1,945,439</u>

(1) During the nine months ended September 30, 2004, we redeemed an aggregate principal amount of \$150 million of our outstanding 4.75% Convertible Subordinated Notes due February 2009 (“4.75% Convertible Subordinated Notes”). As provided in the underlying indenture, the redemption price of \$154 million included a \$4 million (2.375%) premium over the face amount of the redeemed notes. We recorded a charge

**AMAZON.COM, INC.**

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

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 September 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 (\$105.56, based on the exchange rate as of September 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 \$14 million and \$13 million for the three months ended September 30, 2004 and 2003, and \$41 million and \$39 million for the nine months ended September 30, 2004 and 2003.

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

	Three Months Ending December 31, 2004	2005	2006	2007	2008	Thereafter	Total
	(in thousands)						
Operating and capital commitments:							
Debt principal and other (1) . . .	\$ 330	\$ 128	\$ 1,247	\$ 340	\$ 351	\$1,773,483	\$1,775,879
Debt interest (1) . . . . .	—	108,857	108,857	108,857	108,857	142,918	578,346
Capital leases . . . . .	385	1,178	420	20	—	—	2,003
Operating leases (2) . . . . .	14,857	57,040	59,876	51,596	49,307	217,483	450,159
Total operating and capital commitments . . . . .	15,572	167,203	170,400	160,813	158,515	2,133,884	2,806,387
Restructuring-related commitments:							
Operating leases, net of estimated sublease income . . . . .	863	6,993	1,999	1,961	1,614	2,952	16,382
Other . . . . .	3,902	1,201	—	—	—	—	5,103
Total restructuring-related commitments . . . . .	4,765	8,194	1,999	1,961	1,614	2,952	21,485
Total commitments . . . . .	\$20,337	\$175,397	\$172,399	\$162,774	\$160,129	\$2,136,836	\$2,827,872



# 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 September 30, 2004, the Euro to U.S. Dollar exchange rate was 1.2436. 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 \$178 million as of September 30, 2004.
- (2) Pursuant to SFAS No. 13, *Accounting for Leases*, lease agreements are categorized at their inception as either operating or capital leases depending on certain defined criteria. Although operating leases represent obligations for us, pursuant to SFAS No. 13 they are not reflected on the balance sheet. As of September 30, 2004, we have remaining obligations under operating leases for equipment and real estate of \$450 million. If we had applied to our operating leases the same convention used for capital leases, which, however, would not be in accordance with GAAP, we would have recorded approximately \$323 million of additional assets and obligations on our balance sheet at September 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:

	<u>Standby Letters of Credit (1)</u>	<u>Real Estate Leases (2)</u>	<u>Total</u>
		(in thousands)	
Balance at December 31, 2003 .....	\$ 60,799	\$25,936	\$ 86,735
Net change in collateral pledged .....	(12,758)	1,995	(10,763)
Balance at September 30, 2004 (3) .....	<u>\$ 48,041</u>	<u>\$27,931</u>	<u>\$ 75,972</u>

- (1) Pursuant to available standby letter-of-credit facilities totaling \$151 million.
- (2) At September 30, 2004, our market capitalization was \$16.6 billion. The required amount of collateral to be pledged increases \$6 million if our market capitalization is equal to or below \$13 billion, and decreases by \$5 million if our market capitalization exceeds \$18 billion.
- (3) Includes \$9 million of cash equivalents pledged as collateral. See “Note 2 — Cash, Cash Equivalents, and Marketable Securities.”

### *Legal Proceedings*

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

**AMAZON.COM, INC.**

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

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

Beginning in March 2003, we were served with complaints filed in several different states 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, Sovereign 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 Sovereign purporting to cover "Internet Server Access Control and Monitoring Systems" (U.S. Patent No. 5,708,780) and "Network Sales Systems" (U.S. Patent Nos. 5,715,314 and 5,909,492) and seeks injunctive relief, monetary damages in an amount no less than a reasonable royalty, treble damages for alleged willful infringement, prejudgment interest, and attorneys' fees. On October 6, 2004, Sovereign filed an amended complaint alleging that we infringe two additional patents purporting to cover "Digital Active Advertising" (U.S. Patent No. 6,195,649) and an "Open Network Payment System for Providing Real-Time Authorization of Payment and Purchase Transactions" (U.S. Patent No. 6,205,437). 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. On August 25, 2004, the Court entered a judgment in Amazon.com's favor on the grounds that the patent claims asserted by the plaintiff were invalid and that Amazon.com's technology did not infringe those claims in any event. The Court also awarded Amazon.com its attorneys' fees and costs. Plaintiff is appealing that judgment.



**AMAZON.COM, INC.**

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

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

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

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

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:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(in thousands)</b>			
Net income (loss) .....	\$54,147	\$15,563	\$241,763	\$(37,872)
Foreign currency translation gains (losses), net .....	(2,757)	8,174	686	21,537
Net unrealized gains (losses) on available-for-sale securities ...	1,273	2,457	(11,370)	(4,898)
Net activity of Euro Currency Swap (1) .....	450	422	1,328	10,460
Other comprehensive income (loss) .....	(1,034)	11,053	(9,356)	27,099
Comprehensive income (loss) .....	<u>\$53,113</u>	<u>\$26,616</u>	<u>\$232,407</u>	<u>\$(10,773)</u>

Accumulated balances within other comprehensive income were as follows:

	<b>September 30, 2004</b>	<b>December 31, 2003</b>
	<b>(in thousands)</b>	
Net unrealized gains on foreign currency translation .....	\$ 31,136	\$ 30,450
Net unrealized gains on available-for-sale securities .....	8,957	20,327
Net unrealized losses on Euro Currency Swap .....	(11,710)	(13,038)
Total accumulated other comprehensive income .....	<u>\$ 28,383</u>	<u>\$ 37,739</u>

AMAZON.COM, INC.

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

- (1) Due to the termination in 2003 of our currency swap to hedge a portion of our 6.875% PEACS (“Euro Currency Swap”), 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 \$0.3 million and \$0.8 million for the three months ended September 30, 2004 and 2003, and \$0.5 million and \$2.6 million for the nine months ended September 30, 2004 and 2003.

During the first and second quarters of 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 reduced our restructuring-related liability, resulting in a gain of \$8 million for the nine months ended September 30, 2004 (\$1 million in the first quarter and \$7 million in the second quarter). Lease payments for this office space are 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 nine months ended September 30, 2003.

As previously disclosed, we streamlined our organizational structure in France to reduce our operating costs. These efforts were primarily focused on eliminating French-office positions in managerial, professional, clerical and technical roles. The number of employees affected totaled 52 and severance terms were finalized in the third quarter of 2004 and will be paid in the fourth quarter of 2004. The corresponding costs of \$4 million were recorded in the third quarter of 2004 and classified in “Other operating expense (income)” on the consolidated statements of operations.

At September 30, 2004, the accrued liability associated with restructuring-related and other charges was \$21 million and consisted of the following:

	Balance at December 31, 2003	Subsequent Accruals (Credits), net	Payments	Balance at September 30, 2004	Due Within 12 Months (1)	Due After 12 Months (1)
	(in thousands)					
Lease obligations, net of estimated sublease income . . . . .	\$29,343	\$(8,160)	\$(4,801)	\$16,382	\$ 5,968	\$10,414
Termination benefits . . . . .	—	4,352	(450)	3,902	3,902	—
Broker commissions, professional fees and other miscellaneous restructuring costs . . . . .	1,197	82	(78)	1,201	865	336
Total restructuring-related liability . . . . .	<u>\$30,540</u>	<u>\$(3,726)</u>	<u>\$(5,329)</u>	<u>\$21,485</u>	<u>\$10,735</u>	<u>\$10,750</u>

- (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.

