Shareholder Letters: Accounting Themes

Growing earnings, negative free cash flow

Amazon letters: 2004

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What the Letter Says

> *"Though some may find it counterintuitive, a company can actually impair shareholder value in certain circumstances by growing earnings."*
>
> Jeffrey P. Bezos, 2004 letter

- Key letters: 2004
- Course fit: ACC250 Ch9 · ACC531 Analytics · Difficulty: Intermediate

Step 1: Earnings Double Every Year

Bezos's example: a business buys machines to grow ($ thousands).

	Year 1	Year 2	Year 3	Year 4
Sales	100,000	200,000	400,000	800,000
Depreciation	(40,000)	(80,000)	(160,000)	(320,000)
Earnings	10,000	20,000	40,000	80,000

- Earnings growth: 100% a year. Investors would be delighted.

Step 2: Add Back Depreciation

	Year 1	Year 2	Year 3	Year 4
Earnings	10,000	20,000	40,000	80,000
+ Depreciation	40,000	80,000	160,000	320,000
Operating cash flow	50,000	100,000	200,000	400,000

- No change in working capital in the example, so operating cash flow = earnings + depreciation.

Step 3: Subtract Capital Expenditures

	Year 1	Year 2	Year 3	Year 4
Operating cash flow	50,000	100,000	200,000	400,000
− Capital expenditures	(160,000)	(160,000)	(320,000)	(640,000)
Free cash flow	(110,000)	(60,000)	(120,000)	(240,000)

- New machines are paid for **up front**; their cost reaches earnings only slowly.

Back to the Letter

- Bezos (2004): a company can hurt shareholder value **by growing earnings**.
- Same example with EBITDA: $50, $100, $200, $400 million → “EBITDA isn’t cash flow.”
- Over four years the business has negative free cash flow of $530 million.

Questions

1. In Bezos's example (in thousands), Year 1 earnings are $10,000, depreciation is $40,000 and there is no working capital change. Capital expenditures are $160,000. What is free cash flow (operating cash flow – capital expenditures; use a minus sign if negative)?
2. In the example, earnings double every year while free cash flow is negative every year. Why?

   A. Revenue is recorded before it is earned

   B. Depreciation is paid in cash each year

   C. The business pays no income taxes

   D. The business pays cash for new machines up front, more than its operating cash flow, while depreciation spreads their cost over many years

Sources

- Jeffrey P. Bezos, 2004 letter (ir.aboutamazon.com)
- Reading packet and question sheet for this theme

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