

## Amazon.com

**Business Model:** Amazon started off as an online bookseller and later expanded its product offerings to include music, DVDs, videos, toys electronics, software, videogames, home improvement products etc. The Company purchases products from a network of manufacturers/publishers. For the orders that cannot be fulfilled through inventory, the company has a proprietary software that fulfils orders via electronic interfaces and in some cases forwards the order to special order groups.

### Features:

1. Amazon had its own distribution centres to have more control over the distribution system and thus facilitate reliable and timely delivery to its customers.
2. Fulfilment costs represent – operating and staffing the distribution and customer service centres.
3. Operating and staffing costs shown as Marketing and Sales Costs

1. **Prior to reclassification of fulfilment costs** as a part of costs of sales instead of Marketing & Selling Expenses, the Income statements of Amazon are as follows :

|  | 1999            | 1998            | 1997           |
|--|-----------------|-----------------|----------------|
| <b>Net Sales</b>                                 | \$1639839       | \$609819        | \$147787       |
| <b>Cost of sales</b>                             | \$1349194       | \$476155        | \$118969       |
| <b>Gross Profit</b>                              | <b>\$290645</b> | <b>\$133664</b> | <b>\$28818</b> |
| <b>Operating expenses:</b>                       |                 |                 |                |
| <b>Marketing and Sales</b>                       | \$413150        | \$132654        | \$40077        |
| <b>Loss after marketing &amp; Sales expenses</b> | \$ (122505)     | \$1010          | \$ (11259)     |

**Post Reclassification of fulfilment** costs as a part of costs of sales instead of Marketing & Selling Expenses; the Income statements of Amazon are as follows:

|                  | 1999      | 1998     | 1997     |
|------------------|-----------|----------|----------|
| <b>Net Sales</b> | \$1639839 | \$609819 | \$147787 |

|  |                 |                |                |
|--|-----------------|----------------|----------------|
| <b>Cost of sales</b>                             | \$1537594       | \$526455       | \$131069       |
| <b>Gross Profit</b>                              | <b>\$102245</b> | <b>\$83364</b> | <b>\$16718</b> |
| <b>Operating expenses:</b>                       |                 |                |                |
| <b>Marketing and Sales</b>                       | \$224750        | \$82354        | \$27977        |
| <b>Loss after marketing &amp; Sales expenses</b> | \$ (122505)     | \$1010         | \$ (11259)     |

As is evident from the tables above the gross profit has reduced due to the reclassification of fulfilment costs as cost of sales instead of marketing and sales expenses.

|                                |             |             |             |
|--------------------------------|-------------|-------------|-------------|
| <b>Gross Profit Margin</b>     | <b>1999</b> | <b>1998</b> | <b>1997</b> |
| <b>Before Reclassification</b> | 17.72%      | 21.92%      | 19.5%       |
| <b>After Reclassification</b>  | 6.23%       | 13.67%      | 11.31%      |

**Effect on Inventory:**

**Cost of Production before adding fulfilment costs to Cost of Sales:**

|                         |                       |
|-------------------------|-----------------------|
| Cost of Sales           | 1349194               |
| ▲Add: Closing Inventory | 220646                |
| Less: Opening Stock     | <u>29501</u>          |
| Cost of Production      | <u><u>1540339</u></u> |

**Cost of Production after adding fulfillment costs to Cost of Sales:**

|                         |                       |
|-------------------------|-----------------------|
| Cost of Sales           | 1349194               |
| ▲Add: Fulfillment costs | 188400                |
| ▲Add: Closing Inventory | 220646                |
| Less: Opening Stock     | <u>29501</u>          |
| Cost of production      | <u><u>1728739</u></u> |

2. As the CFO of Amazon.com, the preferable option is to classify all the fulfillment costs as a part of marketing and sales expenses. **This enables the company to report a higher gross profit as shown** in question 1.

On observing the Income statement of Amazon.com, it can be seen that the company has been reporting negative earnings for 2 out of 3 years. In such cases, the shareholders and the investors tend to value the company on the basis of gross profits and revenue. Hence the company CFO would always prefer to show the fulfillment costs as a part of marketing and sales expenses.

However, as a member of FASB, we would recommend the fulfillment cost classification as follows:

**Cost of Sales:**

- Receiving cost
- Inspecting and warehousing inventory
- Picking Cost
- Packaging Cost
- Preparing Customers order for shipment

**Administration/ after Sales Cost:** This cost is in the nature of follow up cost and not directly related to the production or selling efforts of the company. This is therefore classified as such

- Responding to inquiries from customers

This shows the **true financial position of the company** to the shareholders and investors. However, it needs to be noted that FASB allows the member companies to opt for any classification of the fulfillment costs. But SEC recommends use of uniform method of classification so as to avoid any confusion of the investors and shareholders.