AOL Time Warner

Application of Income Tax Analysis

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Discussion Questions[1]

1. **AOL Time Warner has reported a pretax loss of $4,756 during fiscal 2001.**
   a. **Identify the amount of depreciation and amortization expense recorded during 2001.**
   b. **Calculate the amount of amortization expense only.**
   c. **Estimate the amount of amortization expense of goodwill only.**
   d. **Clearly and concisely explain why they paid income tax [cash] during 2001.**
   e. **During fiscal 2002, goodwill and certain other intangibles [those with an indefinite life] will no longer be amortized on a systematic basis [GAAP requires an annual impairment test]. If AOL Time Warner's revenues and expenses remain at the 2001 amounts in 2002, except for the change in accounting, estimate the pretax profit and tax expense for 2002.**

2. During fiscal 2001, options were exercised. Write the journal entry for the exercise of options. [You should know that the share prices during the past three years was]:

Stock Price	1999	2000	2001
Low	$40	$38	$36
High	$100	$80	$60

Is there anything unusual about the journal entries you recorded?

3. Write the journal entry for the reversal of the valuation allowance during 2001.

4. AOL Time Warner has *Deferred Income Taxes* on its balance sheet (also see the footnote disclosure). Reconcile the deferred income tax account and the tax payable account.

5. AOL Time Warner reports"As of December 31, 2001, the Company had net operating loss carryforwards of approximately $12 billion, primarily resulting from stock option exercises".

- **Is the $12 billion amount reasonable?**
- **What journal entry did the firm record for the $12 billion?**
- **What journal entry will AOL Time Warner record when they receive the benefit from the loss carryforwards?**
- **How can a banker assist AOL Time Warner with its tax position?**
  - **Prepare a list of strategies/questions for the firm for you meeting in two days.**

end of discussion questions

[1] *For all Discussion Questions, show any computations, list any assumptions and explain the basis for your conclusions. If amounts or accounts are unknown, say so and describe the unknown item "in words". Keep a file of your work because some questions draw upon your work for earlier questions.*

Description of Business

AOL Time Warner is the world's first Internet-powered media and communications company. The Company was formed in connection with the merger of America Online, Inc. and Time Warner Inc., which was consummated on January 11, 2001. As a result of the Merger, America Online and Time Warner each became a wholly owned subsidiary of AOL Time Warner. The Merger was structured as a stock-for-stock exchange and was accounted for by AOL Time Warner as an acquisition of Time Warner using the purchase method of accounting for business combinations. Under the purchase method of accounting, the estimated cost of approximately $147 billion to acquire Time Warner, including transaction costs, was allocated to its underlying net assets based on their respective estimated fair values. Any excess of the purchase price over the estimated fair values of the net assets acquired was recorded as goodwill. The financial results for Time Warner have been included in AOL Time Warner's results since January 1, 2001, as permitted under generally accepted accounting principles.

Consolidated Results

Revenues . **AOL Time Warner's revenues increased predominantly due to the impact of the Merger. In addition, the AOL segment, which represents the only business segment included in the 2000 operating results, increased its revenues to $8.615 billion in 2001 from $7.605 billion in 2000.**

Depreciation and Amortization. **Depreciation and amortization expense increased to $8.936 billion in 2001 from $443 million in 2000. The increase in depreciation expense of $1.406 billion primarily relates to the impact of the Merger, including the impact of acquiring the Cable segment, which contributed $893 million to depreciation expense in 2001, as well as the impact of acquiring the Filmed Entertainment segment of $89 million, the Networks segment of $159 million, the Music segment of $97 million, the Publishing segment of $70 million and Corporate segment of $20 million. Amortization expense increased $7.087 billion primarily as a result of goodwill and other intangible assets recorded as part of the allocation of purchase price related to the Merger, including the impact of the Cable segment of $2.483 billion, the Filmed Entertainment segment of $478 million, the Networks segment of $1.966 billion, the Music segment of $820 million, the Publishing segment of $935 million and the Corporate segment of $363 million.**

Operating Income. **AOL Time Warner's operating income was $118 million in 2001, compared to $1.766 billion in 2000. The decrease primarily related to an increase in both depreciation and amortization expense, which is discussed above, offset in part by an increase in EBITDA, primarily related to the impact of the Merger.**