**AMAZON.COM, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
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Restructuring-related lease obligations are as follows:

	Three Months Ending December 31, 2004	2005	2006	2007	2008	Thereafter	Total
	(in thousands)						
Gross lease obligations . . . . .	\$1,605	\$10,197	\$ 6,155	\$ 6,158	\$ 5,319	\$11,742	\$ 41,176
Estimated sublease income (1) . . . . .	(742)	(3,204)	(4,156)	(4,197)	(3,705)	(8,790)	(24,794)
Estimated net lease obligations . . . . .	<u>\$ 863</u>	<u>\$ 6,993</u>	<u>\$ 1,999</u>	<u>\$ 1,961</u>	<u>\$ 1,614</u>	<u>\$ 2,952</u>	<u>\$ 16,382</u>

(1) At September 30, 2004, we had signed contractual sublease agreements covering \$13 million in future payments.

**Note 7 — Other Income (Expense), Net**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
Gains (losses) on sales of marketable securities, net . . . . .	\$ (220)	\$ 141	\$ 790	\$ 9,393
Foreign-currency transaction losses, net . . . . .	(685)	(1,021)	(1,990)	(1,189)
Foreign, state, and other income taxes (1) . . . . .	(2,692)	1,360	(6,086)	(1,338)
Other miscellaneous gains, net . . . . .	665	(228)	1,519	(70)
Total other income (expense), net . . . . .	<u>\$(2,932)</u>	<u>\$ 252</u>	<u>\$(5,767)</u>	<u>\$ 6,796</u>

(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 September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
Foreign-currency gains (losses) on remeasurement of 6.875% PEACS (1) . . . . .	\$(16,767)	\$(12,213)	\$11,627	\$(74,993)
Currency-related gains on sales of Euro-denominated investments, net . . . . .	4,100	—	9,469	5,827
Loss on redemption of long-term debt . . . . .	—	—	(5,672)	(15,176)
Loss on termination of Euro Currency Swap (2) . . . . .	—	—	—	(5,880)
Foreign-currency effect on intercompany balances (3) . . . . .	7,087	—	(3,328)	—
Other-than-temporary impairments and other (4) . . . . .	139	1,071	19,125	(3,370)
Total remeasurements and other . . . . .	<u>\$ (5,441)</u>	<u>\$(11,142)</u>	<u>\$31,221</u>	<u>\$(93,592)</u>

AMAZON.COM, INC.

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

- (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) Included in the nine months ended September 30, 2004, is a gain of \$14 million associated with the sale of one of our equity investments and a gain of \$6 million relating to the settlement of a contractual dispute. Included in the nine months ended September 30, 2003, is equity in losses of equity-method investees of less than \$1 million. There were no losses from equity method investees during the nine months ended September 30, 2004.

**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 is not allocated to segment results. All other centrally-incurred operating costs are fully allocated to segment results. A significant majority of our costs for “Technology and content” are incurred in the United States and most of these costs are allocated to our North America segment. There are no internal revenue transactions between our reporting segments.

***North America***

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

***International***

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

**AMAZON.COM, INC.**

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

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

**Three Months Ended September 30, 2004:**

	<u>North America</u>	<u>International</u> (in thousands)	<u>Consolidated</u>
Net sales . . . . .	\$816,088	\$646,387	\$1,462,475
Cost of sales . . . . .	<u>592,747</u>	<u>514,077</u>	<u>1,106,824</u>
Gross profit . . . . .	223,341	132,310	355,651
Direct segment operating expenses . . . . .	<u>165,901</u>	<u>94,697</u>	<u>260,598</u>
Segment operating income . . . . .	57,440	37,613	95,053
Stock-based compensation . . . . .			9,274
Other operating expense . . . . .			<u>4,505</u>
Income from operations . . . . .			81,274
Total non-operating expense, net . . . . .			<u>(27,127)</u>
Net income . . . . .			<u><u>\$ 54,147</u></u>

**Three Months Ended September 30, 2003:**

	<u>North America</u>	<u>International</u> (in thousands)	<u>Consolidated</u>
Net sales . . . . .	\$709,271	\$425,185	\$1,134,456
Cost of sales . . . . .	<u>508,150</u>	<u>340,485</u>	<u>848,635</u>
Gross profit . . . . .	201,121	84,700	285,821
Direct segment operating expenses . . . . .	<u>138,606</u>	<u>73,562</u>	<u>212,168</u>
Segment operating income . . . . .	62,515	11,138	73,653
Stock-based compensation . . . . .			20,936
Other operating expense . . . . .			<u>786</u>
Income from operations . . . . .			51,931
Total non-operating expense, net . . . . .			<u>(36,368)</u>
Net income . . . . .			<u><u>\$ 15,563</u></u>

**AMAZON.COM, INC.**

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

**Nine Months Ended September 30, 2004:**

	<u>North America</u>	<u>International</u> (in thousands)	<u>Consolidated</u>
Net sales .....	\$2,455,061	\$1,925,104	\$4,380,165
Cost of sales .....	1,786,133	1,536,501	3,322,634
Gross profit .....	668,928	388,603	1,057,531
Direct segment operating expenses .....	470,058	274,604	744,662
Segment operating income .....	198,870	113,999	312,869
Stock-based compensation .....			38,073
Other operating income .....			(3,187)
Income from operations .....			277,983
Total non-operating expense, net .....			(36,220)
Net income .....			<u>\$ 241,763</u>

**Nine Months Ended September 30, 2003:**

	<u>North America</u>	<u>International</u> (in thousands)	<u>Consolidated</u>
Net sales .....	\$2,116,506	\$1,201,421	\$3,317,927
Cost of sales .....	1,538,496	949,100	2,487,596
Gross profit .....	578,010	252,321	830,331
Direct segment operating expenses .....	409,236	212,793	622,029
Segment operating income .....	168,774	39,528	208,302
Stock-based compensation .....			72,712
Other operating expense .....			2,611
Income from operations .....			132,979
Total non-operating expense, net .....			(170,851)
Net loss .....			<u>\$ (37,872)</u>

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

### **Forward-Looking Statements**

*This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact, including statements regarding guidance, industry prospects or future results of operations or financial position, made in this Quarterly Report on Form 10-Q are forward-looking. We use words such as anticipates, believes, expects, future, intends, and similar expressions to identify forward-looking statements. Forward-looking statements reflect management's current expectations and are inherently uncertain. Actual results could differ materially for a variety of reasons, including, among others, fluctuations in foreign exchange rates, changes in global economic conditions and consumer spending, world events, the rate of growth of the Internet and online commerce, the amount that Amazon.com invests in new business opportunities and the timing of those investments, the mix of products sold to customers, the mix of net sales derived from products as compared with services, competition, management of growth, potential fluctuations in operating results, fulfillment center optimization, risks of inventory management, seasonality, the degree to which the Company enters into, maintains, and develops commercial agreements, acquisitions, and strategic transactions, 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.*

### **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 flow<sup>1</sup>. 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 income and efficiently managing working capital and capital expenditures. Increases in consolidated segment operating income 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 at the grant date recorded over the underlying service periods. Total shares outstanding plus outstanding stock awards are essentially unchanged as of September 30, 2004 compared to September 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*

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



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 flow<sup>2</sup>. On average, our high inventory velocity means we generally collect from our customers before our payments to suppliers come due. Inventory turnover<sup>3</sup> was 17 and 19 for the three months ended September 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 payable days<sup>4</sup> were 57 for the three months ended September 30, 2004 and 54 for the three months ended September 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 nine months ended September 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 create 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 the third quarter of 2004, variable accounting treatment resulted in a credit to our operating results of \$6 million due to a decline in the quoted price of our common stock. Comparisons to the prior year quarter and year-to-date periods show improvement in operating income of \$16 million and \$46 million resulting from the effect of changing stock prices on variable accounting treatment.*

*In addition, as our financial reporting currency is the U.S. Dollar, our total revenue, profit, and operating and free cash flow have 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 29% during the three months ended September 30, 2004 in comparison with the prior year, and holding currency exchange constant with the prior year our growth would have been 24%. 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."

