Revisiting Amazon's Liquidity Issues

Evaluating the Credit Under the "Going Concern" Framework

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- Our primary concern regarding Amazon has always been that the company will have difficulties with liquidity in the first half of 2001. The reported numbers in the past few quarters have only increased our concerns about tightening liquidity. This is primarily because, despite the higher reported numbers on the "cash and marketable" securities line item, the current liabilities for the company have grown much faster than the current assets, clearly leaving Amazon with a much-depleted liquidity position as it enters the new year.

- As opposed to just the stated cash on the balance sheet, working capital (current assets *minus* current liabilities) is the key relevant liquidity measure when evaluating a company's survivability. We see that the company's liquidity as measured by net working capital has been steadily declining since the cash infusion from the debt offering in 1Q00, and without additional capital infusion, the working capital level is expected to dip into negative territory during 2001. Amazon's working capital at the end of 4Q is $386 million, down from $504 million at the end of 3Q, an amount that we expect will not offset the expected cash outflow from the company over its 2001 fiscal year. We believe that the low levels of working capital could trigger a creditor squeeze in the second half of the year, creating considerable downside risk to revenue and cash estimates for the second half.

- In this report, we develop an alternative credit framework for evaluating the company similar to the "going concern" standard set by auditors, and find that the company's liquidity position continues to be tenuous, despite narrowing operating losses and better inventory management over the past three quarters. We believe that this framework is perhaps the best approach to analyzing the company from a liquidity and distress standpoint, as it very clearly shows the negative trends surrounding its recurring operating losses, sustained negative operating cash flows and limited working capital liquidity. The standards are split into an objective part with quantitative metrics, and a more subjective evaluation of the company. Thus, this analysis should be considered more of a framework for credit analysis than an accounting opinion. We continue to recommend that investors avoid Amazon's convertibles.

Companies Mentioned
Amazon.Com

February 5, 2001

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Introduction

When we wrote our initial report recommending that investors avoid Amazon's convertibles last June (please see "Amazon.Com, Inc. – Credit Analysis of the Convertible Bonds," dated June 22, 2000), our primary concern was that the company would have liquidity problems in the first half of 2001. As we enter the first half, we update our analysis of the company's credit profile and explain in more detail why we think that liquidity problems are likely later on this year. Our primary focus remains on the company's working capital, which is a far more important metric of measuring liquidity than reported "cash and marketable securities," as working capital measures the impact of both the current assets and current liabilities side of the balance sheet and takes into account temporary gains in the "cash" item due to stretched payables, unpaid expenses and reduced inventory levels. From the first quarter of 2000 (which was the last time the company raised external capital), Amazon's current assets item (which is mostly cash) has increased only 7%, to $1.36 billion by the end of 4Q from $1.27 billion. However, in the same period current liabilities (which includes the money the company owes in payables and unpaid expenses) increased 72%, to $975 million from $567 million. This resulted in a sharp drop in working capital to $386 million from $700 million-plus—this is our primary liquidity concern. Regarding the balance sheet long term, over the past six months, Amazon's equity sharply dwindled and became negative in 2Q00 with net equity and tangible equity at 4Q00 of *negative* $967 million and *negative $1.2* billion, respectively.

In the past three quarters since the last financing, while current assets grew only 7%, current liabilities jumped an estimated 81%.

Why Is Working Capital Analysis Important?

Since retailing is a business that depends largely on trade credit, it is important to focus on how much current liquidity the company has versus how much it currently owes. The accounting metric that defines this net liquidity is the working capital number (current asset *minus* current liabilities). For the first time ever, without any additional capital infusion, Amazon's working capital is expected to be negative in 2001, declining every quarter as the company pays out cash to support operating losses, interest payments, capex and restructuring charges. We believe that once the working capital levels turns negative in the second half, the company is likely to face a creditor squeeze, as suppliers tighten up on trade terms. By definition, a negative working capital means that the company is using its vendors to finance cash outflows in operations and interest payments, which is a nonsustainable condition. This clearly puts downside risk on all operating and balance sheet projections for the second half of the year. Thus, while we provide investors with financial projections in this report, we would assert that we have very little confidence in the numbers six months out, and most of the risk is on the downside.

However, we would like to clarify that running negative working capital is potentially a positive financial management metric, *but only for healthy retailers*. The key differences between the two operations are: 1) The working capital swings in healthy retailers are seasonal because they generate enough cash from operations to pay for interest payments and fixed charges, i.e., they pay out their payables from profit-making sales. Amazon's working capital declines (Figure 2) are not seasonal but continuous, i.e., by definition, company will continue to bleed liquidity until it starts generating enough cash from operations to make interest payments. 2) To offset the negative working capital swings, big retailers typically have big commercial paper programs or a bank line of credit to provide the liquidity. For example, Wal-Mart currently has a commercial paper program backed by approximately $4.5 billion in a Aa2 rated bank credit facility. Amazon, on the other hand, has a Caa3 corporate rating and no bank facility and thus will be unable to sustain operations in a negative working capital environment without additional capital infusion. We would also like to point out that the credit framework described here under SAS-59, uses working capital and not cash as the primary liquidity metric.

The standards under SAS-59 provide the best analytical framework for evaluating liquidity and distress situations.

In this report, we develop a framework for analyzing Amazon's credit profile using SAS-59, which details the metrics that auditors use for evaluating a company for "Substantial Doubt of an Entity's Ability to Continue as a Going Concern" qualification during the annual audit. We believe that this analysis provides investors with an excellent framework to evaluate liquidity and distress situations, as it clearly shows the negative trends due to the company's recurring operating losses, sustained negative operating cash flow and meager working capital liquidity. It also provides a relatively objective set of accounting and cash flow measures that, we believe, most effectively capture the balance sheet issues surrounding Amazon. As we discuss in detail in the next section, SAS-59 essentially consists of an objective part with quantitative metrics, and a more subjective evaluation of the company. However, we note that auditors generally have much flexibility in making such qualifications, and thus this should be considered more of a framework for credit analysis than an accounting opinion. Our projections for the company's liquidity incorporate the current revenue, operating earnings and margin projections from our equity research group covering the Internet sector. Lehman Brothers' rating on the common stock is 3 –Market Perform, and we continue to recommend that investors avoid Amazon's convertible securities.

The Going Concern Concept

What is "Substantial Doubt as Going Concern"?

The SAS (or Statements of Auditing Standards) are issued by the Accounting Standards Board (ASB) and govern the auditing standards applied to companies. SAS-59 "illuminatingly" named "Auditors Consideration of an Entity's Ability to Continue as a Going Concern," describes the conditions under which the auditor must evaluate the company's ability to remain a going concern or an operating entity. *If these operating deficiencies exist, the auditor must then evaluate the company's sources of liquidity and evaluate management's alternative plans*, and unless satisfied that these plans will allow the company to survive through the next audit cycle (usually a year), will issue a going concern qualifier. This concern expressed by the auditor is usually reported in the company's filed 10-K as a material event. This examination for a going concern essentially consists of two parts: 1) an objective measurement of liquidity using quantitative standard accounting ratios and metrics combined with a qualitative judgement of operations, and 2) a more subjective evaluation of the company's plans and ability to overcome or fund those operating deficiencies. The subjective metrics are much more intangible, but we provide investors with some of the relevant issues that affect these metrics. Again, we would like to point out that we offer this framework more as a viewpoint for credit and liquidity analysis rather than any expectations from the annual audit.

In this report, we draw extensively from a number of sources, including the SAS issued by the ASB, the Miller GAAS Guide, standard auditing checklists from accounting firms, the expertise of Robert Willens, Lehman Brothers' accounting analyst and outside auditing experts. However, the financial analysis and investment conclusions are ours. We will attempt to keep clear of most of the accounting jargon throughout the body of the report, but for the more precise investor, they can be found in Appendix 1. We also provide a number of definitions for the bewildering accounting acronyms in Appendix 2.

Here, we review the going concern concept as outlined by SAS-59 and the Miller GAAS guide. It must be noted that the metrics that we reviewed are substantive and not comprehensive. We quote directly from the sources for the actual text regarding the standards and conditions and provide our own analysis in the Amazon context.

The Standards

To satisfy the standards related to the going concern concept established by SAS-59, the following steps should be followed (AU 341.03):

- Evaluate information obtained during the course of the engagement to determine whether substantial doubt has been raised about the entity's continued existence as a going concern for a reasonable period of time.
- When substantial doubt has been raised, identify and evaluate management's plans for dealing with the conditions or events that prompted the substantial doubt conclusions.
- Draw a conclusion concerning the existence of substantial doubt and consider the effect of this conclusion on disclosures in the financial statements and the format of the auditor's report.

Evaluate Information Related to Substantial Doubt

Although the auditor is not specifically required to employ procedures to identify conditions or events that might raise a substantial doubt question, the auditor should be sensitive to evidential matter collected and implications relative to going concern (AU 341.05). The table below outlines what SAS-59 provides as examples of conditions and events that may raise a substantial doubt question (AU 341.06). When the evidential matters raise a substantial doubt question, the auditor may obtain additional evidence that may remove the question of substantial doubt (AU 341.07).

Condition or Event	Specific Example
Negative trends	· Recurring operating losses · Working capital deficiencies · Negative cash flows from operations · Adverse key financial ratios
Other indications of possible financial difficulties	· Default on loan or similar agreements · Arrearages in dividend · Denial of usual trade credit form vendors · Restructuring of debt · Noncompliance with statutory capital requirements · Need to sell substantial assets
Internal matters	· Labor difficulties, such as work stoppages · Substantial dependence on the success of a particular project · Uneconomic long-term commitments · Need to significantly revise operations
External matters	· Legal proceedings, legislation, or similar matters that might affect the entity's ability continue operations · Loss of key franchise, license, or patent · Loss of principal customer or vendor · Occurrence of uninsured catastrophe

Source: SAS–59 Auditing Standards Board, Miller GAAS Guide

Application of the Going Concern Standard to Amazon's Financials

We apply and review here the metrics outlined in the previous section in the context of Amazon's financials and operations.