Interest Income (Expense), Net. **Interest expense, net, increased due to Time Warner's debt assumed in the Merger.**

Other Income (Expense), Net. **Other expense, net, increased to $3.567 billion in 2001 from $208 million in 2000. Other expense, net, increased primarily because of higher pretax noncash charges to reduce the carrying value of certain publicly traded and privately held investments, restricted securities and investments accounted for using the equity method of accounting, and to reflect market fluctuations in equity derivative instruments. In 2001, these charges were approximately $2.532 billion, including approximately $1.2 billion related to AOL Time Warner's investment in Time Warner Telecom and approximately $270 million related to AOL Time Warner's investment in Hughes. In 2000, these charges amounted to $535 million. In addition, other expense, net, increased due to an increase in losses from equity method investees of $912 million, which primarily related to the amortization of goodwill included in the carrying value of such investments. These equity method investees were acquired in the Merger.**

Minority Interest Income. **Minority interest income increased to $46 million in 2001, compared to $0 in 2000 due to Time Warner's partially owned consolidated subsidiaries, including the impact of income or losses attributable to the minority partners of TWE and The WB Network.**

Income Tax Provision. **The relationship between income before income taxes and income tax expense of AOL Time Warner is principally affected by the amortization of goodwill and certain other financial statement expenses that are not deductible for income tax purposes. AOL Time Warner had income tax expense of $139 million in 2001, compared to $712 million in 2000. Income taxes in 2001, for financial reporting purposes, benefited from the tax effect of the approximate $2.532 billion noncash charges to reduce the carrying value of certain investments and to reflect market fluctuations in equity derivative instruments and $250 million of merger-related costs. Income taxes in 2000, for financial reporting purposes, benefited from the tax effect of the approximate $535 million of noncash charges to reduce the carrying value of certain investments and reflect market fluctuations in equity derivative instruments and $10 million of merger-related costs, partially offset by approximately $275 million of gains on the sale or exchange of various investments. Excluding the tax effect of these items, the effective tax rate was comparable in each period. As of December 31, 2001, the Company had net operating loss carryforwards of approximately $12 billion, primarily resulting from stock option exercises. These carryforwards are available to offset future U.S. Federal taxable income and are therefore expected to reduce Federal taxes paid by the Company. If the net operating losses are not utilized, they expire in varying amounts, starting in 2010 through 2021. To the extent that net operating loss carryforwards, when realized, relate to stock option deductions, the resulting benefits will be credited to shareholders' equity.**

AOL TIME WARNER INC.
CONSOLIDATED BALANCE SHEET
December 31,
(millions, except per share amounts)

	2001	2000
	(Restated)	
ASSETS		
Current assets		
Cash and equivalents	$ 719	$ 2,610
Short-term investments	—	886
Receivables, less allowances of $1.889 billion and $97 million	6,054	613
Inventories	1,791	47
Prepaid expenses and other current assets	1,687	471
Total current assets	10,251	4,627
Noncurrent inventories and film costs	6,853	—
Investments, including available-for-sale securities	6,886	3,824
Property, plant and equipment	12,669	1,041
Music catalogues and copyrights	2,927	—
Cable television and sports franchises	27,109	—
Brands and trademarks	10,684	—
Goodwill and other intangible assets	128,334	816
Other assets	2,791	470
Total assets	$ 208,504	$ 10,778
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 2,266	$ 107
Participations payable	1,253	—
Royalties and programming costs payable	1,515	—
Deferred revenue	1,451	1,063
Debt due within one year	48	2
Other current liabilities	6,443	1,158
Total current liabilities	12,976	2,330
Long-term debt	22,792	1,411
Deferred income taxes	11,231	—
Deferred revenue	1,048	223
Other liabilities	4,839	87
Minority interests	3,591	—
Shareholders' equity		
Series LMCN-V common stock, $.01 par value, 171.2 million shares outstanding at December 31, 2001	2	—
AOL Time Warner (and America Online as predecessor) common stock, $.01 par value, 4.258 and 2.379 billion shares outstanding	42	24
Paid-in capital	155,172	4,946
Accumulated other comprehensive income, net	49	61
Retained earnings (loss)	(3,238)	1,696
Total shareholders' equity	152,027	6,727
Total liabilities and shareholders' equity	$ 208,504	$ 10,778

See accompanying notes.