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

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

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



## Critical Accounting Judgments

The preparation of financial statements in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require 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.

## 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 adjust the carrying amount of our inventories to lower of cost or market value. We provide fulfillment-related services in connection with certain of our Merchants@ and Merchant.com programs. In those arrangements, as well as other product sales by third parties, the third-party maintains ownership of the related products.

### ***Internal-Use Software***

Included in fixed assets is the cost of internal-use software and website development, including software used to upgrade and enhance our websites. We expense all costs related to the development of internal-use software other than those incurred during the application development stage. Costs incurred during the application development stage are capitalized and amortized over the estimated useful life of the software, generally two years.

For the three months ended September 30, 2004 and 2003, we capitalized \$12 million and \$9 million of costs associated with development of internal-use software, which is offset by amortization of previously capitalized amounts of \$8 million and \$6 million. For the nine months ended September 30, 2004 and 2003, we capitalized \$29 million and \$21 million, which was offset by amortization of previously capitalized amounts of \$22 million and \$17 million.

### ***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 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 accordance with SFAS No. 52, currency adjustments arising before the fourth quarter of 2003 continue to be included as a component of "Accumulated other comprehensive income" on our consolidated balance sheets. In association with the remeasurement of intercompany balances, we recorded a gain of \$7 million for the three months ended September 30, 2004, and a loss of \$3 million for the nine months ended September 30, 2004. Repayments among the entities made during the three months and nine months ended September 30, 2004 were \$57 million and \$192 million.

### ***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).”

### ***Purchase Accounting***

Accounting for acquisitions includes estimates for the fair value and useful lives of assets acquired and fair value of liabilities assumed.

### **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 \$1.18 billion at fair value at September 30, 2004 and \$1.39 billion at December 31, 2003. Amounts held in foreign currencies were \$693 million and \$764 million at September 30, 2004 and December 31, 2003. Amounts held in foreign currencies at September 30, 2004 and December 31, 2003 were primarily Euros, British Pounds, and Yen.

During the nine months ended September 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 \$420 million for the twelve months ended September 30, 2004 compared to \$239 million for the twelve months ended September 30, 2003, an increase of 76%. 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 \$117 million and \$37 million for the three months ended September 30, 2004 and 2003, and cash provided by operating activities was \$9 million for the nine months ended September 30, 2004 and cash used in operating activities was \$89 million for the nine months ended September 30, 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 September 30, 2004, payments to product merchandise suppliers, which does not include payments to transportation suppliers, totaled \$948 million, an increase of \$207 million over the same period in the prior 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, and take advantage of additional discounts offered to us by suppliers, and is also affected by foreign exchange rates.

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 \$85 million and \$252 million during the three and nine months ended September 30, 2004. This compares to cash used in investing activities of \$60 million and cash provided by investing activities of \$143 million during the three and nine months ended September 30, 2003. Our capital

expenditures, including internal-use software and website development, were \$29 million and \$52 million for the three and nine months ended September 30, 2004, and \$15 million and \$29 million for the three and nine months ended September 30, 2003. We expect capital expenditures to be \$85 million or less for 2004 and \$150 million or less for 2005. We believe our expenditures for repairs and improvements are sufficient to keep our facilities and equipment in suitable operating condition.

On September 7, 2004, we acquired all of the outstanding shares of Joyo.com at a purchase price of \$74.2 million, including a cash payment of \$72.4 million, the assumption of employee stock options, and transaction-related costs. Cash paid in connection with this acquisition is classified as cash provided by (used in) investing activities on our consolidated statements of cash flows. The operating results of Joyo.com did not have a significant effect on consolidated results in the third quarter of 2004, and are not expected to have a significant effect on consolidated results in the fourth quarter of 2004. See Item 1 of Part I, "Financial Statements — Note 1 — Accounting Policies — Business Acquisition."

Cash provided by financing activities was \$7 million during the three months ended September 30, 2004, and cash used in financing activities was \$114 million during the nine months ended September 30, 2004. This compares to cash provided by financing activities of \$38 million during the three months ended September 30, 2003 and cash used in financing activities of \$155 million during the nine months ended September 30, 2003. Cash inflows from financing activities primarily result from proceeds from exercises of employee stock options, which were \$8 million and \$43 million for the three and nine months ended September 30, 2004, and \$41 million and \$133 million for the three and nine months ended September 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 \$157 million for the three and nine months ended September 30, 2004, and \$3 million and \$288 million for the three and nine months ended September 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 September 30, 2004:

	Three Months Ending December 31, 2004	2005	2006	2007	2008	Thereafter	Total
	(in thousands)						
Operating and capital commitments:							
Debt principal and other (1) . . .	\$ 330	\$ 128	\$ 1,247	\$ 340	\$ 351	\$1,773,483	\$1,775,879
Debt interest (1) . . . . .	—	108,857	108,857	108,857	108,857	142,918	578,346
Capital leases . . . . .	385	1,178	420	20	—	—	2,003
Operating leases (2) . . . . .	14,857	57,040	59,876	51,596	49,307	217,483	450,159
Purchase obligations (3) . . . . .	288,238	—	—	—	—	—	288,238
Total operating and capital commitments . . . . .	303,810	167,203	170,400	160,813	158,515	2,133,884	3,094,625
Restructuring-related commitments:							
Operating leases, net of estimated sublease income (4) . . . . .	863	6,993	1,999	1,961	1,614	2,952	16,382
Other . . . . .	3,902	1,201	—	—	—	—	5,103
Total restructuring-related commitments . . . . .	4,765	8,194	1,999	1,961	1,614	2,952	21,485
Total commitments . . . . .	<u>\$308,575</u>	<u>\$175,397</u>	<u>\$172,399</u>	<u>\$162,774</u>	<u>\$160,129</u>	<u>\$2,136,836</u>	<u>\$3,116,110</u>