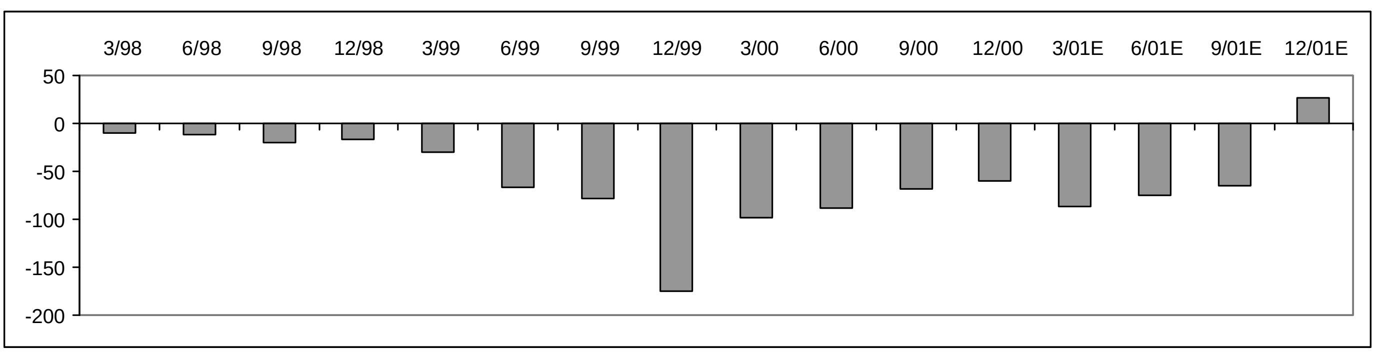
Negative Trends

1) Recurring Operating Losses

Amazon has not posted operating profits since the December quarter of 1997.

As can be seen from the income statement (Figure 9) and the chart in Figure 1, the company has not posted any operating profits since the December quarter of 1997 when it posted an operating profit of approximately $12.9 million. From 1998 through 4Q00, Amazon posted a cumulative operating loss of $1.56 billion on revenues of $5.08 billion, for an operating margin of roughly negative 31%. On a cash basis, the comparable numbers work out to be $673 million, for a cash operating margin of negative 13%. Currently, there are no forecasts for produced annualized operating profits until 4Q01. (These expected loss numbers exclude all noncash expenses such as amortization, depreciation and stock compensation, and thus the company is expected to report losses on both a cash and a pro forma basis). Additionally, the company will not generate cumulative four quarters of positive operating cash flow until the cash profits start exceeding the interest payments.

Figure 1: Amazon.com Inc. – Quarterly Operating Income Excluding Amortization/Merger Costs ($ Millions)



Source: Lehman Brothers Convertibles Research

2) Working Capital Deficiencies

In our opinion, this is perhaps the most critical aspect of the standards and we devote a substantial amount of analysis on this matter. Amazon's working capital inadequacy is exacerbated by negative operating cash flow and the lack of a credit line to provide liquidity. This combination results in a sharply negative credit factor.

Working capital, not cash, is the truly relevant metric in measuring a corporation's liquidity and survivability.

Why Working Capital Is More Important than the Cash Number? At the risk of sounding redundant we would like to revisit our discussion of the importance of working capital. The fundamental numbers that auditors focus on to assess the sustainability of an enterprise is not the cash on the balance sheet but the net available working capital. In accounting textbooks, working capital is defined as the amount of capital the company needs to remain operating over the next auditing period (usually a year) and is therefore calculated from subtracting current assets (cash, marketable securities, inventory and receivables) from current liabilities (trade payables and other current accrued expenses). If a company's current assets (which is cash and inventory in Amazon's case) is offset by its current liabilities (monies it owes that year), then the net liquidity is zero. *Thus, investors should consider working capital and not cash as the correct metric of measuring liquidity, just as the auditors do in evaluating a company's survivability*. We would also like to remind investors that our initial analysis of the company's weak credit in our June report was based upon the weakness due to inadequate working capital management and not necessarily inadequate cash management.

Except when it has raised external debt capital, Amazon's working capital has decreased every single quarter due to its operating losses and interest payments.

Figures 2 and 3 show the working capital items of the balance sheet (for a full balance sheet please see Figure 10). It can be clearly seen that the company's liquidity has been steadily declining in the past three quarters and ended 4Q at $386 million, significantly less than the $703 million after the last financing. This is primarily because although Amazon has managed to keep its cash and current assets relatively stable, it has done so by increasing its current liabilities throughout the year. Over the past couple of years, we have also seen the impact of the two convertible debt offerings, with liquidity jumping in the first quarter of each year after drifting down throughout the year. As Figures 2 and 3 indicate, Amazon is expected to reach negative working capital for the first time in 2001. We believe that levels of working capital lower than $100 million will be enough to potentially trigger a credit squeeze, and Amazon reaches this level by the end of 2Q.

Figure 2: Working Capital Steadily Declines After Every Financing

Source: Lehman Brothers Convertibles Research

Figure 3: Amazon.com Inc. – Working Capital Analysis

	6/1998	9/1998	12/1998	3/1999	6/1999	9/1999	12/1999	3/2000	6/2000	9/2000	12/2000	3/2001E	6/2001E	9/2001E	12/2001E
Current Assets:															
Total Cash and Marketable Sec	339.9	337.3	373.4	1,443.0	1,144.2	905.7	706.2	1,008.9	907.6	900.0	1,100.5	614.6	525.2	201.1	125.2
Cash and Equivalents	339.9	337.3	373.4	1,443.0	1,144.2	905.7	701.2	84.1	720.4	647.0	822.4	336.6	247.1	(77.0)	(152.9)
Non Stock Marketable Sec	-	-	-	-	-	-	-	889.8	171.7	155.1	238.1	238.1	238.1	238.1	238.1
Stock as Marketable Sec	-	-	-	-	-	-	5.0	35.0	15.5	97.9	40.0	40.0	40.0	40.0	40.0
Inventories	17.0	19.8	29.5	45.2	59.4	118.8	220.6	172.3	172.4	163.9	174.6	168.8	175.0	187.5	318.8
Prepaid Exp & Other Curr. Assets	12.5	17.6	21.3	37.1	53.3	55.6	85.3	89.8	86.7	99.2	86.0	87.8	91.0	97.5	165.8
Total Current Assets	369.4	374.7	424.3	1,525.3	1,257.0	1,080.1	1,012.2	1,270.9	1,166.6	1,163.1	1,361.1	871.1	791.2	486.1	609.7
Current Liabilities:															
Debt in Current Liabilities	0.7	0.7	0.8	7.2	9.9	12.8	14.3	16.0	17.7	17.2	16.6	8.0	5.0	5.0	5.0
Accounts Payable	47.6	60.0	113.3	133.0	166.0	236.7	463.0	255.8	286.2	304.7	485.4	303.8	315.0	225.0	255.0
Interest Payable	-	-	0.0	-	24.0	10.0	24.9	15.8	41.2	35.1	69.2	30.0	69.2	30.0	69.2
Accrued Exp/Other Cur Liab	23.7	38.7	47.5	61.4	78.1	98.1	181.9	144.8	146.9	160.1	272.7	189.0	175.0	135.0	191.3
Unearned Revenue	-	-	-	-	-	-	54.8	134.8	115.6	142.0	131.1	135.0	140.0	112.5	127.5
Total Current Liabilities	71.9	99.5	161.6	201.6	277.9	357.7	738.9	567.2	607.6	659.1	975.0	665.8	704.2	507.5	648.0
Net Working Capital excl stock	297.5	275.2	262.7	1,323.7	979.0	722.4	268.2	668.8	543.5	406.1	346.2	165.4	47.0	(61.4)	(78.3)
Net Working Capital incl stock	**297.5**	**275.2**	**262.7**	**1,323.7**	**979.0**	**722.4**	**273.2**	**703.8**	**559.0**	**504.0**	**386.2**	**205.4**	**87.0**	**(21.4)**	**(38.3)**
Current Assets	369.4	374.7	424.3	1,525.3	1,257.0	1,080.1	1,012.2	1,270.9	1,166.6	1,163.1	1,361.1	871.1	791.2	486.1	609.7
Less: Current Liabilities	71.9	99.5	161.6	201.6	277.9	357.7	738.9	567.2	607.6	659.1	975.0	665.8	704.2	507.5	648.0
Change in $ (Sequential)	213.1	(22.3)	(12.5)	1,061.0	(344.7)	(256.6)	(449.2)	430.5	(144.8)	(55.0)	(117.8)	(180.8)	(118.4)	(108.4)	(16.9)
Change % (Sequential)	252%	-8%	-5%	404%	-26%	-26%	-62%	158%	-21%	-10%	-23%	-47%	-58%	125%	-79%

Jumps with $1.25 B convert. issuance

Jumps with Euro 690M convert. issuance

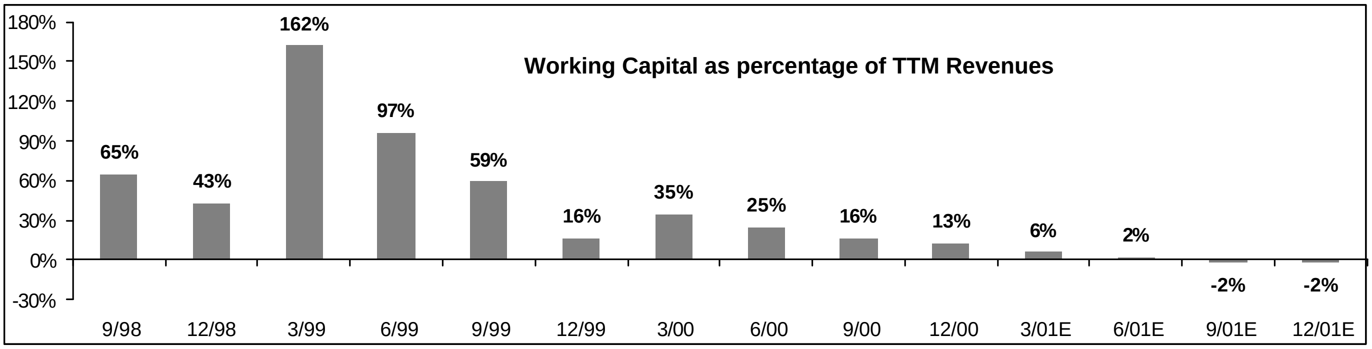
Source: Lehman Brothers Convertibles Research

Figure 4: Amazon.com Inc. Working Capital as a Percentage of Trailing 12-Month Revenues

	6/1998	9/1998	12/1998	3/1999	6/1999	9/1999	12/1999	3/2000	6/2000	9/2000	12/2000	3/2001E	6/2001E	9/2001E	12/2001E
Working Capital	297.5	275.2	262.7	1,323.7	979.0	722.4	273.2	703.8	559.0	504.0	386.2	205.4	87.0	(21.4)	(38.3)
Less: Stock Portion of Marketable Securitie	-	-	-	-	-	-	5.0	35.0	15.5	97.9	36.0	36.0	36.0	36.0	36.0
Working Capital *minus* stock portion	297.5	275.2	262.7	1,323.7	979.0	722.4	268.2	668.8	543.5	406.1	350.2	169.4	51.0	(57.4)	(74.3)
Trailing 12 month Revenues		423	610	816	1,014	1,217	1,640	1,920	2,184	2,466	2,762	2,863	2,985	3,097	3,400
Working Capital/TTM Revenues		65%	43%	162%	97%	59%	17%	37%	26%	20%	14%	7%	3%	-1%	-1%
Working Capital *minus* stock/TTM Revenues		65%	43%	162%	97%	59%	16%	35%	25%	16%	13%	6%	2%	-2%	-2%

Source: Lehman Brothers Convertibles Research

Figure 5: Working Capital as a Percentage of Trailing 12-Month Revenue Declines



Source: Lehman Brothers Convertibles Research

Although higher working capital amounts are required to sustain higher levels of sales, Amazon's working capital as a percentage of sales has shrunk to historically meager levels.