AOL TIME WARNER INC.
CONSOLIDATED STATEMENT OF OPERATIONS
Years Ended December 31,
(millions, except per share amounts)

	2001	2000	1999
Revenues:			
Subscriptions	$ 15,657	$ 4,777	$ 3,874
Advertising and commerce	8,260	2,273	1,240
Content and other	13,307	555	610
Total revenues	37,224	7,605	5,724
Cost of revenues	(20,591)	(3,866)	(3,324)
Selling, general and administrative	(9,079)	(1,864)	(1,390)
Amortization of goodwill and other intangible assets	(7,186)	(99)	(68)
Merger-related costs	(250)	(10)	(123)
Operating income (loss)	118	1,766	819
Interest income (expense), net	(1,353)	275	138
Other income (expense), net	(3,567)	(208)	677
Minority interest income	46	—	—
Income (loss) before income taxes and discontinued operations	(4,756)	1,833	1,634
Income tax provision	(139)	(712)	(607)
Income (loss) before discontinued operations	(4,895)	1,121	1,027
Discontinued operations, net of tax	(39)	—	—
Net income (loss)	$ (4,934)	$ 1,121	$ 1,027
Basic net income (loss) per common share before discontinued operations	$ (1.11)	$ 0.48	$ 0.47
Discontinued operations	—	—	—
Basic net income (loss) per common share	$ (1.11)	$ 0.48	$ 0.47
Average basic common shares	4,429.1	2,323.0	2,199.0
Diluted net income (loss) per common share before discontinued operations	$ (1.11)	$ 0.43	$ 0.40
Discontinued operations	—	—	—
Diluted net income (loss) per common share	$ (1.11)	$ 0.43	$ 0.40
Average diluted common shares	4,429.1	2,595.0	2,599.0

AOL TIME WARNER INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
Years Ended December 31,
(millions)

	2001	2000	1999
OPERATING ACTIVITIES			
Net income (loss)	$ (4,934)	$ 1,121	$ 1,027
Adjustments for noncash and nonoperating items:			
Depreciation and amortization	8,936	443	316
Amortization of film costs	2,380	—	—
Loss on writedown of investments	2,537	465	—
Net gains on sale of investments	(34)	(358)	(681)
Equity in losses of other investee companies after distributions	975	36	5
Changes in operating assets and liabilities, net of acquisitions:			
Receivables	(469)	(84)	(134)
Inventories	(2,801)	—	—
Accounts payable and other liabilities	(1,973)	996	1,543
Other balance sheet changes	68	(668)	(436)
Adjustments for noncash and nonoperating items, and changes in operating assets and liabilities for discontinued operations	596	—	—
Cash provided by operating activities	5,281	1,951	1,640
INVESTING ACTIVITIES			
Acquisition of Time Warner Inc. cash and equivalents	690	—	—
Investment in available-for-sale securities	(527)	(283)	(1,703)
Other investments and acquisitions	(3,650)	(2,065)	(773)
Capital expenditures and product development costs from continuing operations	(3,213)	(778)	(612)
Capital expenditures from discontinued operations	(408)	—	—
Investment proceeds from available-for-sale securities	30	527	228
Other investment proceeds	1,821	285	541
Other	—	(2)	(28)
Cash used by investing activities	(5,257)	(2,316)	(2,347)
FINANCING ACTIVITIES			
Borrowings	10,692	104	1,286
Debt repayments	(9,900)	(1)	(22)
Redemption of mandatorily redeemable preferred securities of Subsidiary	(575)	—	—
Proceeds from issuance of stock, primarily exercise of stock option and dividend reimbursement plans	926	318	494
Repurchases of common stock	(3,031)	—	—
Dividends paid and partnership distributions for continuing operations	(4)	—	—
Dividends paid and partnership distributions for discontinued operations	(59)	—	—
Other	36	—	(29)
Cash provided (used) by financing activities	(1,915)	421	1,729
INCREASE (DECREASE) IN CASH AND EQUIVALENTS	(1,891)	56	1,022
CASH AND EQUIVALENTS AT BEGINNING OF PERIOD	2,610	2,554	1,532
CASH AND EQUIVALENTS AT END OF PERIOD	$ 719	$ 2,610	$ 2,554