- (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 September 30, 2004, the Euro to U.S. Dollar exchange rate was 1.2436. 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 \$178 million as of September 30, 2004.
- (2) Pursuant to SFAS No. 13, *Accounting for Leases*, lease agreements are categorized at their inception as either operating or capital leases depending on certain defined criteria. Although operating leases represent obligations for us, pursuant to SFAS No. 13 they are not reflected on the balance sheet. As of September 30, 2004, we have remaining obligations under operating leases for equipment and real estate of \$450 million. If we had applied to our operating leases the same convention used for capital leases, which, however, would not be in accordance with GAAP, we would have recorded approximately \$323 million of additional assets and obligations on our balance sheet at September 30, 2004.
- (3) Consists of legally-binding commitments to purchase inventory. Legally-binding commitments associated with non-inventory purchases are not significant.
- (4) Net of an estimated \$25 million in sublease rentals. At September 30, 2004, we had signed sublease agreements totaling \$13 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 September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
Segment Operating Income:				
North America .....	\$57,440	\$62,515	\$198,870	\$168,774
International .....	37,613	11,138	113,999	39,528
Consolidated .....	<u>\$95,053</u>	<u>\$73,653</u>	<u>\$312,869</u>	<u>\$208,302</u>
Operating Income Growth Rate:				
North America .....	(8)%	137%	18%	73%
International .....	238	872	188	N/A
Consolidated .....	29	168	50	167
Segment Operating Margin:				
North America .....	7.0%	8.8%	8.1%	8.0%
International .....	5.8	2.6	5.9	3.3
Consolidated .....	6.5	6.5	7.1	6.3

Consolidated segment operating income increased \$21 million and \$105 million for the three months and nine months ended September 30, 2004 compared to the prior year periods. These increases result from revenue growth (offset partially by lower year-over-year gross margins) and year-over-year reductions in direct segment operating expenses relative to revenue.

North America segment operating income decreased \$5 million for the three months ended September 30, 2004 in comparison to the prior year. This decline generally results from a lower gross margin on increased revenues, as well as increases in our operating expenses at a rate higher than our increases in gross profit. North America segment operating income increased \$30 million for the nine months ended September 30, 2004 compared to the prior year period. This increase results primarily from growth in revenue while holding gross profit and direct segment operating expenses essentially flat relative to revenues. Increased acceptance of our free shipping offer contributed to increases of \$7 million and \$10 million in net shipping cost for the three months and nine months ended September 30, 2004 compared with the prior year periods.

International segment operating income increased \$26 million and \$74 million for the three months and nine months ended September 30, 2004, compared to prior year periods. For the three months ended September 30, 2004, the increase was due to an increase in gross margin and reductions in direct segment operating expenses relative to revenue. For the nine months ended September 30, 2004, the increase was primarily due to reductions in direct segment operating expenses relative to revenue, offset partially by a reduction in gross margin.

See our “Net Sales and Gross Profit,” and “Direct Segment Operating Expenses” sections below for further discussion of these results. See also Item 1 of Part I, “Financial Statements — Note 9 — Segment Information” for a reconciliation of consolidated segment operating income to “Net income.”

### ***Net Sales and Gross Profit***

Net sales information is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
Net Sales:				
North America				
Media . . . . .	\$ 563,595	\$ 502,271	\$1,704,084	\$1,518,581
Electronics and other general merchandise . . . .	228,626	180,418	678,864	526,002
Other . . . . .	23,867	26,582	72,113	71,923
Total North America . . . . .	<u>\$ 816,088</u>	<u>\$ 709,271</u>	<u>\$2,455,061</u>	<u>\$2,116,506</u>
International				
Media . . . . .	\$ 530,314	\$ 374,989	\$1,601,900	\$1,096,735
Electronics and other general merchandise . . . .	115,615	49,804	321,563	103,756
Other . . . . .	458	392	1,641	930
Total International . . . . .	<u>\$ 646,387</u>	<u>\$ 425,185</u>	<u>\$1,925,104</u>	<u>\$1,201,421</u>
Consolidated				
Media . . . . .	\$1,093,909	\$ 877,260	\$3,305,984	\$2,615,316
Electronics and other general merchandise . . . .	344,241	230,222	1,000,427	629,758
Other . . . . .	24,325	26,974	73,754	72,853
Total consolidated . . . . .	<u>\$1,462,475</u>	<u>\$1,134,456</u>	<u>\$4,380,165</u>	<u>\$3,317,927</u>

		Three Months Ended September 30,		Nine Months Ended September 30,	
		2004	2003	2004	2003
		(in thousands)			
Net Sales Growth Rate:					
North America					
Media	.....	12%	15%	12%	13%
Electronics and other general merchandise	.....	27	35	29	34
Other	.....	(10)	49	0	26
Total North America	.....	15	21	16	18
International					
Media	.....	41%	50%	46%	63%
Electronics and other general merchandise	.....	132	259	210	197
Other	.....	17	(31)	76	(41)
Total International	.....	52	61	60	69
Consolidated					
Media	.....	25%	28%	26%	30%
Electronics and other general merchandise	.....	50	56	59	48
Other	.....	(10)	46	1	24
Total consolidated	.....	29	33	32	32
Consolidated Net Sales Mix:					
Media	.....	75%	77%	75%	79%
Electronics and other general merchandise	.....	24	20	23	19
Other	.....	2	2	2	2
Total consolidated	.....	100%	100%	100%	100%
North America	.....	56%	63%	56%	64%
International	.....	44	37	44	36
Total 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. Net sales from “Other” consists of non-retail activities, such as our Merchant.com program and miscellaneous marketing and promotional activities.



Gross profit information is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
<b>Gross Profit:</b>				
North America .....	\$223,341	\$201,121	\$ 668,928	\$578,010
International .....	132,310	84,700	388,603	252,321
Consolidated .....	<u>\$355,651</u>	<u>\$285,821</u>	<u>\$1,057,531</u>	<u>\$830,331</u>
<b>Gross Profit Growth Rate:</b>				
North America .....	11%	30%	16%	16%
International .....	56	38	54	59
Consolidated .....	24	32	27	26
<b>Gross Margin:</b>				
North America .....	27.4%	28.4%	27.2%	27.3%
International .....	20.5	19.9	20.2	21.0
Consolidated .....	24.3	25.2	24.1	25.0

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, 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 indefinitely.

North America segment gross margins decreased slightly during the three months ended September 30, 2004 and were flat for the nine months ended September 30, 2004 compared to the same periods last year. The decline in North America gross margin during the three months ended September 30, 2004 primarily results from changes in product mix and price reductions, including our year-round free shipping offers, offset partially by increased sales volume by third-party sellers.

International segment gross margins increased slightly during the three months ended September 30, 2004 compared to the same period last year. This was primarily the result of increased third-party sales, offset partially by changes in product mix; price reductions; and the degree to which our customers accepted our free shipping offer in the U.K., including the effect of the lower threshold introduced in September 2004.

International segment gross margins decreased during the nine months ended September 30, 2004 compared to the same period last year. This was primarily the result of continuing efforts to reduce prices for customers, including through our free shipping offer in the U.K., offset partially by increased sales by third parties.

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***

Supplemental information about shipping results is as follows:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(in thousands)</b>			
Shipping Activity:				
Shipping revenue .....	\$ 86,538	\$ 76,630	\$ 264,256	\$ 234,910
Outbound shipping costs .....	(127,683)	(103,682)	(382,879)	(315,461)
Net shipping cost .....	<u>\$ (41,145)</u>	<u>\$ (27,052)</u>	<u>\$(118,623)</u>	<u>\$ (80,551)</u>

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.