Working Capital as a Percentage of Sales: Equally critical as the absolute level of working capital is the ratio of working capital to annualized sales as higher levels of working capital are required to sustain higher revenue levels. Based on this metric, we see that the situation is much worse. From Figures 4 and 5, it can be seen that working capital/trailing 12-month sales have been decreasing faster than the absolute level from 1Q00, when the company last raised money, and is now down to approximately 14% of Trailing Twelve Month sales compared to 17% in 4Q99. In the fourth quarters of 1998 and 1999, working capital levels declined to lower than $300 million, forcing the company to raise capital in the next quarter – working capital at year-end 2000 is $386 million on a much higher sales base.

The reclassification of dot-com stock as marketable securities provided a one-time boost to working capital in 3Q, masking the actual decrease in the level by roughly $96 million.

The Impact of Stock: One of the factors boosting the level of reported liquidity over the past couple of quarters is increase provided to the stock portion of the marketable securities, as the company moved the stock in its equity investees from a long-term asset to the current account (for more details please see our "Amazon Credit Update - Further Analysis of Cash and Cash Flows'" note dated October 25 which discusses the quality of the reported cash and marketable securities). However, it is questionable whether it is appropriate to accept stock as a liquid current asset, especially if it primarily consists of the shares of companies such as Ashford and Webvan, both of which trade well under a dollar. It must be remembered that this stock level, which was marked at $97 million in the end 3Q, was marked down to $36 million by the end of 4Q, clearly indicating the risk of accepting these as stable investments. Thus, we also evaluate working capital excluding the stock portion of the marketable securities. With this assumption, working capital actually decreases to $346 million and 13% of trailing 12-month sales, relative liquidity levels that the company has never tested before.

Current working capital levels are unlikely to be sufficient to offset conservative estimates of liquidity needs in 2001, requiring external capital infusion.

How Much Liquidity Is Required in the Next Year? Amazon ended 2000 with roughly $386 million in net working capital or net liquidity. We compare this number with the expected cash outflows for the year. The company announced restructuring charges in excess of $150 million, out of which $50 million is expected to be a cash outflow in 1Q. Cash interest payments for the year are approximately $130 million, and capex is estimated to be $120 million. Finally, cash operating losses for the year are expected to be $140 million (which consists of $200 million in pro forma operating losses minus roughly $60 million in fixed asset depreciation after accounting for the $100 million in fixed asset writedowns related to the restructuring). This leads to an expected cash outflow of $440 million, much higher than the $386 million in net working capital. Additionally, the $386 million includes $36 million of stock, which means that nonstock working capital is only at $350 million.

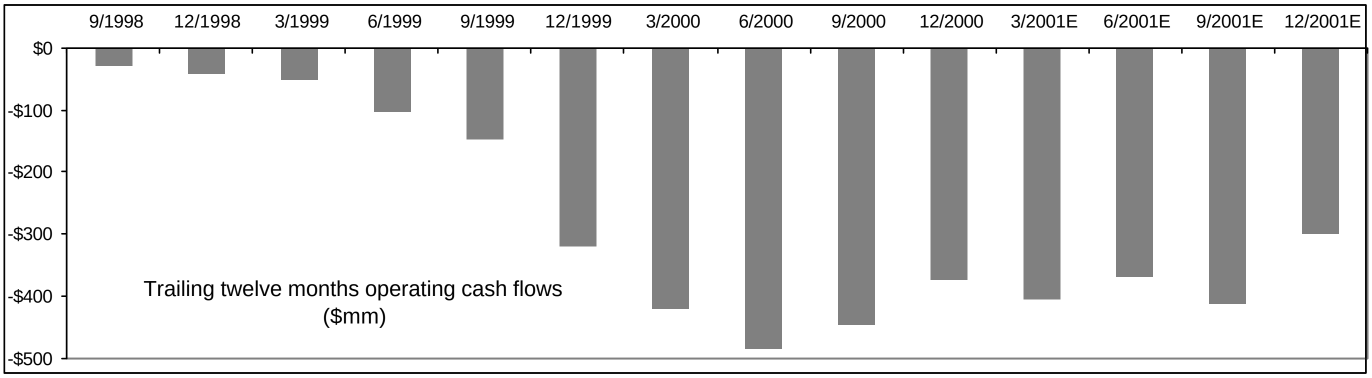
Of course, the low level of working capital might not be an issue if the company generates operating profits and cash flow but, as we discuss in the next section, Amazon does not do either, and is not expected to generate annual operating profits over the next year, leaving the current working capital to sustain the business.

3) Negative Cash Flows from Operations

Consistent with operating losses, 12-month operating cash flow has been negative over the past few years.

As we discussed in our earlier reports, our metric for operational success at Amazon has been its cash flow from operations. When we measure operating cash flow, we tend to look at it from an annual basis rather than a quarterly basis purely because of the seasonal nature of cash flows in a retailing company, which do not match the reported period dates. Figure 6 shows the trailing 12-month cash flow of the company and it can be seen that the number is clearly negative, running from $370 million and more in the past few quarters. The negative operating cash flow is consistent with the operating losses that the company has consistently reported in the last three years and will not become positive as long as operating losses are predicted. At this point, we would like to emphasize the fact that the important point is not necessarily the narrowing amount of negative operating cash flow, but the fact that it remains negative—and thus the company continues to bleed liquidity every operating cycle. Additionally, as we discussed in our First Call note on Amazon's 3Q results (see note dated October 25), the reported operating cash flow in 3Q included cash from three sources that did not constitute operations (a $20 million inventory sale, a $57 million advance for future obligations from its ACN partners and $96 million from reclassifying stock as cash/marketable securities). It is unlikely that this can be considered as recurring cash from operations, thus making the numbers shown in Figure 6 much more negative than reported. Again, we would like to point out that the numbers in Figure 6 are annualized on a trailing 12-month basis, and quarterly cash flow can be positive depending upon the mismatch between the reporting period and the actual time the cash is paid out.

Figure 6: Amazon.com Inc. – Trailing 12 Month Operating Cash Flows ($ Millions)



Source: Lehman Brothers Convertibles Research

Figure 7: Amazon.com Inc. – Financial Ratios

	6/1998	9/1998	12/1998	3/1999	6/1999	9/1999	12/1999	3/2000	6/2000	9/2000	12/2000	3/2001E	6/2001E	9/2001E	12/2001E
Leverage:															
LT Debt/LT Capital	0.89	0.65	0.72	0.95	0.72	0.78	0.85	0.99	1.15	1.31	1.83	2.67	4.78	11.87	NM
LT Debt/LT Tangible Capital	1.04	1.11	1.13	1.08	1.13	1.24	1.46	1.41	1.70	1.94	2.35	3.43	6.10	17.37	NM
Total Debt/Total Capital	0.89	0.65	0.72	0.95	0.72	0.78	0.85	0.99	1.15	1.30	1.82	2.65	4.73	11.58	NM
Total Debt/Total Tangible Capital	1.04	1.11	1.13	1.08	1.13	1.24	1.46	1.41	1.69	1.92	2.33	3.40	6.03	16.73	NM
Liquidity:															
Current Ratio	5.14	3.77	2.63	7.57	4.52	3.02	1.37	2.24	1.92	1.76	1.40	1.31	1.12	0.96	0.94
Quick Ratio	4.90	3.57	2.44	7.34	4.31	2.69	1.07	1.94	1.64	1.52	1.22	1.06	0.88	0.59	0.45
Working Capital/TTM Revenues	N/A	0.65	0.43	1.62	0.97	0.59	0.17	0.37	0.26	0.20	0.14	0.07	0.03	(0.01)	(0.01)

Source: Lehman Brothers Convertibles Research

4) Adverse Key Financial Ratios

We examine the financial ratios of the company from the key liquidity, profitability and leverage ratios, which are commonly found in any auditing textbooks. Amazon's financials clearly fail to show any real positive improvements.

Amazon's liquidity would have turned negative both in 1999 and 2000 if the company had not raised $1.25 billion in January 1999 and roughly $690 million in February 2000.

Given that this is a liquidity, distress and leverage analysis rather than a profitability or return on capital analysis, we will focus on the liquidity and leverage ratios solely. Amazon is currently not profitable and is not expected to be so until 4Q00—given our lack of faith in predictability of results in the second half, there are clearly risks to those estimates. As we have discussed in our prior reports, Amazon's liquidity would have turned negative both in 1999 and 2000 if the company had not raised $1.25 billion in January 1999 and roughly $690 million in February 2000. It is quite possible that the capital that was raised in these two years essentially provided the company enough liquidity to avoid the going concern statement in those years.

2001 Expectations

Given everything that we have indicated to date, we believe that:

- Amazon's cash position is likely to fall significantly in 1Q01, despite improving gross and operating margins because of payments to creditors for the merchandise purchased and sold in 4Q00. More critically, working capital will continue to decline every quarter in the foreseeable future until the company starts generating enough cash profits to cover interest payments or receives a capital infusion. Net working capital is expected to be $205 million in 1Q, $87 million in 2Q, negative $21 million in 3Q, and will finish the year at negative $38 million. Subtracting the stock portion of the current assets only makes the situation worse.

- With the significant decrease in working capital and assuming the availability of no financing, vendors and suppliers will require Amazon to speed up payments and therefore incur quicker and higher cash outflows than in the past. Consequently, various payable accounts, including accounts payable and accrued expenses, will fall as a percentage of sales compared to the past, and cash and cash equivalents (not including marketable securities) will come into severe pressure in 2H01.

Assumptions Underlying Projections

Revenue and Operating Margin Assumptions: We use the current revenue and operating margin assumptions from our equity research group, which are at approximately $3.4 billion and negative 5.9% for 2001. Additionally, the margin assumptions could be optimistic, given 4Q's sharp drop in gross margins and our concerns about operating numbers for 2H. This would increase operating cash losses and increase the decline in working capital.

Cash and Marketable Securities: Given that marketable securities are marked to market, we assume that they remain constant at the last marked levels and adjust all cash inflows and outflows to the liquid cash number.

Inventory Assumption: We estimate that the company will have to ramp up the inventory level as sales normalize and given the estimated 23% growth in revenues and our credit concerns for the second half, we estimate that the inventory level ends 2001 at 25% of sales compared to 18% in 4Q00 and 33% in 4Q499.