AOL TIME WARNER INC.
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(restated; millions)

	Common Stock	Paid-In Capital	Retained Earnings (Accumulated Deficit)	Total
BALANCE AT DECEMBER 31, 1998	$ 20	$ 2,134	$ (292)	$ 1,862
Net income	—	—	1,027	1,027
Unrealized gains on securities, net of $820 million tax provision	—	—	1,339	1,339
Comprehensive income	—	—	2,366	2,366
Investment in Gateway Inc.	—	100	—	100
Shares issued in connection with the conversion of convertible debt	—	101	—	101
Shares issued pursuant to stock option, warrant and employee stock purchase plans, including $551 million tax benefit	3	1,032		1,035
Amortization of compensatory stock options	—	21	—	21
Sale of stock, net	—	10	—	10
Other	—	868	(32)	836
BALANCE AT DECEMBER 31, 1999	23	4,266	2,042	6,331
Net income	—	—	1,121	1,121
Realized and unrealized losses on derivative financial instruments, net of a $1 million tax benefit	—	—	(1)	(1)
Unrealized losses on securities, net of $861 million tax benefit	—	—	(1,405)	(1,405)
Comprehensive loss	—	—	(285)	(285)
Shares issued for acquisitions	—	275	—	275
Shares issued in connection with the conversion of convertible debt	—	244	—	244
Shares issued pursuant to stock option and employee stock purchase plans, including $711 million tax benefit	1	1,028	—	1,029
Amortization of compensatory stock options	—	13	—	13
Other	—	(880)	—	(880)
BALANCE AT DECEMBER 31, 2000	24	4,946	1,757	6,727
Shares issued in connection with the America Online-Time Warner merger	19	146,411	—	146,430
Reversal of America Online's deferred tax valuation allowance	—	4,439	—	4,439
Balance at December 31, 2000 adjusted to give effect to America Online-Time Warner merger	43	155,796	1,757	157,596
Net loss(a)	—	—	(4,934)	(4,934)
Foreign currency translation adjustments	—	—	(11)	(11)
Unrealized gains on securities, net of $2 million tax provision(a)	—	—	4	4
Realized and unrealized losses on derivative financial instruments, net of $3 million tax benefit	—	—	(5)	(5)
Comprehensive (loss)	—	—	(4,946)	(4,946)
Repurchases of AOL Time Warner common stock	(1)	(3,045)	—	(3,046)
Shares issued pursuant to stock options, restricted stock, dividend reinvestment and benefit plans including $1.446 billion income tax benefit	2	2,421	—	2,423
BALANCE AT DECEMBER 31, 2001	$ 44	$ 155,172	$ (3,189)	$ 152,027

(a) Includes a $34 million pretax reduction (tax effect of $14 million) related to realized gains on the sale of securities in 2001 and an increase of $629 million pretax (tax effect of $251 million) related to impairment charges on investments that had experienced other-than-temporary declines. These charges are included in the 2001 net loss.

AOL TIME WARNER INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

America Online-Time Warner Merger

The Merger was accounted for by AOL Time Warner as an acquisition of Time Warner under the purchase method of accounting for business combinations. The financial results for Time Warner have been included in AOL Time Warner's results since January 1, 2001, as permitted under generally accepted accounting principles. Under the purchase method of accounting, the cost of approximately $147 billion to acquire Time Warner, including transaction costs, was allocated to its underlying net assets, based on their respective estimated fair values. The excess of the purchase price over the estimated fair values of the net assets acquired was recorded as goodwill. This allocation includes intangible assets, such as film and television libraries, music catalogues and copyrights, cable television and sports franchises, and brands and trademarks. The goodwill and identified intangible assets are being amortized on a straight-line basis over the following weighted-average useful lives:

		Weighted-Average Useful Life
		(Years)
Film and television libraries		17
Music catalogues and copyrights		20
Cable television and sports franchises		25
Brands and trademarks		34
Subscriber lists		5
Goodwill		25

As discussed further below, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," which provides, among other things, for the nonamortization of goodwill and intangible assets with indefinite useful lives. Consequently, goodwill and some intangible assets recognized in connection with the Merger will no longer be amortized, beginning in the first quarter of 2002. The following supplemental unaudited pro forma information for 2000 assumes that the Merger was consummated on January 1, 2000.

