Shareholder Letters: Accounting Themes

GAAP earnings vs. cash flows

Amazon letters: 1997, 2001

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What the Letter Says

> *“When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we’ll take the cash flows.”*
>
> Jeffrey P. Bezos, 1997 letter

- Key letters: 1997, 2001
- Course fit: ACC250 Ch1, Ch3 · ACC531 — · Difficulty: Intro

Step 1: Two Ways to Keep Score

- **Accrual basis** (GAAP): record revenue when **earned** and expenses when **incurred**.
- **Cash basis**: record only when cash comes in or goes out.
- Net income (accrual) and the change in cash are usually **different numbers**.

Step 2: Revenue Earned, No Cash Yet

EX. Sell $80 of goods on account on Dec 20; the customer pays on Jan 15.

Dec 20:	A/R (+A)	80	
	Sales Rev (+R)		80

	December	January
Revenue recorded	$80	$0
Cash collected	$0	$80

Step 3: Cash Paid, Expense Later

EX. Pay $60 cash for equipment with a 3-year life (no salvage value).

Jan 1:	PPE (+A)	60	
	Cash (−A)		60
Dec 31:	Depreciation Expense (+E)	20	
	Accumulated Depreciation (+xA, −A)		20

Year 1	Amount
Cash paid	$60
Expense recorded	$20

Step 4: From Net Income to Cash

EX. Net income $25; depreciation $40; paid $60 cash for new equipment.

	Amount
Net income	$25
+ Depreciation (expense, no cash this year)	40
− Cash paid for equipment (no expense this year)	(60)
Change in cash	$5

Back to the Letter

- Bezos (1997): if a choice makes GAAP earnings **look** better but lowers future cash flows, Amazon takes the **cash flows**.
- Bezos (2001): a share of stock is a share of the company's **future cash flows**.
- Lesson: read net income **and** the cash flow statement.

Questions

1. Net income is $25 million. The company recorded $40 million of depreciation and paid $60 million in cash for new equipment. Ignoring everything else, by how much did cash change ($ millions; use a minus sign for a decrease)?
2. Why can GAAP net income differ from the cash a company generates?

   A. GAAP ignores revenue earned on account

   B. Net income always equals cash flow

   C. Cash flows include only income taxes

   D. Accrual accounting records revenues when earned and expenses when incurred, not when cash is received or paid

Sources

- Jeffrey P. Bezos, 1997 letter (ir.aboutamazon.com)
- Jeffrey P. Bezos, 2001 letter (ir.aboutamazon.com)
- Reading packet and question sheet for this theme

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