Payables Assumption: We believe that given the steep decline in working capital, the slowing economy and tightening credit standards for low quality borrowers, the company is likely to feel a payables squeeze as it progresses through the year. We model the payables levels to be at 45% of sales in the first two quarters, before an expected vendor squeeze drops it down to 20% by year-end 2001. However, we would clearly state that we have very little comfort in projected numbers for 2H, as we expect a squeeze from creditors. We would also like to point out that we have always preferred to consider the payables and the inventory numbers as a percentage of sales as opposed to a percentage of COGS, mainly because the revenue and COGS numbers include ACN revenues and shipping revenues and charges which tend to distort the actual cost of the inventory.

Unearned Revenue Assumption: This is a line item that first appeared on Amazon's liability side in 4Q99. While we assume that some of the unearned revenue needs to be worked off in the earlier part of the year, we keep year end balances comparable with current absolute levels.

Capex Assumption: Using the company's guidance, we project it will have to spend approximately $120 million in capex for the year, slightly higher than our $60 million fixed asset depreciation estimate and in line with our equity research group's capex estimate .

Looking at the Cash Balances

In Figure 8 we show a brief cash flow table in which we compare the cash number at the end of 1999, 2000 and 2001. Given that the company has started splitting the cash number into cash and marketable securities, we do the same in our analysis. As we discussed previously, we keep the marketable securities number constant and adjust only the pure cash number. Once more, the actual cash number obtained will be determined by credit issues in 2H—what investors should be more focused on is that the working capital turns negative after 2Q—the company will owe more that it owns on a current basis.

Figure 8: Estimated Change in Working Capital and Cash and Marketable Securities

AMAZON.COM INC
Estimated Change in Working Capital
From 12/2000 to 12/2001

BOP Current Assets	1,361.1
Less: BOP Current Liabilities	975.0
BOP Balance Working Capital	386.2
Change in Working Capital:	
Operating Income	(200.9)
Deprec/Amort of Fixed Assets	60.0
Restructuring Charge	(50.0)
Net Interest Expense	(108.6)
Inventories	-
Prepaid Expenses & Othr Current Assets	-
Accounts Payable	-
Accrued expenses & othr Curr Liab	-
Unearned Revenue	
Interest Payable	
Capital Expenditures	(125.0)
Change in Current Debt	-
Net Change in Long-Term Debt	-
Change in Capital Stock	-
Proceeds from Exercise of Stock Options	-
Exchange Rate Effect	-
Total Incr(Decr) in Cash & Cash Equiv.	(424.5)
EOP Current Assets	609.7
Less: EOP Current Liabilities	648.0
EOP Working Capital	(38.3)

AMAZON.COM INC
Estimated Change in Cash & Marketable Securities
From 12/2000 to 12/2001

BOP Cash & Cash Equivalents	822.4
Plus: Marketable Securities	278.1
BOP Balance - Cash & Marketable Securities	1,100.5
Change in Cash & Cash Equiv. Items:	
Operating Income	(200.9)
Deprec/Amort of Fixed Assets	60.0
Restructuring Charge	(50.0)
Net Interest Expense	(108.6)
Inventories	(144.2)
Prepaid Expenses & Othr Current Assets	(79.7)
Accounts Payable	(230.4)
Accrued expenses & othr Curr Liab	(93.0)
Unearned Revenue	(3.6)
Interest Payable	0.0
Capital Expenditures	(125.0)
Change in Current Debt	-
Net Change in Long-Term Debt	-
Change in Capital Stock	-
Proceeds from Exercise of Stock Options	-
Exchange Rate Effect	-
Total Incr(Decr) in Cash & Cash Equiv.	(975.4)
EOP Balance - Cash & Marketable Securities	125.2
Less: Marketable Securities	278.1
EOP Cash & Cash Equivalents	(152.9)

Source: Lehman Brothers Convertibles Research

We now move on to the other events beyond the Negative Trends section as described by SAS-59. This part of the analysis is more qualitative although no less objective than the first part, and we will discuss them more briefly.

Other Indications of Possible Financial Difficulties

1) Default on Loan or Similar Agreements

While Amazon has two convertible debt issues outstanding and some remnants ($264 million par) of its high yield debt left, it is currently not in default on any of the debt covenants. It also does not have a credit facility and, given its weak credit and Caa1rating, is not expected to get one without substantial collateral. Since convertible debt is typically issued with fairly weak covenant restrictions, we do not expect the company to default on payments or on covenants over the next two quarters.

2) Arrearages in Dividends

The company has never paid any dividends nor is it expected to in the foreseeable future.

3) Denial of Usual Trade Credit from Vendors

While this is currently not a problem with the company, a negative working capital situation without a bank credit line could trigger the trade credit problem—this remains our biggest concern.

4) Restructuring of Debt

While the company has not attempted to do any restructuring as we discuss later in the section discussing the induced conversion of the debt, it is not implausible for the company to attempt to restructure its obligations. However, this could possibly be negatively viewed as an indication of financial strength.

5) Noncompliance with Statutory Capital Requirements

This is usually applicable to financial or regulated industries and is not relevant in Amazon's case.

6) Need to Sell Substantial Assets

Like the default scenario, this is not something that we currently envision. In any case, the company has virtually no tangible assets (net fixed assets of approximately $350 million on September 2000) and has negative reported and tangible net worth. Thus, the sale of substantial assets is hardly likely to deliver substantial funds.

Internal Matters

1) Labor Difficulties, such as Work Stoppages

Severe labor difficulties have not manifested themselves in the company, partly due to the use of extensive temporary help during the peak holiday season. However, issues related to this aspect are the departure of top executives, including the president and COO in the past few quarters, the much-publicized recent efforts to unionize workers in the company and company layoffs in 1Q00 and 1Q01.

2) Substantial Dependence on the Success of a Particular Project

In Amazon's case it is unlikely that the company has total dependence on one particular project given its diverse interests. However, we can look at the company's projects in 2000 in an attempt to evaluate its business prospects. The bankruptcies of a number of Amazon's ACN partnerships (which were supposed to provide the growth impetus), including living.com, pets.com and the poor performance of the others such as ashford.com, della.com, greenlight.com, drugstore.com. homegrocer.com, wineshopper.com, kozmo.com, blah.com, etc., are to be considered. Additionally, the failure of the much-touted Associates network and the z-shops, which were expected to generate substantial revenue growth, is likely to be reviewed, as well as the company's changing of the z-shops fee structures. Among other relevant factors are the profitability metrics associated with Amazon's new international businesses.

3) Uneconomic Long-Term Commitments

Under this category are Amazon's arrangements with Toys'R Us, for which it is contracted to provide fulfillment services and other long-term leases at the company's distribution centers. For example, its facility in Lexington, Kentucky, which was initially expected to be up and running in 4Q99, was not operational until October 2000 and is now the company's primary return center, and could potentially have uneconomic long-term lease obligations. The charges associated with the shutdown of the Georgia facility and the seasonal shutdown of the Seattle customer service center, which include closing of long-term leases, provide more information on these commitments.

4) Need to Significantly Revise Operations

While this aspect is harder to comment upon, the company clearly embarked on this path with the recently announced layoffs and facility shutdowns. Additional factors that could be considered include operational parameters such as logistics, fulfillment efficiency and so on. As Amazon clearly stated in its 10-Q covering 2Q, "Our inventory management systems are not fully integrated with our financial reporting systems, and a significant amount of manual effort may be necessary to reconcile our inventory and other financial accounts. We are also exposed to significant inventory risks because our inventory forecasting, purchasing, receiving, reconciliation, accounting and payment systems are not well developed and are not well integrated. The lack of systems integration makes it a difficult and manual process to receive inventory, reconcile inventory invoices to purchase orders, account for inventory efficiently, request refunds from suppliers and pay supplier invoices. In addition, certain manual operational processes further complicate our ability to manage inventory efficiently." Similar risk statements are disclosed in the more recent filings additionally covering the recent web site interruptions.

External Matters

1) Legal Proceedings, Legislation, or Similar Matters That Might Affect the Entity's Ability to Continue Operations

Under this section, a clear cause for concern is the informal SEC inquiry into the use of stock for revenue recognition. However, on the surface this matter does not appear to have severely damaged the company's ability to continue operations.

2) Loss of Key Franchise, License, or Patent

There are obviously not too many issues associated with this event, although the problems with the ACN network that we described previously could easily fall into this category. The company's defense of its 1-Click technology is likely to be a positive.

3) Loss of Principal Customer or Vendor

Again, Amazon does not have a principal customer or vendor, but the lack of revenue growth from the ACN stream is a consideration. The biggest risk clearly lies on the vendor side. As we have discussed, our biggest concern is the potential vendor squeeze in 2H01. The company has three main vendors for its books, music and video business.

4) Occurrence of Uninsured Catastrophe

This is obviously not a currently relevant event, although in light of the recent California power crisis, the web site shutdowns and the increased frequency of hacker attacks on commercial web sites, the following risk statement from the latest 10-Q might be relevant, "We maintain substantially all of our computer and communications hardware at two leased facilities on the East and West Coasts. Our systems and operations could be damaged or interrupted by fire, flood, power loss, telecommunications failure, break-ins, earthquake and similar events. We do not have backup systems or a formal disaster recovery plan, and we may have inadequate insurance coverage or insurance limits to compensate us for losses from a major interruption. Computer viruses, physical or electronic break-ins and similar disruptions could cause system interruptions, delays and loss of critical data and could significantly diminish our reputation and brand name and prevent us from providing services and accepting and fulfilling customer orders."

Review of Potential Relief Actions

The Standards – Identify and Evaluate Management's Plans

When the evidential matter raises a substantial doubt question, the auditor may obtain additional evidence that may remove the question of substantial doubt (AU 341.07)

Identify and Evaluate Management's Plans: If it is concluded that there is a substantial doubt about the continued existence of the entity as a going concern for a reasonable period of time, the auditor should identify and evaluate management's plans to mitigate the effects of the adverse conditions or events. SAS-59 identifies the following as examples of plans and factors that are relevant to the evaluation of those plans (AU 341.07).