		2000 Pro Forma	
		(millions)	
Revenues	$	35,379	
Operating loss		(689	)
Loss before discontinued operations and cumulative effect of accounting change		(3,914	)
Basic and diluted net loss per common share before discontinued operations and cumulative effect of accounting change	$	(0.91	)

New Accounting Principles

Accounting for Business Combinations

In July 2001, the FASB issued Statements No. 141, "Business Combinations" and No. 142, "Goodwill and Other Intangible Assets". These standards change the accounting for business combinations by, among other things, prohibiting the prospective use of pooling-of-interests accounting and requiring companies to stop amortizing goodwill and certain intangible assets with an indefinite useful life created by business combinations accounted for using the purchase method of accounting. Instead, goodwill and intangible assets deemed to have an indefinite useful life will be subject to an annual review for impairment. The new standards generally will be effective for AOL Time Warner in the first quarter of 2002 and for purchase business combinations consummated after June 30, 2001.

AOL Time Warner is in the process of finalizing the impact of adopting the provisions of FAS 142, which is expected to be significant. Upon adoption, AOL Time Warner will stop amortizing goodwill, including goodwill included in the carrying value of certain investments accounted for under the equity method of accounting. In addition, AOL Time Warner will stop amortizing approximately $38 billion of intangible assets deemed to have an indefinite useful life, primarily intangible assets related to cable franchises and certain brands and trademarks. Based on the current levels of goodwill and intangible assets deemed to have an indefinite useful life, the adoption of FAS 142 will reduce annual amortization expense by approximately $6.7 billion. Similarly, with respect to equity investees, other expense, net, will be reduced by approximately $500 million. Because goodwill amortization is nondeductible for tax purposes, the impact of stopping the amortization of goodwill, certain intangible assets and the goodwill included in the carrying value

of equity investees, after considering the portion applicable to minority shareholders, would be to increase AOL Time Warner's annual net income by approximately $6.3 billion.

As noted above, goodwill and intangible assets deemed to have an indefinite useful life will be subject to an annual review for impairment. In addition, when FAS 142 is initially applied, all goodwill recognized on the Company's consolidated balance sheet on that date will need to be reviewed for impairment using the new guidance. Before performing the review for impairment, the new guidance requires that all goodwill deemed to relate to the entity as a whole be assigned to all of the Company's reporting units (generally, the AOL Time Warner operating segments), including the reporting units of the acquirer, in a reasonable and supportable manner. This differs from the previous accounting rules, which required goodwill to be assigned only to the businesses of the company acquired. As a result, a portion of the goodwill generated in the Merger will be reallocated to the AOL segment resulting in a change in segment assets.

As a result of this initial review for impairment, AOL Time Warner expects to record a noncash charge of approximately $54 billion upon adoption of the new accounting standard in the first quarter of 2002. Such charge is non-operational in nature and will be reflected as a cumulative effect of an accounting change.

Summary of Significant Accounting Policies

Basis of Consolidation and Accounting for Investments

The consolidated financial statements include 100% of the assets, liabilities, revenues, expenses, income, loss and cash flows of AOL Time Warner and all companies in which AOL Time Warner has a controlling voting interest, as if AOL Time Warner and its subsidiaries were a single company. Intercompany accounts and transactions between the consolidated companies have been eliminated.

Investments in companies in which AOL Time Warner has significant influence, but less than a controlling voting interest, are accounted for using the equity method. This is generally presumed to exist when AOL Time Warner owns between 20% and 50% of the investee. However, in certain circumstances, AOL Time Warner's ownership percentage exceeds 50% but the Company accounts for the investment using the equity method because the minority shareholders hold certain rights which allow them to participate in the day-to-day operations of the business.

Under the equity method, only AOL Time Warner's investment in and amounts due to and from the equity investee are included in the consolidated balance sheet; only AOL Time Warner's share of the investee's earnings is included in the consolidated operating results; and only the dividends, cash distributions, loans or other cash received from the investee, additional cash investments, loan repayments or other cash paid to the investee, are included in the consolidated cash flows. In circumstances where the Company's ownership in an investee is in the form of a preferred security or otherwise senior security, AOL Time Warner's share in the investee's income or loss is determined by applying the equity method of accounting using the "hypothetical- liquidation-at-book-value" method. Under the hypothetical-liquidation-at-book-value method, the investor's share of earnings or losses is determined based on changes in the investor's claim in the book value of the investee. Additionally, the carrying value of investments accounted for using the equity method of accounting are adjusted downward to reflect any other-than-temporary declines in value.