### Direct Segment Operating Expenses

Selected operating expense information is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
<b>Segment Operating Expenses:</b>				
North America .....	\$165,901	\$138,606	\$470,058	\$409,236
International .....	94,697	73,562	274,604	212,793
Consolidated .....	<u>\$260,598</u>	<u>\$212,168</u>	<u>\$744,662</u>	<u>\$622,029</u>
<b>Percent of Net Sales:</b>				
North America .....	20.3%	19.5%	19.1%	19.3%
International .....	14.7	17.3	14.3	17.7
Consolidated .....	17.8	18.7	17.0	18.7
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
<b>Consolidated Segment Operating Expenses:</b>				
Fulfillment .....	\$135,521	\$107,057	\$385,943	\$318,217
Marketing .....	34,347	28,943	99,822	82,496
Technology and content .....	64,823	53,775	178,374	155,998
General and administrative .....	25,907	22,393	80,523	65,318
Total .....	<u>\$260,598</u>	<u>\$212,168</u>	<u>\$744,662</u>	<u>\$622,029</u>
<b>Percent of Net Sales:</b>				
Fulfillment .....	9.3%	9.4%	8.8%	9.6%
Marketing .....	2.3	2.6	2.3	2.5
Technology and content .....	4.4	4.7	4.1	4.7
General and administrative .....	1.8	2.0	1.8	2.0
Total .....	17.8	18.7	17.0	18.7
<b>Year-over-year Percentage Change:</b>				
Fulfillment .....	27%	19%	21%	20%
Marketing .....	19	8	21	(6)
Technology and content .....	21	2	14	(6)
General and administrative .....	16	20	23	11
Total .....	23	12	20	7

**Fulfillment:** The increase in fulfillment costs in comparison with the prior year relates to variable costs corresponding with sales volume, our mix of product sales, costs associated with credit card fees, and bad debt costs, including costs of our guarantee for certain third party seller transactions. The mix of product sales affects fulfillment costs per shipment based on variations in shape and weight of products we sell. Additionally, since credit card fees associated with third-party seller transactions are based on the gross purchase price of underlying transactions, and bad debt costs are higher as a percentage of revenue versus our retail sales, our increasing third-party sales result in increasing costs as a percent of net sales. Also, we began operations during the third quarter of 2004 of a new European fulfillment center in Scotland. The center is approximately 300,000 square feet and employs approximately 200 associates and will grow to employ approximately 300 associates over the next calendar year. Cost increases are partially offset by 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. We expect absolute amounts spent in fulfillment to increase over time.

**Marketing:** We direct customers to our websites primarily through a number of targeted online marketing channels, such as our Associates program, our Syndicated Stores program, portal advertising, e-mail campaigns, sponsored search, and other initiatives. Since our marketing expenses are largely variable, we expect absolute amounts spent in marketing to increase over time. To the extent there is increased or decreased competition for these traffic sources, or to the extent our mix of these channels shifts, we would expect to see a corresponding change in our marketing expense. While costs associated with free shipping are not included in marketing expense, we view free shipping as an effective worldwide marketing tool, and intend to continue offering it indefinitely.

**Technology and Content:** Our spending in technology and content has increased as we are adding computer scientists and software engineers to continue to enhance the customer experience on our websites and those websites powered by us, and improve our process efficiency. Additionally, we continue to invest in several areas of technology, including seller platform; A9.com, our wholly-owned subsidiary focused on search technology; web services; and additional development centers. We intend to continue investing in these and other initiatives and 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. A significant majority of these costs are incurred in the United States and most of them are allocated to our North America segment.

**General and Administrative:** The increase in spending in general and administrative is primarily due to increases in professional fees. We expect absolute dollars spent in general and administrative to increase over time.

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

Stock-based compensation was \$9 million and \$21 million for the three months ended September 30, 2004 and 2003, and \$38 million and \$73 million for the nine months ended September 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. In the third quarter of 2004, variable accounting treatment resulted in a credit to our operating results of \$6 million due to a decline in the quoted price of our common stock. Comparisons to the prior year quarter and year-to-date periods show improvement in operating income of \$16 million and \$46 million resulting from the effect of changing stock prices on variable accounting treatment.

At September 30, 2004, we had 27 million stock awards outstanding, including 20 million stock options with a \$12.90 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 September 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 \$0.3 million and \$0.8 million for the three months ended September 30, 2004 and 2003, and \$0.5 million and \$2.6 million for the nine months ended September 30, 2004 and 2003.

During the first and second quarters of 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 \$8 million in the nine months ended September 30, 2004 (\$1 million in the first quarter and \$7 million in the second quarter). Lease-related payments for this office space, which is approximately \$0.6 million per quarter, are 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 three quarters of 2003.

As previously disclosed, we streamlined our organizational structure in France to reduce our operating costs. These efforts were primarily focused on eliminating French office positions in managerial, professional, clerical, and technical roles. The number of employees affected totaled 52 and severance terms were finalized in the third quarter of 2004 and will be paid in the fourth quarter of 2004. The corresponding costs of \$4 million were recorded in the third quarter of 2004 and classified in “Other operating expense (income)” on the consolidated statements of operations.

Cash payments resulting from our January 2001 operational restructuring were \$2 million and \$3 million for the three months ended September 30, 2004 and 2003, and \$5 million and \$23 million for the nine months ended September 30, 2004 and 2003. Based on currently available information, we estimate the remaining restructuring-related cash outflows will be as follows:

	<u>Leases</u>	<u>Other</u>	<u>Total</u>
	<u>(in thousands)</u>		
Three months ending December 31, 2004 .....	\$ 863	\$3,902	\$ 4,765
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) .....	<u>\$16,382</u>	<u>\$5,103</u>	<u>\$21,485</u>

- (1) Cash flows are presented net of an estimated \$25 million in sublease rentals. At September 30, 2004, we had signed sublease agreements totaling \$13 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 \$81 million and \$52 million for the three months ended September 30, 2004 and 2003, and \$278 million and \$133 million for the nine months ended September 30, 2004 and 2003. The improvement in operating results in comparison with the prior year was attributable to increasing revenues and leveraging our direct cost structure relative to sales growth. Additionally, operating income improved from year-over-year reductions of \$16 million and \$46 million in stock-based compensation expense associated with variable accounting.

### ***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 September 30, 2004, our total long-term indebtedness was \$1.78 billion compared to \$2.08 billion a year ago. See Item 1 of Part I, “Financial Statements — Note 3 — Long-Term Debt and Other.”

### ***Other Income (Expense), Net***

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
Gains (losses) on sales of marketable securities, net	\$ (220)	\$ 141	\$ 790	\$ 9,393
Foreign-currency transaction losses, net	(685)	(1,021)	(1,990)	(1,189)
Foreign, state, and other income taxes	(2,692)	1,360	(6,086)	(1,338)
Other miscellaneous gains, net	665	(228)	1,519	(70)
Total other income (expense), net	<u>\$(2,932)</u>	<u>\$ 252</u>	<u>\$(5,767)</u>	<u>\$ 6,796</u>

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

Remeasurements and other consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(in thousands)			
Foreign-currency gains (losses) on remeasurement of 6.875% PEACS (1)	\$(16,767)	\$(12,213)	\$11,627	\$(74,993)
Currency-related gains on sales of Euro-denominated investments, net	4,100	—	9,469	5,827
Loss on redemption of long-term debt	—	—	(5,672)	(15,176)
Loss on termination of Euro Currency Swap (2)	—	—	—	(5,880)
Foreign-currency effect on intercompany balances (3)	7,087	—	(3,328)	—
Other-than-temporary impairments and other (4)	139	1,071	19,125	(3,370)
Total remeasurements and other	<u>\$ (5,441)</u>	<u>\$(11,142)</u>	<u>\$31,221</u>	<u>\$(93,592)</u>

- (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 gain or loss associated with the remeasurement of intercompany balances due to changes in foreign exchange rates. See “Note 1 — Accounting Policies.”
- (4) Included in the nine months ended September 30, 2004 is a gain of \$14 million associated with the sale of one of our equity investments and a gain of \$6 million relating to the settlement of a contractual dispute. Included in the nine months ended September 30, 2003 is equity in losses of equity-method investees of less than \$1 million. There were no losses from equity method investees in the nine months ended September 30, 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 September 30, 2004, we have recorded a net deferred tax asset of \$6 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.