Planned Action	Factors Relevant to Evaluation of Planned Action
Sales of assets	▪ Restrictions on the sale of assets ▪ Likely marketability of assets ▪ Effects from sale of assets
Borrow or restructure debt	▪ Likelihood of raising funds based on existing or committed debt arrangements ▪ Existing or committed arrangements for restructuring debt or obtaining guarantees for loans ▪ Restrictions on ability to borrow or use assets as collateral
Reduce or delay expenditures	▪ Feasibility of reducing or postponing expenditures ▪ Effects of reducing or postponing expenditures
Increase ownership equity	▪ Feasibility of increasing equity based on existing or committed arrangements ▪ Flexibility of dividend policy ▪ Ability to raise funds from affiliates or other investors

Source: *SAS – 59 Auditing Standards Board, Miller GAAS Guide*

Analysis of Potential Relief Actions with Respect to Amazon

In this section, we turn our attention to that part of SAS-59 that involves the auditor who attempts to obtain additional evidence that removes the question of substantial doubt. It is clear that this part of the analysis is much more subjective and left to the auditor's own discretion to a large extent. However, from the planned actions shown in the previous section, we attempt to evaluate the feasibility of each action with the current information that is provided to investors. *However, it must be noted that auditors are likely to have much more information about the company's plans, and therefore this analysis is subject to a fair degree of variance.*

1) Sales of Assets

Restrictions on, Likely Marketability and Effects from Sale of Assets

As of 4Q00, Amazon's fixed assets were marked at $366 million, which include everything from its warehouses to the web site. Of this, approximately $100 million is expected to be written down in 1H. It is likely that the remaining assets cannot be sold separately and any such sale would have an adverse impact on the operations of the firm. Other long-term assets on the books included equity in equity method investees, other investments and other assets, which totaled $152 million after 4Q writedowns. A substantial amount of this is in stock in other Internet companies, which certainly brings to question the effective marketability of these assets. As of 4Q00, we know that on the current asset side, the company is left with only $175 million in inventory, which possibly could be used for collateral in up to $100 million in a short-term credit facility.

2) Borrow or Restructure Debt

Likelihood of Raising Funds Based on Existing or Committed Debt Arrangements, Existing or Committed Arrangements for Restructuring Debt or Obtaining Guarantees for Loans, and Restrictions on Ability to Borrow or Use Assets as Collateral

The capital availability environment has become far worse since our initial report in June 2000.

Given the company's extremely high debt leverage, it is unlikely that it will be able to borrow unsecured money from the high yield or convertible debt markets. We discussed in detail all the potential sources of liquidity in our initial report in June (see pages 22 to 24). Our June analysis of the tight capital availability situation still stands, with the capital markets becoming much more restrictive since then. However, there is currently no restriction for using assets (especially inventory) as collateral. *Given the low amount of assets and the Caa1 rating of the company, it is highly unlikely that Amazon will be able to raise debt funding of any sizeable magnitude, especially compared to the $1.25 billion that it raised in January 1999 or the €690 million in February 2000.*

3) Reduce or Delay Expenditures

Feasibility of Reducing or Postponing Expenditures, Effects of Reducing or Postponing Expenditures

In our analysis, we use the company's guidance of $120 million in capital investments. This can be reduced to provide liquidity in 2001, as it is somewhat discretionary.

However, the challenge of maintaining a much higher projected level of sales with a much lower level of fixed assets is relevant. Other postponement of expenditures could be related to the company's international ventures.

4) Increase Ownership Equity

Feasibility of Increasing Equity Based on Existing or Committed Arrangements, Flexibility of Dividend Policy and Ability to Raise Funds from Affiliates or other Investors

As far as raising capital is concerned, despite the recent Fed rate cut, we still stick by our initial analysis in June in which we describe in detail the challenges involved in raising various forms of capital from equity and converts to straight debt and bank credit. (For a detailed analysis of the feasibility of each source of capital, investors are directed to the section entitled, "Future Operating Viability and Avenues for Raising Cash," in pages 22-23 of our June report). The company does not pay dividends, so there is no dividend flexibility. The company's capital raising from its ACN partners such as the $57 million last quarter could be a potential source of financing, although a forecast is not possible. Additionally, places of funding such as private equity might be possible but quite expensive, issues that we have already addressed in our first report.

Other Topics

Cash Raised Last Year

In considering potential sources of cash that the company could tap into, we look at the various sources Amazon used to raise the cash and marketable securities line in the first three quarters of 2000. As we discussed in our last First Call note (see "Amazon.com – Further Analysis of Cash and Cash Flows," dated October 25, 2000), the company raised approximately $173 million from sources such as reclassification and advances from ACN partners. In addition, in the first three quarters, the company also raised roughly $30 million from changes in capital stock and proceeds from stock option exercises. By definition, these are non-forecastable events and thus cannot be projected in modeling future sources of cash, inducing conversion in the debt.

While it is not really helpful to current liquidity, one of the strategies the company can use to improve its balance sheet is to induce conversion of its outstanding convertible debt issues. We addressed the mechanics and effect of this particular tactic in our initial report on Amazon credit in June (see section entitled, "Reducing the Debt Level – The Beauty of Convertibles Versus Straight Debt," page 24 of the June report). Companies with convertible debt can do this by sharply reducing the conversion price (i.e., offering many more shares in a dilutive transaction) and inducing holders to convert out well below par to make a short-term trading profit. As we discussed in the previous report, this is essentially a capital market tactic utilized by distressed companies and employed only when the debt burden gets too onerous and the interest payment is in danger of default, which certainly was not the situation last June.

History indicates that attempts to induce conversion of the convertible debt are unlikely to be completely successful.

The biggest problem with this particular maneuver is the fact that on the average convertible debt holders do not like to convert into an asset that is lower than the capital structure, especially if it a distressed scenario. A clear example was the case of the Baan convertible last year when the company offered to induce a similar conversion. However, less than one-third of the debt holders actually accepted the equity exchange, leaving the company with most of the debt still on the balance sheet and the investor relations issues associated with the failed attempt. In the takeover from Invensys that followed, most of the value of the transaction was realized by the convertible debt holders who had not accepted the exchange offer as the debt traded up to par while the holders who had converted to equity received a very meager premium. Given recent precedents like this, we would not consider it likely that a large portion of debt holders will convert to common stock. Additionally, as we mentioned in our initial report, these maneuvers are much more easier with smaller-sized convertible issues; it is hard to imagine it working effectively with nearly $2 billion in convertible securities.

Convertible holders are likely to make more money holding on to the debt rather than converting to the current equity.

We would not recommend that convertible holders accept such a conversion purely because it will take them from the top of the capital structure to the bottom. In a distressed scenario, the convertible debt holders are likely to end up owning the company outright and most likely have more upside potential than any premature conversion to the current equity.

More on Going Concern Qualifications

One of the most distinct differences between the auditing season in 2000 and 2001 is clearly the lack of ebullience in the capital markets and a consequent paucity of funding to companies with money-losing business plans. Given that a going concern statement usually requires a combination of money-losing operations and tight capital funding environment, we believe that this auditing season could see a substantial jump in the number of such qualifications attached with the annual audits. Thus, it is probable that a many money-losing companies whose stock prices are off sharply and that have substantial debt load will be likely under the risk of getting this qualification this time around. We believe that this event could pose a risk in a number of growth companies in the convertibles universe that are currently facing operational losses and a weak working capital balance.

The tight capital markets are likely to going to trigger much more "going concern" clauses in companies that continue to lose money during 2001.

Adding to the pressure faced by auditors, a number of companies (most notably pets.com), "IPOed" in 2000 and filed for bankruptcy inside the next auditing period. The financials for the IPOs were based upon audits conducted for the previous fiscal year, and very often did not include the going concern qualification, although the companies had posted substantial operating losses since inception. *We believe that this was principally a result of the accommodative and ebullient capital markets, which helped assuage auditor concerns about liquidity events.* However, the fact that, despite the liquidity provided, a number of companies that had to close operations are going to make auditors much more conservative this year about giving companies the benefit of the doubt in terms of raising capital to offset operational outflows.

Where Could We Go Wrong?

Given our obvious concerns about Amazon's liquidity, and the non-deterministic nature of all forecasts, it is relevant to note the points that would help alleviate our concerns. Among the key points are obviously an elimination of cash operating losses for all of 2001 (which can be achieved through either raising prices or sharply cutting back on fulfillment and IT costs), a large reduction in capex (although it might mean an erosion of fixed assets) and an infusion of capital through the company's ACN partners, other strategic investors or the capital markets. We will update our analysis as we get better visibility on these issues.

Convertible Valuation

The Amazon 4.75% Convertible Bond due 2009 was trading at $44.48, with the underlying common stock at $19.00 on January 25. The convertible has a current yield and yield to maturity of 10.68% and 18.18%, respectively. The convertible was trading 82.67% over its conversion value and 2% over its investment value. The bond is convertible at $78.03 per share to 12.816 shares of AMZN common stock and is rated Caa3 by Moody's and CCC+ by Standard & Poor's. The note has a provisional call feature in which the bond is callable should the common reach 150% of its conversion price. However, since the convertible is trading deeply out of the money, it is unlikely that the provisional call will be triggered. Based on our assumption of a 1,300-basis-point credit spread and 50% volatility, the bond is 15.48% cheap on our model. However, as we have continuously reminded investors, given our concern about the downside credit support in the convertibles, the theoretical valuation can be meaningless. The downside asset floor in the convertible is probably in the $20 range, although attempting to value the assets without substantial due diligence can be very risky.

We continue to recommend that investors avoid the company's convertible securities.