Investments in companies in which AOL Time Warner does not have a controlling interest, or an ownership and voting interest so large as to exert significant influence, are accounted for at market value if the investments are publicly traded and there are no resale restrictions greater than one year. If there are resale restrictions greater than one year, or if the investment is not publicly traded, then the investment is accounted for at cost. Unrealized gains and losses on investments accounted for at market value are reported, net-of-tax, in the accompanying consolidated statement of shareholders' equity as a component of accumulated other comprehensive income (loss) until the investment is sold, at which time the realized gain or loss is included in income. Dividends and other distributions of earnings from both market-value and investments accounted for at cost are included in income when declared.

The effect of any changes in the Company's ownership interests resulting from the issuance of equity capital by consolidated subsidiaries or equity investees to unaffiliated parties are accounted for as capital transactions.

AOL Time Warner has certain accounts receivable facilities that provide for the accelerated receipt of cash on available accounts receivables. These securitization transactions are accounted for as a sale in accordance with FAS 140 because the Company relinquished control of the receivables. Since the Company has relinquished control over these receivables and does not control the Qualifying SPE that holds the receivables, the amounts held in these securitization facilities are not included in the consolidated financial statements of the Company.

Business Combinations

Business combinations have been accounted for using either the purchase method or the pooling-of-interests method of accounting. Business combinations which have been accounted for under the purchase method of accounting include the results of operations of the acquired business from the effective date of acquisition. The cost to acquire companies, including transaction costs, have been allocated to the underlying net assets of the acquired company in proportion to their respective fair values. Any excess of the purchase price over

estimated fair values of the net assets acquired has been recorded as goodwill. Amounts allocated to acquired in-process research and development are expensed in the period of acquisition. In certain purchase business combinations, the Company may review the operations of the acquired company and implement plans to restructure its operations. As a result, the Company may accrue a liability related to these restructuring plans using the criteria prescribed in EITF Issue No. 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination." The impact of accruing these liabilities in connection with a purchase business combination is that the related cost is reflected as a liability assumed in the acquisition and results in additional goodwill as opposed to being included as a charge in the current period determination of income.

Other business combinations completed by America Online prior to the Merger have been accounted for under the pooling-of-interests method of accounting. In such cases, the assets, liabilities and stockholders' equity of the acquired entities were combined with America Online's respective accounts at recorded values. Prior period financial statements have been restated to give effect to the combination unless the effect of the business combination is not material to the financial statements of America Online (Note 2). As previously discussed, FAS 141 prohibits the use of the pooling-of-interests method of accounting for business combinations, effective July 1, 2001.

Intangible Assets

As a creator and distributor of branded information and entertainment copyrights, AOL Time Warner has a significant and growing number of intangible assets, including goodwill, cable television and sports franchises, film and television libraries, music catalogues, contracts and copyrights, and other copyrighted products and trademarks. In accordance with generally accepted accounting principles, AOL Time Warner does not recognize the fair value of internally generated intangible assets. Costs incurred to create and produce copyrighted product, such as feature films, television series and compact discs, generally are either expensed as incurred, or capitalized as tangible assets as in the case of cash advances and inventoriable product costs. However, accounting recognition is not given to any increasing asset value that may be associated with the collection of the underlying copyrighted material. Additionally, costs incurred to create or extend brands, such as magazine titles and new television networks, generally result in losses over an extended development period and are recognized as a reduction of income as incurred, while any corresponding brand value created is not recognized as an intangible asset in the consolidated balance sheet. On the other hand, intangible assets acquired in business combinations accounted for by the purchase method of accounting are capitalized and amortized over their expected useful life as a noncash charge against future results of operations. As of January 1, 2001, in connection with the Merger, the intangible assets of Time Warner, including the significant value of internally generated intangible assets, were recorded at fair value on AOL Time Warner's consolidated balance sheet. However, the fair value of internally generated intangible assets of America Online's businesses, and increases in the fair value of or creation of intangible assets related to Time Warner businesses subsequent to the consummation of the Merger, are not reflected on AOL Time Warner's consolidated balance sheet.