At September 30, 2004, we have net operating loss carryforwards ("NOLs") of \$2.8 billion, primarily related to U.S. federal taxes. Utilization of NOLs, which begin to expire at various times starting in 2010, may be subject to certain limitations. Approximately \$1 billion of our NOLs are attributable to continuing operations and the related tax benefits, if realized, will be credited to results of operations for both financial reporting and tax reporting purposes. The remaining portion of approximately \$1.8 billion relates to tax deductible stock-based compensation in excess of amounts recognized for financial reporting purposes and the related tax benefits, if realized, will be credited to stockholders' equity rather than to results of operations for financial reporting purposes.

Additionally, we have approximately \$228 million of capital loss carryforwards that begin to expire in 2005.

### ***Net Income (Loss)***

Although we reported net income for the three months and nine months ended September 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 balances. 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. In the third quarter of 2004, variable accounting treatment resulted in a credit to our operating results of \$6 million due to a decline in the quoted price of our common stock. Comparisons to the prior year quarter and year-to-date periods show improvement in operating income of \$16 million and \$46 million resulting from the effect of changing stock prices on variable accounting treatment. Variable accounting has resulted in significant expense and contra-expense in past periods and will continue to be unpredictable going forward.

### ***Effect of Exchange Rates***

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(in thousands, except per share amounts)</b>			
Exchange-rate effect on (1):				
Net sales	\$56,746	\$ 29,140	\$190,856	\$134,785
Gross profit	11,662	5,941	38,514	29,184
Operating expenses	(7,309)	(4,653)	(23,469)	(21,099)
Operating income	4,353	1,288	15,045	8,085
Net interest expense and other	(1,306)	(2,314)	(4,137)	(5,601)
Remeasurements and other (2)	(5,580)	(12,213)	17,768	(69,166)
Net income (loss)	(2,533)	(13,239)	28,676	(66,682)
Diluted earnings (loss) per share	\$ (0.01)	\$ (0.03)	\$ 0.07	\$ (0.17)

- (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 1 of Part I, “Financial Statements — Note 8 — Remeasurements and Other.”

### ***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 that 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;
- Other operating expense (income); and
- Impairments of goodwill (if any)

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.

Our management believes that consolidated segment operating income (loss) is useful and meaningful to investors because consolidated segment operating income (loss), together with pro forma net income (loss), and



ratios based on them, are the primary measures of profitability that we use to manage and evaluate our business operations and overall financial performance. Our management evaluates consolidated segment operating income (loss) 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 and is currently immaterial; 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.

##### *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 nine months ended September 30, 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 (if any).

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 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 certain of our reporting periods 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 or cash payments for business acquisitions such as our third quarter 2004 acquisition of Joyo.com (see Item 1 of Part I, “Financial Statements — Note 1 — Accounting Policies”). Therefore, we believe it is important to view free cash flow as a complement to our entire consolidated statements of cash flows.

## Reconciliation Tables

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

	Three Months Ended September 30, 2004			Three Months Ended September 30, 2003		
	As Reported (1)	Adjustments	Pro Forma	As Reported (1)	Adjustments	Pro Forma
Net sales .....	\$1,462,475	\$ —	\$1,462,475	\$1,134,456	\$ —	\$1,134,456
Cost of sales .....	1,106,824	—	1,106,824	848,635	—	848,635
Gross profit .....	355,651	—	355,651	285,821	—	285,821
Operating expenses:						
Fulfillment .....	135,521	—	135,521	107,057	—	107,057
Marketing .....	34,347	—	34,347	28,943	—	28,943
Technology and content ...	64,823	—	64,823	53,775	—	53,775
General and administrative .....	25,907	—	25,907	22,393	—	22,393
Stock-based compensation .....	9,274	(9,274)	—	20,936	(20,936)	—
Other operating expense ..	4,505	(4,505)	—	786	(786)	—
Total operating expenses .....	274,377	(13,779)	260,598	233,890	(21,722)	212,168
Income from operations .....	81,274	13,779	95,053(2)	51,931	21,722	73,653(2)
Interest income .....	7,553	—	7,553	4,324	—	4,324
Interest expense .....	(26,307)	—	(26,307)	(29,802)	—	(29,802)
Other income (expense), net ...	(2,932)	—	(2,932)	252	—	252
Remeasurements and other ....	(5,441)	5,441	—	(11,142)	11,142	—
Total non-operating expense, net .....	(27,127)	5,441	(21,686)	(36,368)	11,142	(25,226)
Net income .....	\$ 54,147	\$ 19,220	\$ 73,367	\$ 15,563	\$ 32,864	\$ 48,427
Basic earnings per share .....	\$ 0.13	\$ 0.05	\$ 0.18	\$ 0.04	\$ 0.08	\$ 0.12
Diluted earnings per share .....	\$ 0.13	\$ 0.04	\$ 0.17	\$ 0.04	\$ 0.07	\$ 0.11
Weighted average shares used in computation of earnings per share:						
Basic .....	406,647		406,647	397,912		397,912
Diluted .....	424,777		424,777	422,802		422,802
Net cash provided by operating activities .....			\$ 116,645			\$ 36,817
Purchases of fixed assets, including internal-use software and website development .....			(28,722)			(15,192)
Free cash flow .....			\$ 87,923			\$ 21,625
Net cash used in investing activities .....			\$ (85,481)			\$ (60,012)
Net cash provided by financing activities .....			\$ 7,177			\$ 37,798

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

(2) Consolidated segment operating income.