Figure 9: Amazon.com Inc. Income Statement

	6/1998	9/1998	12/1998	3/1999	6/1999	9/1999	12/1999	3/2000	6/2000	9/2000	12/2000	3/2001E	6/2001E	9/2001E	12/2001E
Net Sales	116.0	153.6	252.8	293.6	314.4	355.8	676.0	573.9	577.9	637.9	**972.4**	675.0	700.0	750.0	1,275.0
% Growth (Sequential)	33%	32%	65%	16%	7%	13%	90%	-15%	0.7%	10.4%	52.4%	-31%	4%	7%	70%
Cost of Goods Sold	89.8	118.8	199.5	228.9	246.8	285.3	588.2	445.8	441.8	470.6	748.1	529.9	539.0	577.5	994.5
% Growth (Sequential)	32%	32%	68%	15%	8%	16%	106%	-24%	-0.9%	6.5%	59.0%	-15%	1%	2%	35%
Gross Income	26.2	34.8	53.3	64.8	67.5	70.5	87.8	128.1	136.1	167.3	224.3	145.1	161.0	172.5	280.5
Gross Margin	22.58%	22.67%	21.09%	22.06%	21.48%	19.81%	12.99%	22.33%	23.55%	26.23%	23.07%	21.50%	23.00%	23.00%	22.00%
Gross Income as a % of sales	22.6%	22.7%	21.1%	22.1%	21.5%	19.8%	13.0%	22.3%	23.5%	26.2%	23.1%	21.5%	23.0%	23.0%	22.0%
Selling, General and Admin Expenses	44.6	76.3	92.5	120.7	190.0	260.9	324.8	326.0	316.4	330.8	546.4	323.5	327.0	289.5	275.8
Marketing Sales & Fulfillment	27.0	37.5	48.3	60.7	85.9	86.6	179.9	140.1	129.8	138.3	186.2	135.0	137.5	140.0	152.0
Technology & Content (Product Developm	8.7	13.2	17.1	23.4	34.3	44.6	57.4	61.2	67.1	71.2	69.8	72.5	72.5	72.5	75.0
General & Administrative	3.3	5.0	5.3	11.2	14.5	18.5	25.8	26.0	28.5	26.2	28.2	25.0	26.0	25.0	27.0
Stock Based Compensation (N/C)	0.2	1.2	0.5	0.1	4.7	11.8	14.0	13.7	8.2	4.1	(1.1)	-	-	-	-
Amort. of Goodwill/Other Intang (N/C)	5.4	19.5	17.7	25.2	50.6	99.5	39.4	83.0	80.4	79.2	79.2	79.2	79.2	40.2	10.0
Merger, acquisition/Inv Related (N/C)	-	-	3.5	-	-	-	8.1	2.0	2.4	11.8	184.1	11.8	11.8	11.8	11.8
Mkt/Fullfillment as a % of Sales	23.3%	24.4%	19.1%	20.7%	27.3%	24.3%	26.6%	24.4%	22.5%	21.7%	19.2%	20.0%	19.6%	18.7%	11.9%
Tech/Content as a % of Sales	7.5%	8.6%	6.8%	8.0%	10.9%	12.5%	8.5%	10.7%	11.6%	11.2%	7.2%	10.7%	10.4%	9.7%	5.9%
General/Admin as a % of Sales	2.8%	3.2%	2.1%	3.8%	4.6%	5.2%	3.8%	4.5%	4.9%	4.1%	2.9%	3.7%	3.7%	3.3%	2.1%
Stock Based Comp as a % of Sales	0.2%	0.8%	0.2%	0.0%	1.5%	3.3%	2.1%	2.4%	1.4%	0.6%	-0.1%	0.0%	0.0%	0.0%	0.0%
Amort as a % of Sales	4.7%	12.7%	7.0%	8.6%	16.1%	28.0%	5.8%	14.5%	13.9%	12.4%	8.1%	11.7%	11.3%	5.4%	0.8%
Merger,Acq/Inv Rel as a % of Sales	0.0%	0.0%	1.4%	0.0%	0.0%	0.0%	1.2%	0.4%	0.4%	1.8%	18.9%	1.7%	1.7%	1.6%	0.9%
SGA Exp. as a % of sales	38.4%	49.7%	36.6%	41.1%	60.4%	73.3%	48.0%	56.8%	54.8%	51.9%	56.2%	47.9%	46.7%	38.6%	21.6%
Operating Income after Depreciation	(18.4)	(41.5)	(39.2)	(55.9)	(122.5)	(190.5)	(236.9)	(197.9)	(180.4)	(163.5)	(322.1)	(178.4)	(166.0)	(117.0)	4.7
Interest Income	3.4	4.8	4.3	10.9	12.9	12.7	9.0	10.1	10.3	9.4	11.0	5.4	5.4	5.4	5.4
Interest Expense	7.6	8.4	8.6	16.6	28.4	21.5	18.1	27.6	33.4	33.8	36.1	32.5	32.5	32.5	32.5
Other Income/Expense (Net)	-	-	-	(0.0)	-	2.2	(0.4)	(4.8)	(3.3)	3.4	(5.4)	-	-	-	-
Non-cash investment gains and losses, ne	-	-	-	-	-	-	-	-	-	12.4	(155.0)	-	-	-	-
Equity in Losses of Equity Investees (N/C)	-	-	2.9	-	-	-	76.8	88.3	110.5	68.3	37.6	83.1	83.1	122.1	152.3
Nonrecurring Pretax Income (Expense)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Pretax Income	(22.6)	(45.2)	(46.4)	(61.7)	(138.0)	(197.1)	(323.2)	(308.4)	(317.2)	(240.5)	(545.1)	(288.6)	(276.2)	(266.2)	(174.7)
Total Income Taxes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Minority Interest	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income before Extraordinaries	(22.6)	(45.2)	(46.4)	(61.7)	(138.0)	(197.1)	(323.2)	(308.4)	(317.2)	(240.5)	(545.1)	(288.6)	(276.2)	(266.2)	(174.7)
Extraordinaries	-	-	-	-	-	-	-	-	-	-	-	(75.0)	(75.0)	-	-
Net Income after Extraordinaries	(22.6)	(45.2)	(46.4)	(61.7)	(138.0)	(197.1)	(323.2)	(308.4)	(317.2)	(240.5)	(545.1)	(363.6)	(351.2)	(266.2)	(174.7)
Operating Results Excluding Amort/Merger	(12.8)	(20.8)	(17.5)	(30.6)	(67.3)	(79.2)	(175.3)	(99.3)	(89.3)	(68.4)	(59.9)	(87.4)	(75.0)	(65.0)	26.5
As a % of Sales	-11.0%	-13.5%	-6.9%	-10.4%	-21.4%	-22.3%	-25.9%	-17.3%	-15.5%	-10.7%	-6.2%	-12.9%	-10.7%	-8.7%	2.1%

Source: Lehman Brothers Convertibles Research

Figure 10: Amazon.com Inc. Balance Sheet

	6/1998	9/1998	12/1998	3/1999	6/1999	9/1999	12/1999	3/2000	6/2000	9/2000	12/2000	3/2001E	6/2001E	9/2001E	12/2001E
Assets															
Cash and Marketable Securities	339.9	337.3	373.4	1,443.0	1,144.2	905.7	706.2	1,008.9	907.6	900.0	1,100.5	614.6	525.2	201.1	125.2
Cash and Cash Equivalents	-	-	-	-	-	-	-	84.1	720.4	647.0	822.4	336.6	247.1	(77.0)	(152.9)
Marketable Securities	-	-	-	-	-	-	-	924.8	187.2	253.0	278.1	278.1	278.1	278.1	278.1
Net Receivables	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Inventories	17.0	19.8	29.5	45.2	59.4	118.8	220.6	172.3	172.4	163.9	174.6	168.8	175.0	187.5	318.8
Inventory as a % of sales	15%	13%	12%	15%	19%	33%	33%	30%	30%	26%	18%	25%	25%	25%	25%
Inventory Turnover (using sales)	8.1	8.3	10.3	7.9	6.0	4.0	4.0	2.9	3.4	3.8	5.7	3.9	4.1	4.1	5.0
Qtrly Inventory Days (using 90 days)	11	11	9	11	15	23	23	31	27	24	16	23	22	22	18
Prepaid Exp & Other Current Assets	12.5	17.6	21.3	37.1	53.3	55.6	85.3	89.8	86.7	99.2	86.0	87.8	91.0	97.5	165.8
Prep & Othr Curr Assts as a % of sale	11%	11%	8%	13%	17%	16%	13%	16%	15%	16%	9%	13%	13%	13%	13%
Total Current Assets	369.4	374.7	424.3	1,525.3	1,257.0	1,080.1	1,012.2	1,270.9	1,166.6	1,163.1	1,361.1	871.1	791.2	486.1	609.7
Gross Property, Plant and Equipment	21.2		43.6	79.4	183.2	-	-	-	-	-	-	-	-	-	-
Net Property, Plant and Equipment	14.0	23.8	29.8	60.6	156.3	221.2	317.6	334.4	344.0	352.3	366.4	357.7	298.9	315.2	331.4
Net Goodwill	52.4	213.1	174.1	187.2	741.9	705.9	534.7	471.7	441.2	384.0	159.0	99.6	40.2	10.0	2.5
Other Intangibles Net	-	-	4.6	-	-	-	195.4	175.4	155.5	136.5	96.3	76.5	56.7	46.7	44.2
Investments In Equity Method Investees	-	-	7.7	-	-	-	226.7	271.5	211.7	91.1	52.1	52.1	52.1	52.1	52.1
Other Investments	-	-	-	-	106.0	196.3	144.7	150.8	88.3	73.3	40.2	40.2	40.2	40.2	40.2
Other Assets	7.9	8.2	8.0	39.9	37.0	36.2	40.2	54.9	53.3	54.3	60.0	60.0	60.0	60.0	60.0
Intangible Assets	52.4	213.1	178.6	187.2	741.9	705.9	730.1	647.2	596.8	520.5	255.3	176.1	96.9	56.7	46.7
Total Assets	443.8	619.7	648.5	1,813.0	2,298.2	2,239.8	2,471.6	2,729.7	2,460.7	2,254.6	2,135.2	1,557.2	1,339.3	1,010.3	1,140.1
Liabilities and Shareholders' Equity															
Debt in Current Liabilities	0.7	0.7	0.8	7.2	9.9	12.8	14.3	16.0	17.7	17.2	16.6	8.0	5.0	5.0	5.0
Accounts Payable	47.6	60.0	113.3	133.0	166.0	236.7	463.0	255.8	286.2	304.7	485.4	303.8	315.0	225.0	255.0
As a % of Sales	41%	39%	45%	45%	53%	67%	68%	45%	50%	48%	50%	45%	45%	30%	20%
Income Taxes Payable	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Accrued Exp & Othr Current Liab	23.7	38.7	47.5	61.4	78.1	98.1	181.9	144.8	146.9	160.1	272.7	189.0	175.0	135.0	191.3
As a % of Sales	20%	25%	19%	21%	25%	28%	27%	25%	25%	25%	28%	28%	25%	18%	15%
Unearned Revenue	-	-	-	-	-	-	54.8	134.8	115.6	142.0	131.1	135.0	140.0	112.5	127.5
As % of Sales	0%	0%	0%	0%	0%	0%	8%	23%	20%	22%	13%	20%	20%	15%	10%
Interest Payable	-	-	0.0	-	24.0	10.0	24.9	15.8	41.2	35.1	69.2	30.0	69.2	30.0	69.2
Total Current Liabilities	71.9	99.5	161.6	201.6	277.9	357.7	738.9	567.2	607.6	659.1	975.0	665.8	704.2	507.5	648.0
Long-Term Debt	332.4	340.5	348.1	1,533.9	1,449.2	1,462.2	1,466.3	2,137.0	2,131.5	2,082.7	2,127.5	2,127.5	2,127.5	2,127.5	2,127.5
Preferred Stock (Carrying Value)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Common Equity	39.4	179.8	138.7	77.5	571.0	419.9	266.3	25.6	(278.4)	(487.2)	(967.3)	(1,330.8)	(1,682.0)	(1,948.3)	(2,123.0)
Total Shareholders' Equity	39.4	179.8	138.7	77.5	571.0	419.9	266.3	25.6	(278.4)	(487.2)	(967.3)	(1,330.8)	(1,682.0)	(1,948.3)	(2,123.0)
Total Liabilities and Shareholders' Equity	443.8	619.7	648.5	1,813.0	2,298.2	2,239.8	2,471.6	2,729.7	2,460.7	2,254.6	2,135.2	1,557.2	1,339.3	1,010.3	1,140.1

