GAAP earnings vs. cash flows

Amazon letters: 1997, 2001 · Difficulty: Intro

Summary

Accrual (GAAP) accounting records revenues when they are earned and expenses when they are incurred, so net income and cash flow can differ a lot. In his first letter, Bezos told shareholders that when the two conflict, Amazon would choose what maximizes future **cash flows** over what makes its **GAAP earnings** look better. In 2001 he explained why: a share of stock is worth the company's future cash flows.

1997 letter

We will continue to learn from both our successes and our failures. • We will make bold rather than timid investment decisions where we see a sufficient probability of gaining market leadership advantages. Some of these investments will pay off, others will not, and we will have learned another valuable lesson in either case. • 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. • We will share our strategic thought processes with you when we make bold choices (to the extent competitive pressures allow), so that you may evaluate for yourselves whether we are making rational long-term leadership investments. • We will work hard to spend wisely and maintain our lean culture. We understand the importance of continually reinforcing a cost-conscious culture, particularly in a business incurring net losses. • We will balance our focus on growth with emphasis on long-term profitability and capital management.

2001 letter

I think we have. In that 1997 letter, we wrote, "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." Why focus on cash flows? Because a share of stock is a share of a company's future cash flows, and, as a result, cash flows more than any other single variable seem to do the best job of explaining a company's stock price over the long term. If you could know for certain just two things--a company's future cash flows and its future number of shares outstanding--you would have an excellent idea of the fair value of a share of that company's stock today.

(You'd also need to know appropriate discount rates, but if you knew the future cash flows for certain, it would also be reasonably easy to know which discount rates to use.) It's not easy, but you can make an informed forecast of future cash flows by examining a company's performance in the past and by looking at factors such as the leverage points and scalability in that company's model. Estimating the number of shares outstanding in the future requires you to forecast items such as option grants to employees or other potential capital transactions. Ultimately, your determination of cash flow per share will be a strong indicator of the price you might be willing to pay for a share of ownership in any company. Since we expect to keep our fixed costs largely fixed, even at significantly higher unit volumes, we believe Amazon.com is poised over the coming years to generate meaningful, sustained, free cash flow.

Our goal for 2002 reflects just that. As we said in January when we reported our fourth quarter results, we plan this year to generate positive operating cash flow, leading to free cash flow (the difference between the two is up to $75 million of planned capital expenditures). Our trailing twelve-month pro forma net income should, roughly but not perfectly, trend like trailing twelve-month cash flow. Limiting share count means more cash flow per share and more long-term value for owners.

Our current objective is to target net dilution from employee stock options (grants net of cancellations) to an average of 3% per year over the next five years, although in any given year it might be higher or lower. Relentless commitment to long-term shareholder value As I've discussed many times before, we are firm believers that the long-term interests of shareholders are tightly linked to the interests of our customers: if we do our jobs right, today's customers will buy more tomorrow, we'll add more customers in the process, and it will all add up to more cash flow and more long-term value

for our shareholders. To that end, we are committed to extending our leadership in e-commerce in a way that benefits customers and therefore, inherently, investors--you can't do one without the other.

Source: Jeffrey P. Bezos, Letters to Amazon.com Shareholders: 1997, 2001 (ir.aboutamazon.com). Excerpts © Amazon.com, Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Amazon.com, Inc.