Shareholder Letters: Accounting Themes

Fixed costs and operating leverage

Amazon letters: 2002, 2001

Jaeyoon Yu, Ph.D.
Central Michigan University

What the Letter Says

> *"With customer experience costs largely fixed (more like a publishing model than a retailing model), our costs as a percentage of sales can shrink rapidly as we grow our business."*
>
> Jeffrey P. Bezos, 2002 letter

- Key letters: 2002, 2001
- Course fit: ACC250 Ch3 · ACC531 Analytics · Difficulty: Intermediate

Step 1: Fixed vs. Variable Costs

- **Variable costs** rise with sales (cost of goods sold, shipping).
- **Fixed costs** stay the same when sales change (software, a website, headquarters).

EX. Variable costs: 60% of sales. Fixed costs: $100.

Step 2: Double the Sales

	Before	After
Sales	$500	$1,000
− Variable costs (60%)	(300)	(600)
− Fixed costs	(100)	(100)
Operating income	$100	$300

- Sales ×2, operating income ×3: **operating leverage**.

Step 3: Fixed Costs as a Percent of Sales

	Before	After
Fixed costs	$100	$100
Sales	$500	$1,000
Fixed costs ÷ sales	20%	10%

- Works in reverse too: when sales fall, operating income falls faster.

Back to the Letter

- Bezos (2002): customer-experience costs are largely fixed, “more like a publishing model than a retailing model.”
- Bezos (2001): growth spreads fixed costs across more sales → lower cost per unit → lower prices.

Questions

1. Fixed costs are $100 million. Sales grow from $500 million to $1,000 million and fixed costs stay the same. Fixed costs as a percent of sales fall from 20% to what percent?
2. When most of a company's costs are fixed, as sales grow...

   A. operating income grows slower than sales

   B. costs grow faster than sales

   C. the operating margin falls

   D. operating income grows faster than sales

Sources

- Jeffrey P. Bezos, 2002 letter (ir.aboutamazon.com)
- Jeffrey P. Bezos, 2001 letter (ir.aboutamazon.com)
- Reading packet and question sheet for this theme

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