Source: Lehman Brothers Convertibles Research

Figure 11: Amazon.com Inc. Cash Flow Statement

	6/1998	9/1998	12/1998	3/1999	6/1999	9/1999	12/1999	3/2000	6/2000	9/2000	12/2000	3/2001E	6/2001E	9/2001E	12/2001E
Operating															
Net Income before Extraordinaries	(22.6)	(45.2)	(46.4)	(61.7)	(138.0)	(197.1)	(323.2)	(308.4)	(317.2)	(240.5)	(545.1)	(363.6)	(351.2)	(266.2)	(174.7)
Deprec/Amort of Fixed Assets	6.9	-	0.6	5.2	8.1	9.6	13.9	18.2	20.7	22.9	22.7	15.0	15.0	15.0	15.0
As % of Prior Period PPE	71%	0%	3%	18%	13%	6%	6%	6%	6%	7%	6%	4%	4%	5%	5%
Other Non Cash:															
Stock Based Compensation (N/C)	0.4	(0.1)	1.8	0.1	4.7	11.8	14.0	13.7	8.2	4.09	(1.1)	-	-	-	-
Equity in Losses of Equity Investees (N/	-	-	2.9	-	-	-	76.8	88.3	110.5	68.32	37.6	83.1	83.1	122.1	152.3
Amort. of Goodwill/Other Intang (N/C)	7.1	17.9	17.7	25.2	50.6	99.5	39.4	83.0	80.4	79.19	79.2	79.2	79.2	40.2	10.0
Merger, acquisition/Inv Related (N/C)	-	-	1.6	-	-	-	8.1	2.0	2.4	11.79	184.1	11.8	11.8	11.8	11.8
Unearned Revenue	-	-	-	-	-	-	-	-	-	57.47	-	-	-	-	-
Amortization of Previously Unearned Re	-	-	-	-	-	-	(5.8)	(18.5)	(18.8)	(26.87)	(42.7)	-	-	-	-
Non-cash Investment Gains/Losses	-	-	-	-	-	-	-	-	-	(12.37)	155.0	-	-	-	-
Gain/Loss on Sale of Marketable Secur	-	-	0.3	4.2	3.3	(1.4)	2.6	(2.6)	1.6	(3.21)	3.9	-	-	-	-
Non Cash Int Exp & Other	-	-	24.0	7.5	13.1	5.6	3.1	5.7	(10.0)	6.23	6.5	25.0	75.0	-	-
Other Non Cash	7.5	17.8	48.2	37.0	71.5	115.5	138.1	171.6	174.4	184.65	422.4	199.1	249.1	174.1	174.1
Gross Cash Flow - Operating	(8.12)	(27.37)	2.44	(19.45)	(58.38)	(71.96)	(171.19)	(118.70)	(122.12)	(33.02)	(100.01)	(149.52)	(87.15)	(77.15)	14.35
Net Chg in Operating Assets and Liabs															
Inventories	(5.3)	(2.7)	(9.7)	(15.7)	(14.2)	(59.4)	(82.8)	48.4	(0.1)	8.48	(10.7)	5.8	(6.3)	(12.5)	(131.3)
Prepaid Expenses & Othr Current Assets	(6.9)	(4.4)	(4.2)	(15.6)	(15.9)	(1.2)	(27.9)	2.6	4.1	(6.03)	3.4	(1.7)	(3.3)	(6.5)	(68.3)
Accounts Payable	12.0	11.8	53.2	19.7	31.8	70.2	208.4	(207.2)	30.4	18.47	180.7	(181.6)	11.3	(90.0)	30.0
Accrued expenses & othr Curr Liab	9.1	9.9	8.7	4.7	12.2	0.7	89.9	(37.1)	(0.8)	12.89	113.4	(92.3)	(17.0)	(40.0)	56.3
Unearned Revenue	-	-	-	-	-	-	0.3	0.6	(0.4)	-	31.7	3.9	5.0	(27.5)	15.0
Interest Payable	-	-	(0.2)	9.1	14.9	(13.9)	14.8	(9.1)	18.6	(4.47)	29.2	(39.2)	39.2	(39.2)	39.2
Operating Assets & Liab	8.8	14.6	47.9	2.3	28.8	(3.6)	202.7	(201.8)	51.9	29.33	347.7	(305.1)	29.0	(215.7)	(59.1)
Net Cash Flow - Operating	0.7	(12.8)	50.3	(17.2)	(29.6)	(75.6)	31.5	(320.5)	(70.2)	(3.69)	247.7	(454.6)	(58.2)	(292.8)	(44.7)
Investing															
Capital Expenditures	(5.6)	(11.1)	(9.6)	(19.1)	(92.0)	(70.8)	(105.2)	(26.6)	(28.9)	(42.00)	(37.3)	(31.3)	(31.3)	(31.3)	(31.3)
Cap Ex as a % of sales	-5%	-7%	-4%	-6%	-29%	-20%	-16%	-5%	-5%	-7%	-4%	-5%	-4%	-4%	-2%
Acquisitions and Investments in Businesse	15.0	(0.6)	14.4	-	(107.4)	(115.5)	(146.8)	(47.5)	(8.6)	-	(0.7)	-	-	-	-
Net Purchase of Securities	(210.9)	16.0	(16.5)	(1,124.3)	352.2	238.8	267.7	(319.4)	718.0	27.67	(64.9)	-	-	-	-
Sales and Maturities of Mktable Securitie	-	-	-	-	-	-	-	-	-	72.62	23.8	-	-	-	-
Purchases of Mktable Securities	-	-	-	-	-	-	-	-	-	(44.95)	(88.7)	-	-	-	-
Other Investing Activities	-	-	(19.0)	-	-	-	-	-	-	-	-	-	-	-	-
Net Cash Flow - Investing	(231.6)	5.5	(30.7)	(1,143.4)	152.8	52.6	15.7	(393.5)	680.5	(14.34)	(102.9)	(31.3)	(31.3)	(31.3)	(31.3)
Financing															
Change in Current Debt	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Change in Long-Term Debt	248.8	(0.2)	(0.7)	1,168.8	(101.2)	8.4	(1.2)	675.4	(3.6)	(3.28)	(3.9)	-	-	-	-
Change in Capital Stock	0.6	10.3	3.0	6.5	15.1	15.3	27.5	21.4	13.8	-	-	-	-	-	-
Proceeds from Exercise of Stock Options	-	-	-	-	-	-	-	-	-	4.56	5.0	-	-	-	-
Other Financing Activity	(7.8)	(0.0)	-	(34.9)	(0.0)	(0.2)	-	(15.9)	(0.2)	-	-	-	-	-	-
Net Cash Flow - Financing	241.6	10.1	2.3	1,140.4	(86.2)	23.5	26.4	680.8	10.0	1.29	1.1	-	-	-	-
Exchange Rate Effect	(0.0)	(0.4)	0.4	(0.2)	0.3	0.1	0.2	0.4	(0.3)	(50.89)	29.6	-	-	-	-
Miscellaneous	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Increase (Dec) in Cash	12.2	12.0	10.7	(20.3)	37.3	0.6	73.8	(32.8)	619.9	(67.62)	175.4	(485.9)	(89.4)	(324.1)	(75.9)

Source: Lehman Brothers Convertibles Research

Appendix One – The Going Concern Concept

Financial statements are usually prepared on the assumption that the entity will continue as a going concern. When a company decides or is forced to liquidate, the going concern concept is not appropriate, and assets should be presented at their estimated net realizable values and legally enforceable liabilities should be classified according to priorities established by law (AU 341.01).

SAS-59 (The Auditor's Consideration of an Entity's Ability to Continue as a going concern) concludes that as part of an examination, the auditor should evaluate conditions or events discovered during the engagement that raise questions about the appropriateness of the going concern concept. Such conditions or events may be identified at various points during the engagement, including the performance of analytical procedures, reading of responses received from the entity's legal counsel, and evaluating the entity's compliance with restrictions imposed by loan agreements (AU 341.02).

Information that raises questions about going concern generally relates to the entity's ability to meet its maturing obligations without selling operating assets, restructuring debt or revising operations based on outside pressures or similar strategies. SAS-59 concludes that the projection of the going concern concept is limited to a reasonable period of time, which is defined as not exceeding one year beyond the date of the audited financial statements (AU 341.01).

To satisfy the standards related to the going concern concept established by SAS-59, the following steps should be followed (AU 341.03):

- Evaluate information obtained during the course of the engagement to determine whether substantial doubt has been raised about the entity's continued existence as a going concern for a reasonable period of time.
- When substantial doubt has been raised, identify and evaluate management's plans for dealing with the conditions or events that prompted the substantial doubt conclusions.
- Draw a conclusion concerning the existence of substantial doubt and consider the effect of this conclusion on disclosures in the financial statements and the format of the auditor's report.

Evaluate Information Related to Substantial Doubt: Although the auditor is not specifically required to employ procedures to identify conditions or events that might raise a substantial doubt question, the auditor should be sensitive to evidential matter collected and implications relative to going concern (AU 341.05).

SAS-59 provides the following on the next page as examples of conditions and events that may raise a substantial doubt question (AU 341.06).

Source: *SAS – 59 Auditing Standards Board, Miller GAAS Guide*

Appendix One – The Going Concern Concept (Continued)

Condition or Event	Specific Example
Negative trends	▪ Recurring operating losses ▪ Working capital deficiencies ▪ Negative cash flows from operations ▪ Adverse key financial ratios
Other indications of possible financial difficulties	▪ Default on loan or similar agreements ▪ Arrearages in dividend ▪ Denial of usual trade credit form vendors ▪ Restructuring of debt ▪ Noncompliance with statutory capital requirements ▪ Need to sell substantial assets
Internal matters	▪ Labor difficulties, such as work stoppages ▪ Substantial dependence on the success of a particular project ▪ Uneconomic long-term commitments ▪ Need to significantly revise operations
External matters	▪ Legal proceedings, legislation, or similar matters that might effect the entity's ability to continue operations ▪ Loss of key franchise, license, or patent ▪ Loss of principal customer or vendor ▪ Occurrence of uninsured catastrophe

When the evidential matter raises a substantial doubt question, the auditor may obtain additional evidence that may remove the question of substantial doubt (AU 341.07).

Identify and Evaluate Management's Plans: If it is concluded that there is a substantial doubt about the continued existence of the entity as a going concern for a reasonable period of time, the auditor should identify and evaluate management's plans to mitigate the effects of the adverse conditions or events. SAS-59 identifies the following on the next page as examples of plans and factors that are relevant to the evaluation of those plans (AU 341.07).