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

	Nine Months Ended September 30, 2004			Nine Months Ended September 30, 2003		
	As Reported (1)	Adjustments	Pro Forma	As Reported (1)	Adjustments	Pro Forma
Net sales .....	\$4,380,165	\$ —	\$4,380,165	\$3,317,927	\$ —	\$3,317,927
Cost of sales .....	3,322,634	—	3,322,634	2,487,596	—	2,487,596
Gross profit .....	1,057,531	—	1,057,531	830,331	—	830,331
Operating expenses:						
Fulfillment .....	385,943	—	385,943	318,217	—	318,217
Marketing .....	99,822	—	99,822	82,496	—	82,496
Technology and content ...	178,374	—	178,374	155,998	—	155,998
General and administrative .....	80,523	—	80,523	65,318	—	65,318
Stock-based compensation .....	38,073	(38,073)	—	72,712	(72,712)	—
Other operating expense (income) .....	(3,187)	3,187	—	2,611	(2,611)	—
Total operating expenses .....	779,548	(34,886)	744,662	697,352	(75,323)	622,029
Income from operations .....	277,983	34,886	312,869(2)	132,979	75,323	208,302(2)
Interest income .....	18,419	—	18,419	16,625	—	16,625
Interest expense .....	(80,093)	—	(80,093)	(100,680)	—	(100,680)
Other income (expense), net ...	(5,767)	—	(5,767)	6,796	—	6,796
Remeasurements and other ....	31,221	(31,221)	—	(93,592)	93,592	—
Total non-operating expense, net .....	(36,220)	(31,221)	(67,441)	(170,851)	93,592	(77,259)
Net income (loss) .....	\$ 241,763	\$ 3,665	\$ 245,428	\$ (37,872)	\$168,915	\$ 131,043
Basic earnings (loss) per share .....	\$ 0.60	\$ 0.01	\$ 0.61	\$ (0.10)	\$ 0.43	\$ 0.33
Diluted earnings (loss) per share .....	\$ 0.57	\$ 0.01	\$ 0.58	\$ (0.10)	\$ 0.41	\$ 0.31
Weighted average shares used in computation of earnings (loss) per share:						
Basic .....	405,153		405,153	393,477		393,477
Diluted .....	423,924		423,924	393,477		418,359
Net cash provided by (used in) operating activities .....			\$ 8,993			\$ (88,941)
Purchases of fixed assets, including internal-use software and website development .....			(52,378)			(28,727)
Free cash flow .....			\$ (43,385)			\$ (117,668)
Net cash provided by (used in) investing activities .....			\$ (252,194)			\$ 143,162
Net cash used in financing activities .....			\$ (114,224)			\$ (154,744)

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

(2) Consolidated segment operating income.

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 September 30, 2004 and 2003 (in thousands):

	Twelve Months Ended	
	September 30, 2004	September 30, 2003
Net cash provided by operating activities .....	\$ 489,956	\$283,638
Purchases of fixed assets, including internal-use software and website development .....	(69,614)	(44,243)
Free cash flow .....	<u>\$ 420,342</u>	<u>\$239,395</u>
Net cash provided by (used in) investing activities .....	<u>\$(158,705)</u>	<u>\$106,883</u>
Net cash used in financing activities .....	<u>\$(291,466)</u>	<u>\$(92,042)</u>

## Guidance

Consistent with our October 21, 2004 earnings release furnished on Form 8-K and as of the date of this filing, our fourth quarter and full year 2004 guidance and full year 2005 expectations are as follows:

### Fourth Quarter 2004 Guidance

- Net sales are expected to be between \$2.295 billion and \$2.545 billion, or grow between 18% and 31%, compared with fourth quarter 2003.
- Consolidated segment operating income is expected to be between \$162 million and \$222 million, or grow between 6% and 45%, compared with fourth quarter 2003.
- Operating income is expected to be between \$137 million and \$197 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 \$40.86 on September 30, 2004.

### Full Year 2004 Guidance

- Net sales are expected to be between \$6.675 billion and \$6.925 billion, or grow between 27% and 32%, compared with 2003.
- Consolidated segment operating income is expected to be between \$475 million and \$535 million, or grow between 31% and 48%, compared with 2003.
- Operating income is expected to be between \$415 million and \$475 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 \$40.86 on September 30, 2004.

### Full Year 2005 Expectations

- Net sales are expected to be between \$7.40 billion and \$8.15 billion.
- Consolidated segment operating income is expected to be between \$500 million and \$625 million.
- Operating income is expected to be between \$400 million and \$525 million, excluding any impact from SFAS No. 123R, and 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, 2005, is identical to the closing price of \$40.86 on September 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 September 30, 2004, we had an accumulated deficit of \$2.73 billion and our stockholders' deficit was \$721 million. We have incurred substantial operating losses since our inception, and although we earned net income in the three and nine months ended September 30, 2004, we may incur losses again in the future.

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

As of September 30, 2004, we had long-term indebtedness of \$1.78 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 Growth Will Place a Significant Strain on our Management, Operational and Financial Resources***

We are rapidly and significantly expanding our operations both domestically and internationally and will continue to expand further to pursue growth of our product and service offerings and customer base. Such growth

increases the complexity of our business and places a significant strain on our management, operations, and financial resources, and there can be no assurance that we will be able to manage it effectively. Our current and planned personnel, systems, procedures, and controls may not be adequate to support and effectively manage our future operations, especially as we employ personnel in multiple geographic locations. We may not be able to hire, train, retain, motivate, and manage required personnel, which may limit our growth.

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

If any of this were to occur, it could damage our reputation, limit our growth, negatively affect our operating results and harm our business.

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

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

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.

***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 most of our internationally-focused websites are fulfilled primarily from a single fulfillment center, and we have only a limited ability to reroute orders to third parties for drop-shipping. We and our co-sourcers may be unable to adequately staff our fulfillment and customer service centers. As we continue to add fulfillment capability, operating our fulfillment network becomes more challenging and there can be no assurance that we will be able to operate our network effectively. 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.

***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 most 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.

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

We may enter into commercial agreements, strategic alliances, and other business relationships with other companies. We have entered into agreements to provide e-commerce services to other businesses and we plan to enter into similar agreements in the future, including as part of our Merchants@, Syndicated Stores, and Merchant.com initiatives. Under such agreements, we may perform services such as: providing our technology services such as search, browse, and personalization; permitting other businesses and individuals to offer products or services through our websites; and powering third-party websites, either with or without providing accompanying fulfillment services. These arrangements are complex and require substantial personnel and resource commitments by us, which may constrain the number of such agreements we are able to enter into and may affect our ability to integrate and deliver services under the relevant agreements. If we fail to implement, maintain, and develop successfully the various components of such commercial relationships, which may include fulfillment, customer service, inventory management, tax collection, payment processing, licensing of third party software, hardware, and content, and engaging third parties to perform hosting and other services, these initiatives may not be viable. The amount of compensation we receive under certain of these agreements is 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 our commercial agreements or encounter other parties that have difficulty meeting their contractual obligations to us, which could adversely affect our operating results. As an example, we are currently in litigation with Toysrus.com over our commercial agreement, and Toyus.com's parent, Toysrus, Inc., has experienced financial difficulties and announced that it may sell its toy business. In the event of the early termination of our commercial agreement with Toysrus.com, we would attempt to replace the product selection currently provided by Toysrus.com with owned inventory and offerings from other parties, but our revenues and gross margins could be negatively impacted.

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

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

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

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

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

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

***Our Recent Acquisition of Joyo.com Creates Risks and Uncertainties Relating to the Laws of the PRC***

In September, 2004, we acquired Joyo.com, a company organized under the laws of the British Virgin Islands. Joyo.com operates [www.joyo.com](http://www.joyo.com) and [www.joyo.com.cn](http://www.joyo.com.cn) in the PRC in cooperation with a PRC subsidiary and PRC affiliates and is subject to many of the risks described in "Our Business Could Suffer if We are Unsuccessful in Making, Integrating, and Maintaining Acquisitions and Investments" and "We May Not Be Successful in Our Efforts to Expand into International Market Segments." In addition, the PRC regulates

Joyo.com's business through regulations and license requirements restricting (i) the scope of foreign investment in the Internet, retail and delivery sectors, (ii) Internet content and (iii) the sale of certain media products. In order to meet the PRC local ownership and regulatory licensing requirements, Joyo.com's business is operated through a PRC subsidiary which acts in cooperation with PRC companies owned by nominee shareholders who are PRC nationals. Although we believe Joyo.com's structure complies with existing PRC laws, it involves unique risks. There are substantial uncertainties regarding the interpretation of PRC laws and regulations, and it is possible that the PRC government will ultimately take a view contrary to ours. If Joyo.com or its subsidiary or affiliates were found to be in violation of any existing or future PRC laws or regulations or if interpretations of those laws and regulations were to change, the business could be subject to fines and other financial penalties, have its licenses revoked or be forced to shut down entirely. In addition, if Joyo.com were unable to enforce its contractual relationships with respect to management and control of its business, it might be unable to continue to operate the business.

