Growing earnings, negative free cash flow

Amazon letters: 2004 · Difficulty: Intermediate

> *“Though some may find it counterintuitive, a company can actually impair shareholder value in certain circumstances by growing earnings.” (2004)*

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

Source: Jeffrey P. Bezos, Letters to Amazon.com Shareholders: 2004 (ir.aboutamazon.com). Quotation © Amazon.com, Inc., all rights reserved; reproduced in part for non-commercial teaching. Numbers in the questions are made up unless stated.