Source: *SAS – 59 Auditing Standards Board, Miller GAAS Guide*

Appendix One – The Going Concern Concept (Continued)

Planned Action	Factors Relevant to Evaluation of Planned Action
Sales of assets	▪ Restrictions on the sale of assets ▪ Likely marketability of assets ▪ Effects from sale of assets
Borrow or restructure debt	▪ Likelihood of raising funds based on existing or committed debt arrangements ▪ Existing or committed arrangements for restructuring debt or obtaining guarantees for loans ▪ Restrictions on ability to borrow or use assets as collateral
Reduce or delay expenditures	▪ Feasibility of reducing or postponing expenditures ▪ Effects of reducing or postponing expenditures
Increase ownership equity	▪ Feasibility of increasing equity based on existing or committed arrangements ▪ Flexibility of dividend policy ▪ Ability to raise funds from affiliates or other investors

The auditor should consider obtaining evidential matter to support planned actions that are significant to the substantial doubt question (AU 341.08).

Some management strategies may, in part, be evaluated through the auditor's investigation of management's prospective financial statements. The specific audit procedures that may be employed include the following (AU 341.09):

- Read the prospective financial statements
- Identify fundamental assumptions used to prepare the prospective financial statements
- Evaluate the prospective financial statements on the basis of the auditor's familiarity with the client's operations
- Compare the prospective financial statements for prior periods with actual results
- Compare the prospective financial statements for the current period with actual results to date

During the evaluation of fundamental assumptions used to prepare the prospective financial statements, special emphasis should be directed to the following assumptions (AU 341.09):

- Assumptions that have a material effect on the prospective financial statements
- Assumptions that have a high degree of uncertainty
- Assumptions that are inconsistent with past patterns

Source: *SAS – 59 Auditing Standards Board, Miller GAAS Guide*

Appendix One – The Going Concern Concept (Continued)

If the auditor discovers material factors that are not reflected in the preparation of the prospective financial statements, such discoveries should be discussed with management with the understanding that the statements may have to be revised (AU 341.09).

Draw a Conclusion Concerning Substantial Doubt: Once the auditor has evaluated management's strategies designed to mitigate the adverse effects of conditions or events that raise a question about continued existence, a determination must be made of whatever substantial doubt about the going concern concept exists (AU 341.10).

If substantial doubt does not exist, there is no need to modify the auditor's report. However, the auditor should consider whether the conditions or events that originally created the question about going concern should be disclosed in the financial statements. The disclosure might include the possible effect of the conditions or events and mitigating factors (including management's plans) AU 341.11).

If the auditor concludes that substantial doubt exists, the effects of the conditions or events should be considered as they relate to: (1) adequate disclosures in the financial statements, and (2) modifications to the auditor's report (AU 341.10).

Adequate Disclosures: If an auditor concludes that substantial doubt exists about the client's ability to continue in existence, care must be taken to ensure that presentations and related disclosures in the financial statements properly reflect the: (1) recoverability and classification of assets, and (2) amount and classification of liabilities. In addition, an auditor should consider whether disclosures related to the possible discontinuation of operations are adequate in the financial statements. SAS-59 notes the disclosure might include the following (AU 341.10):

- Conditions or events that gave rise to the substantial doubt concerning continued existence
- Possible effects of the conditions or events
- Management's assessments concerning the significance of the conditions or events
- Other factors that may aggravate or mitigate the conditions or events
- Management's strategies that will attempt to deal with the adverse conditions or events
- Possible discontinuance of operations

> Observation: The financial statement effects described above are relevant when there is substantial doubt about continued existence. If it is concluded that the going concern concept is not applicable, the financial statements must be prepared on a liquidation basis. Guidance for reporting on liquidation-based financial statements can be found in an Auditing Interpretation entitled "Reporting on Financial Statement Prepared on Liquidation Basis of Accounting" (December 1984) (AU 9508.33-.38).

Source: *SAS – 59 Auditing Standards Board, Miller GAAS Guide*

Appendix One – The Going Concern Concept (Continued)

Report modifications: If an auditor concludes that substantial doubt exists about the continued existence of the client, the audit report should be modified. When the auditor believes that the financial statements can still be relied on, the report modification is limited to a reference to the going concern matter in the report, but the opinion expressed is unqualified (AU 341.12).

The substantial doubt question is discussed in an explanatory paragraph following the opinion paragraph. SAS-64 (Omnibus Statement on Auditing Standards – 1990) requires that the explanatory paragraph include the phrase "substantial doubt is about its [the entity's] ability to continue as a going concern," or similar wording. If similar wording is used, the terms substantial doubt and going concern must be used in the phrase.

When an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, the audit report should not use language that suggests that the conclusion is conditional on future events. Specifically, SAS-77 notes that the use of conditional terminology, such as "if the company is unable to obtain refinancing, there may be substantial doubt about the company's ability to continue as a going concern" is precluded.

The introductory, scope, and opinion paragraphs make no reference to the explanatory paragraph. An example of an explanatory paragraph based on a substantial doubt question is presented below (AU 341.12-.13).

> The accompanying financial statements have been prepared assuming that the company will continue as a gong concern. As discussed in Note X to the financial statements, the company is involved in litigation concerning alleged patent infringement. Because operations of the company could be substantially impeded if the charges are upheld, the pending litigation raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to the litigation are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Observation: An auditor can no longer express a "subject to" qualified opinion because of an uncertainty.

When the auditor concludes that the uncertainty related to the substantial doubt question is so significant to an opinion cannot be expressed on the financial statements, a disclaimer of opinion may be expressed AU 341.12).

The modification of the auditor's report because of a substantial doubt question in the current year does not imply that the auditor's report on a prior year's financial statements (presented on a comparative basis) should also be modified (AU 341.15).

Source: *SAS – 59 Auditing Standards Board, Miller GAAS Guide*

Appendix One – The Going Concern Concept (Continued)

During the current year, a question of substantial doubt contained in an auditor's report on a prior year's financial statements may no longer be applicable. Under this circumstance, the explanatory paragraph should not be repeated in the auditor's report on the comparative financial statements (AU 341.16).

> Observation: The noninclusion of the explanatory paragraph is not a change in the opinion expressed by the auditor and therefore does not require the observance of the report guidelines established in SAS-58 concerning changes of opinions.

Although the auditor is responsible for including an explanatory paragraph in the auditor's report when a substantial doubt question arises, the auditor is not responsible for predicting the outcome of future events. Thus, the liquidation of an entity (even within one year of the date of the financial statements) does not imply that the audit was substandard when an explanatory paragraph has not been included in the auditor's report. Similarly, the lack of including an explanatory paragraph in the auditor's report should not be taken as an assurance that the entity will continue as a going concern within a reasonable period of time (AU 341.04).

Source: *SAS – 59 Auditing Standards Board, Miller GAAS Guide*

Appendix Two – Some Accounting Terms

Term	Definition
Accounting	A system of providing quantitative/financial information about economic and business entities with the primary functions/goals being to record, classify, summarize, analyze and disclose the information.
Accounting Concepts and Conventions	Generally centers on relevance and reliability, comparability and consistency, conservatism, materiality, and full disclosure.
Accounting Research Bulletins	From 1939 to 1953, the **AICPA** issued 42 Accounting Research Bulletins of which eight concerned Accounting terminology and 34 dealt with problems the accounting profession was most concerned with at the time.
Accounting Standards Executive Committee	The AcSEC is a committee of the **AICPA** that establishes accounting principles by issuing Statements of Position, Audit and Accounting Guides, and **AICPA** Practice Bulletins.
AICPA	**American Institute of Certified Public Accountants.** The professional association of CPAs.
Audit	A methodical review and objective examination of an item, including the verification of specific information. Generally the purpose is to express an opinion on or reach a conclusion about what is being audited (in financial accounting, it is the financial statements that are being audited).
Auditing Interpretations	Provide guidance to the independent auditor in interpreting Statements on Auditing Standards **(SAS)** issued by the **Auditing Standards Board**.
ASB	**Auditing Standards Board** set up by the **AICPA** designated to promulgate auditing and attest standards and procedures.
Broad principles	The bridge between basic and detailed principles. They provide the guidelines for selecting, recording, and communicating financial events produced by the accounting process.
Code of Professional Conduct	A member engaged in the practice of public accounting must observe all the Rules of Conduct.
Continuity (going concern)	An enterprise is viewed as a continuing operation, possessing the resources to meet its obligations and commitments. However, if liquidation is imminent or if the entity cannot continue in existence to meet its current plans and obligations, financial information may be prepared on the assumption that operations will cease and/or liquidation will occcur.

Appendix Two – Some Accounting Terms, Continued

Term	Definition
Conservatism	Has evolved over the years because accountants prefer that estimates or errors result in understatement rather than overstatement of net income or net assets.
Consistency/Comparability	Comparable financial statements reveal more information by providing useful data about differences in results of operations for different time periods, consistency between entities, time periods, and accounting data is necessary for comparability.
FASB	**Financial Accounting Standards Board** created in 1973 to be a private sector independent accounting standard setter, the board primarily issues statements and other releases.
Full disclosure	Financial statements including footnotes should contain adequate disclosure of all pertinent data necessary for a fair presentation in conformity with **GAAP**.
GAAP	**Generally Accepted Accounting Principles**. Defined as technical accounting principles, methods, and procedures that are generally accepted at a particular time. The major groups involved in setting standards include: (1) **AICPA**, (2) **FASB**, (3) **SEC** and (4) **AAA** - professional association of accountants.
GAAS	**Generally Accepted Auditing Standards**. Deal with the quality of the audit. Ten generally accepted auditing standards have been approved and adopted by the members of the **AICPA**. **GAAS** are divided into three groups: (1) general standards, (2) standards of fieldwork, and (3) standards of reporting.
Industry Audit Guides	Published for the guidance of **AICPA** members in a particular area. It does not have the authority of a pronouncement issued by the Auditing Standards Board.
Interpretations of Rules of Conduct	Prepared by the professional ethics division's executive committee to provide guidelines as to the scope and application of the Rules but are not intended to limit such scope or application.
Materiality	Evaluations and decisions in finacial reporting should be based on materiality, the determination of which requires informed professional judgement.
Opinions of Accounting Principles Board (APB)	The **APB** was a committee set up by the **AICPA** to develop accounting standards. **APB** Issued 31 opinions before going out of existence. Opinions present the conclusions of at least two-thirds of the board members. The **APB** was replaced by **FASB** in 1973.
Representational faithfulness	**GAAP** require that the economic substance of an event take precendence over its legal form when it is measured or recorded.

Appendix Two – Some Accounting Terms, Continued

Term	Definition
SAS	**Statements on Auditing Standards** are interpretations of **generally accepted auditing standards**, which are issued by the **Auditing Standards Board**.
SAS 59	The Auditor's consideration of an entity's ability to continue as an ongoing concern
SOPs	Statements of Position of the Accounting Standards Division are issued by the **AICPA** Accounting Standards Executive Committee.
Statements on Quality Control Standards	Issued by the **AICPA**'s Quality Control Standards Committee. The standards apply to audit, compilation, review, and other services governed by standards issued by the **Auditing Standard Board** or the Accounting Review and Services Committee.

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LEHMAN BROTHERS