As discussed previously, AOL Time Warner amortizes goodwill, cable television franchises and sports franchises over a weighted-average useful life of twenty-five years using the straight-line method. Film and television libraries, music catalogues and copyrights, and other intangible assets are amortized over a weighted-average useful life of up to twenty years using the straight-line method. Brands and trademarks are amortized over a weighted-average useful life of thirty-four years using the straight-line method. Amortization of goodwill and intangible assets was $7.186 billion in 2001, $99 million in 2000 and $68 million in 1999. Accumulated amortization of goodwill and intangible assets was $8.594 billion at December 31, 2001 and $224 million at December 31, 2000.

Income Taxes

Income taxes are provided using the liability method prescribed by FASB Statement No. 109, "Accounting for Income Taxes." Under the liability method, deferred income taxes reflect the tax effect of net operating loss and investment carryforwards and the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial statement and income tax purposes, as determined under enacted tax laws and rates. The financial effect of changes in tax laws or rates is accounted for in the period of enactment. The subsequent realization of net operating loss and investment tax credit carryforwards acquired in acquisitions accounted for using the purchase method of accounting is recorded as a reduction of goodwill.

Since the principal operations of TWE are conducted by partnerships, AOL Time Warner's income tax expense for all periods includes all income taxes related to its allocable share of partnership income and its equity in the income tax expense of corporate subsidiaries of TWE.

Stock-Based Compensation

The Company follows the provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("FAS 123"). The provisions of FAS 123 allow companies to either expense the estimated fair value of stock options or to continue to follow the intrinsic value method set forth in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), but disclose the pro forma effects on net income (loss) had the fair value of the options been expensed. AOL Time Warner has elected to continue to apply APB 25 in accounting for its stock option incentive plans.

In accordance with APB 25 and related interpretations, compensation expense for stock options is recognized in income based on the excess, if any, of the quoted market price of the stock at the grant date of the award or other measurement date over the amount an

employee must pay to acquire the stock. Generally, the exercise price for stock options granted to employees equals or exceeds the fair market value of AOL Time Warner common stock at the date of grant, thereby resulting in no recognition of compensation expense by AOL Time Warner. For awards that generate compensation expense as defined under APB 25, the Company calculates the amount of compensation expense and recognizes the expense over the vesting period of the award.

Comprehensive Income (Loss)

Comprehensive income (loss), which is reported on the accompanying consolidated statement of shareholders' equity as a component of accumulated other comprehensive income (loss), consists of net income and other gains and losses affecting shareholders' equity that, under generally accepted accounting principles, are excluded from net income (loss). For AOL Time Warner, such items consist primarily of unrealized gains and losses on marketable equity investments, gains and losses on certain derivative financial instruments and foreign currency translation gains and losses.

The following summary sets forth the components of other comprehensive income (loss) accumulated in shareholders' equity:

	Foreign Currency Translation Losses	Unrealized Gains on Securities	Derivative Financial Instrument Losses	Accumulated Other Comprehensive Income (Loss)
			(millions)	
Balance at December 31, 1998	$ —	$ 128	$ —	$ 128
1999 activity	—	1,339	—	1,339
Balance at December 31, 1999	—	1,467	—	1,467
2000 activity	—	(1,405)	(1)	(1,406)
Balance at December 31, 2000	—	62	(1)	61
2001 activity	(11)	4	(5)	(12)
Balance at December 31, 2001	$ (11)	$ 66	$ (6)	$ 49

2. OTHER BUSINESS COMBINATIONS

In 2001, AOL Time Warner acquired businesses for an aggregated purchase price of approximately $2.2 billion, substantially all of which was paid in cash during the year. Of these amounts, approximately $1.6 billion relates to the October acquisition of 100% of IPC Group Limited, the parent company of IPC Media, and approximately $285 million, net of cash acquired, relates to the December acquisition of an additional 60% interest in Synapse Group Inc. IPC is the leading consumer magazine publisher in the United Kingdom with approximately 80 titles, including *Woman's Own* , *Marie Claire* and *Horse & Hound* . The financial results of IPC have been included in AOL Time Warner's consolidated results since October 1, 2001. Synapse is a leading U.S. magazine subscription agent. AOL Time Warner had a previous ownership interest in Synapse of approximately 20%, which was accounted for using the equity method of accounting. The results of Synapse have been included in the consolidated results of AOL Time Warner since December 1, 2001. In addition, during 2001, AOL Time Warner completed the acquisitions of Business 2.0, eVoice, Inc., InfoInteractive Inc., Obongo, Inc. and various cable systems and other businesses.

