

Amazon inventory evaluation method essay sample

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The Internet has become an extremely popular place for small businesses and firms to advertise and sell their products. Although this is a very easy and popular way to sell, it all depends on how well the company uses its resources and marketing ideas. One company that is widely known across the country and famous for having grown so fast since its online creation is Amazon. com. It opened a whole new market for competitive business in the specialty industries on the computer and has proven to be a successful company on the Net. Amazon. com is one of the famous public companies that investors love to invest into.

How can Amazon. com meet its goal of achieving profitability to please its investors? What information do investors need to have to consider continuing investment in Amazon. com? Financial statements are meant to enable the investors to evaluate the performance of Amazon. com, analyze its cash flow and assess its financial position. In this paper, Learning Team D will examine the cost-flow method that Amazon uses in its inventory, its impact on adjustment and how Amazon discloses on its financial statement. In addition, this paper also analyzes the impact on adjustment to Amazon's current ratio and discusses whether its competitors made the same adjustment.

The inventory valuation method used and whether this method impacted the adjustment

There are four basic approaches to inventory valuation that are allowed by GAAP (Generally Accepted Accounting Principles). The first approach is first in-first out (FIFO). According to our text FIFO is defined as “ the inventory

cost-flow assumption that the first cost in inventory are the first costs out to cost of goods sold" (Marshall et al, 2004). Typically when dealing with food items FIFO makes that most sense as it reflects the fact that the first food items purchased, are the first food items sold. Also typically during times of rising prices the FIFO method will result in lower expenses and higher net income than the LIFO method would.

The second approach is last-in, last out (LIFO). LIFO is defined as " the cost flow assumption that the last costs in to inventory are the first costs out to cost of goods sold"(Mc-Graw-Hill, p. 152). Since costs rise and fall over time businesses will often use the LIFO approach during times of high inflation. Therefore, businesses will often use the LIFO approach for tax breaks during periods of high inflation.

The third approach is weighted average. Weighted average is " the cost flow assumption that is based on an average of the cost of beginning inventory plus the cost of purchases during the year, weighted by the quantity of items at each cost" (Marshall et al, 2004). Weighted average is calculated by taking an average weighted by the number of units in beginning inventory and each purchase. For items that are homogenous in nature such as paper goods the weighted average approach can work.

The fourth approach is specific identification. Specific identification is " the cost flow assumption that matches cost flow with physical flow" (Marshall et al, 2004). This approach is typically appropriate for a firm dealing with specifically identifiable products, such as automobiles. This assumption is not

practical for a firm having a large number of inventory items that are not easily identified individually.

Amazon. com uses the LIFO method to record their value of inventory. Where prices are increasing, it is used by some companies to save money in taxes. LIFO generally delays the recognition of net profit to future periods, temporarily resulting in a tax savings and therefore higher cash flow.

The amount of the adjustment and how it was disclosed

As stated above, Amazon. com as an internet-based company uses the last in, last out (LIFO) approach as their inventory valuation method. According to Amazon. com's 2004 annual report, the company's ultimate goal is to have "long-term growth in free cash flow per share" (p. 4). By having this as their focal point, Amazon. com achieved their goals because they believe that their company's success is dependent upon increases in operating profit and effectively managing the company's capital. Utilizing the last in, last out approach encourages the company to financially succeed.

As far as the adjustments that Amazon. com has made using the LIFO approach, the company experienced a net gain in profit from 2000 to 2004. According to the financial report, in 2000 the company was at an income loss of \$1, 411, 273 while in 2004 they experienced a positive income of \$588, 451 (p. 25). As per any company, there will be times of losses and gains primarily because of how well companies respond to consumers needs and wants. Since Amazon. com is internet-based and technology driven, they can

easily make adjustments in their goods and services, where inventory is a concern.

Another important factor for the company's adjustment was the "diluted earnings per share made prior to the cumulative effect of change in accounting principles" (p. 25). The year 2000's per share earnings were at a loss of \$4.02 whereas in 2004, it was at a gain of \$1.39. Over the span of 4 years, Amazon.com has seen significant growth in its company because of well they responded to internal and external changes and it shows in their overall numbers.

The impact of the adjustment on the firm's current ratio

Amazon reports its revenues through three business divisions: media (73.7% of total revenues during fiscal 2004), electronics and other general merchandise (24.4%), and other (1.9%). (Amazon.com . <http://www.mergentonline.com>.)

"Amazon recorded revenues of \$6921.1 million during the fiscal year of December 2004, which was an increase of 31.5% over 2003. Revenues of fiscal year 2004 accounted for 55.6% of the total revenues of North America, which is the company's largest geographical market." (Amazon.com . <http://www.mergentonline.com>.)

Revenues by Division

"During the fiscal year 2004, the media division recorded revenues of \$5102.4 million, an increase of 26.0% over fiscal 2003. The electronics and

other general merchandise division recorded revenues of \$1686.2 million in 2004, an increase of 52.9% over fiscal 2003. The other division recorded revenues of \$132.5 million in 2004, a decrease of 18.7% from fiscal 2003.” (Amazon.com. <http://www.mergentonline.com>.)

Revenues by Geography

” North America, Amazon’s largest geographical market, accounted for 55.6% of the total revenues in the fiscal year 2004. Revenues from North America reached \$3847.3 million in 2004, an increase of 18.1% over fiscal 2003.

International region accounted for 44.4% of the total revenues. Revenues from the international region reached \$3073.8 million in 2004, an increase of 53.3% over fiscal 2003.” (Amazon.com. <http://www.mergentonline.com>.)

Amazon.com is an internet business that would have no issues with recruiting investors and very capable of occurring more debt. In addition, based off the financial report this entity can afford to move into different investments or business opportunities if interested.

Amazon’s dumping of pro forma accounting in 2002 has led to big profits for the internet company. Internet companies think that pro forma results-which are operating results excluding one-time charges for items such as layoffs and restructuring changes, bad investments, acquisition costs etc- offer investors better insight into just how the company is performing-excluding those special charges (Lorek, 2001). When Amazon’s operating cash flow

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was recorded at 4.6 million and its net loss was reported at \$94 million in 2002, CEO Jeff Bezo banished pro forma accounting. Since that time, generally accepted accounting principles (GAAP) has brought the company to a full year profit of \$35 million in 2003. Internet companies are currently in a position where they are seeking credibility from investors that are weary about all internet stocks.

Due to pro forma accounting, investors believe that it is rare for a web company to do well. In reality, more than 50 of the roughly 200 public Internet companies make GAAP profits now, and others will follow soon (Mullaney, 2002). What web companies are beginning to understand is that trust in the stability of the company will bring more profits. By excluding the regulatory charges brought about by pro forma, decreases an investor's confidence in that company. In a speech by Lyn Turner, the Securities and Exchange Commission chief consultant, attacked company disclosures that appeared to "turn straw into gold." Turner calls many of the pro forma earnings reports "EBS, or everything but the bad stuff." (Lorek, 2001) Travelocity.com and Expedia.com have now switched from pro forma to GAAP accounting.

Whether competitors made similar adjustments

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Conclusion

Based on the above analysis of the Amazon. com financial statement of Amazon. com of the year 2004, Learning Team D concludes that using LIFO as its cost-flow method for inventory, Amazon. com can benefit from write-downs and create a tax benefit. In addition, as a retail business, the

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inventory costs are often increasing, LIFO allows Amazon. com to reduce income taxes and keep more cash-flow and achieve the company's ultimate goal of having a long-term growth in free cash flow.

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