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

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

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

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

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

In the past, we amended several of our commercial agreements to reduce future cash proceeds to be received by us, shorten the term of our commercial agreements, or both. We may in the future enter into further amendments of our commercial agreements. Although these amendments did not affect the amount of unearned revenue previously recorded by us (if any), the timing of revenue recognition of these recorded unearned amounts 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 September 30, 2004, our recorded basis in equity securities was \$20 million, including \$8 million classified as “Marketable securities” and \$12 million classified as “Other assets.”

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

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

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

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

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

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

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

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

- foreign exchange rate fluctuations;
- local economic and political conditions;
- restrictive governmental actions (such as trade protection measures, including export duties and quotas and custom duties and tariffs) and restrictions on the level of foreign ownership;
- restrictions on sales of certain products or services and uncertainty regarding our liability for the products or services we offer and content provided by us or our users, including uncertainty as a result

of less Internet-friendly legal systems, local laws, lack of legal precedent, and varying rules, regulations, and practices regarding the distribution of media products and enforcement of intellectual property rights;

- import, export or other business licensing requirements;
- limitations on the repatriation of funds and foreign currency exchange restrictions;
- difficulty in obtaining distribution and support;
- nationalization or restrictions on foreign ownership;
- longer receivable cycles;
- consumer and data 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 staffing, developing and managing a number of unique foreign operations as a result of distance, language and cultural differences;
- different employee/employer relationships and the existence of workers' councils and labor unions;
- laws and policies of the U.S. and other jurisdictions affecting trade, foreign investment, and loans;
- tax and other laws of the U.S. and other jurisdictions; and
- geopolitical events, including war and terrorism.

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

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

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

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

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

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

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

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

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



- changes in financial estimates by us or securities analysts and recommendations by securities analysts;
- 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 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 subject to VAT that are ordered on [www.amazon.co.uk](http://www.amazon.co.uk), [www.amazon.de](http://www.amazon.de), and [www.amazon.fr](http://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](http://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](http://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 businesses and individuals also sell products using our e-commerce platform that may increase our exposure to product liability claims, such as if these sellers do not have sufficient resources to protect themselves from such claims. Although we maintain liability insurance, we cannot be certain that our coverage will be adequate for liabilities actually incurred or that insurance will continue to be available to us on economically reasonable terms, or at all. In addition, some of our vendor agreements with our distributors, manufacturers, and third party sellers do not indemnify us from product liability.

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

Consumer use of the Internet as a medium for commerce is subject to uncertainty. While the number of Internet users has been rising, the Internet infrastructure may not expand fast enough to meet the increased levels of demand. 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 could 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@, 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.

### ***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 September 30, 2004, we had long-term debt of \$1.78 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 \$859 million and \$870 million at September 30, 2004 and December 31, 2003, and the fair value of the 4.75% Convertible Subordinated Notes was \$897 million (outstanding principal of \$900 million) and \$1.06 billion (outstanding principal of \$1.05 billion) at September 30, 2004 and December 31, 2003.

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

During the three months ended September 30, 2004, net sales from our International segment (consisting of, [www.amazon.co.uk](http://www.amazon.co.uk), [www.amazon.de](http://www.amazon.de), [www.amazon.fr](http://www.amazon.fr), [www.amazon.co.jp](http://www.amazon.co.jp), and [www.joyo.com](http://www.joyo.com)) accounted for

44% of our 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, Canadian Dollars, and Chinese Yuan. 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 September 30, 2004, International segment revenues improved \$56 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 September 30, 2004 of \$693 million, an assumed 5%, 10%, and 20% negative currency movement would result in fair value declines of \$35 million, \$69 million, and \$139 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 (\$858 million, based on the exchange rate as of September 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 \$43 million, \$86 million, and \$172 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 September 30, 2004, our recorded basis in equity securities was \$20 million, including \$8 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 September 30, 2004 of \$58 million (recorded basis of \$14 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 \$9 million, \$17 million, and \$29 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” of this Quarterly Report on Form 10-Q.

### **Item 2. *Unregistered Sales of 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***

None.

### **Item 5. *Other Information***

None.

**Item 6. Exhibits***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.

## 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: October 21, 2004



## EXHIBIT INDEX

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## COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES

	Nine Months Ended September 30, 2004	Year Ended December 31,			
		2003	2002	2001	2000
		(in thousands)			
Net income (loss) . . . . .	\$241,763	\$ 35,282	\$(149,132)	\$(567,277)	\$(1,411,273)
Equity in losses of equity-method investees . . . . .	—	436	4,169	30,327	304,596
Net income (loss) before equity in losses of equity-method investees . . . . .	241,763	35,718	(144,963)	(536,950)	(1,106,677)
Plus fixed charges:					
Interest expense including amortization of debt issuance costs . . . . .	80,093	129,979	142,925	139,232	130,921
Assumed interest element included in rent expense . . . . .	4,546	5,718	6,205	8,880	10,773
	84,639	135,697	149,130	148,112	141,694
Adjusted earnings (loss) . . . . .	326,402	171,415	4,167	(388,838)	(964,983)
Fixed charges . . . . .	(84,639)	(135,697)	(149,130)	(148,112)	(141,694)
Excess (deficiency) in earnings to cover fixed charges . . . . .	\$241,763	\$ 35,718	\$(144,963)	\$(536,950)	\$(1,106,677)
Ratio of earnings to fixed charges (1) . . . . .	3.86	1.26	0.03	(2.63)	(6.81)

- (1) The ratio of earnings to fixed charges is computed by dividing (i) income (loss) before income taxes and losses from equity interests, plus fixed charges by (ii) fixed charges.

## CERTIFICATIONS

I, Jeffrey P. Bezos, certify that:

1. I have reviewed this Form 10-Q of Amazon.com, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ JEFFREY P. BEZOS

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

Date: October 21, 2004

## CERTIFICATIONS

I, Thomas J. Szkutak, certify that:

1. I have reviewed this Form 10-Q of Amazon.com, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ THOMAS J. SZKUTAK

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

Date: October 21, 2004

**Certification Pursuant to 18 U.S.C. Section 1350**

In connection with the Quarterly Report of Amazon.com, Inc. (the “Company”) on Form 10-Q for the period ended September 30, 2004 as filed with the Securities and Exchange Commission (“SEC”) on or about the date hereof (the “Report”), I, Jeffrey P. Bezos, Chairman and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement has been provided to the Company and will be retained by the Company and furnished to the SEC or its staff upon request.

/s/ JEFFREY P. BEZOS

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

Date: October 21, 2004

**Certification Pursuant to 18 U.S.C. Section 1350**

In connection with the Quarterly Report of Amazon.com, Inc. (the “Company”) on Form 10-Q for the period ended September 30, 2004 as filed with the Securities and Exchange Commission (the “SEC”) on or about the date hereof (the “Report”), I, Thomas J. Szkutak, Senior Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement has been provided to the Company and will be retained by the Company and furnished to the SEC or its staff upon request.

/s/ THOMAS J. SZKUTAK

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

Date: October 21, 2004