AOL Time Warner is currently in the process of allocating the purchase price paid to acquire IPC and Synapse. Based upon a preliminary purchase price allocation, as of December 31, 2001, approximately $1.9 billion of the purchase price has been allocated to goodwill of the Publishing segment. Approximately $25 million has been allocated to subscription lists, which are being amortized over a 5-year useful life. The acquisition of IPC and Synapse were both made by AOL Time Warner's Publishing segment.

In 2000, America Online entered into several business combinations accounted for under the purchase method of accounting, including the acquisitions of 100% of Quack.com, Inc., iAmaze, Inc., LocalEyes Corporation and the 20% interest in Digital City, Inc. that it did not already own. The aggregate purchase price, including transaction costs, was approximately $357 million. America Online recognized goodwill of approximately $343 million on these acquisitions which is being amortized over useful lives of up to 10 years. The financial results of these acquisitions have been included in America Online's financial results since their respective acquisition dates. In addition, America Online completed mergers with Prophead Development, Inc. and MapQuest.com Inc. which were accounted for using the pooling-of-interests method. In connection with these mergers, America Online issued approximately 12.3 million shares for all of the outstanding common shares of the acquired companies. As Prophead's historical results were not material in relation to those of America Online, the financial information prior to the acquisition of Prophead has not been restated to reflect the results of this acquisition. The accompanying financial statements have been restated to include the results of MapQuest for all periods presented. For the years ended December 31, 2000 (through the date of the merger) and 1999, MapQuest's revenues were approximately $22 million and $35 million, respectively, and the net loss was approximately $22 million and $18 million, respectively.

In 1999, America Online completed mergers with Tegic Communications, Inc., Moviefone Inc., Netscape Communications Corporation, Nullsoft Inc., Spinner Networks Incorporated and When, Inc., which were accounted for using the pooling-of-interests method, in which each company became a wholly owned subsidiary of America Online. In connection with these mergers, America Online issued approximately 212.3 million shares for all of the outstanding common and preferred shares of the acquired companies. Because the historical results of Tegic and Moviefone were not material in relation to those of America Online, the financial

information prior to the respective acquisition of Tegic and Moviefone has not been restated to reflect the respective results of these acquisitions. The accompanying financial statements have been restated to include the operations of Netscape, Nullsoft, Spinner and When, Inc. for all periods presented. For the year ended December 31, 1999 (through the respective dates of the mergers) these companies, primarily Netscape, had revenues of approximately $165 million and a net loss of $56 million.

3. MERGER-RELATED COSTS

In accordance with generally accepted accounting principles, AOL Time Warner generally treats merger-related costs relating to business combinations accounted for using the purchase method of accounting as additional purchase price paid. However, certain merger-related costs do not meet the criteria for capitalization and are expensed as incurred, including merger-related costs incurred in business combinations accounted for using the pooling-of-interests method of accounting. Merger-related costs expensed as incurred were $250 million in 2001, $10 million in 2000 and $123 million in 1999.

America Online-Time Warner Merger

Merger-Related Costs Capitalized as a Cost of Acquisition

In connection with the Merger, the Company has reviewed its operations and implemented several plans to restructure the operations of America Online and Time Warner. As part of the restructuring plans, the Company accrued an initial restructuring liability of approximately $965 million during the first quarter of 2001. The Company accrued an additional liability of approximately $375 million during the year as additional initiatives met the accounting criteria required for accrual. The restructuring accruals relate to costs to exit and consolidate certain activities of Time Warner, as well as costs to terminate employees across various Time Warner business units. Such amounts were recognized as liabilities assumed in the purchase business combination and included in the allocation of the cost to acquire Time Warner. Accordingly, such amounts resulted in additional goodwill being recorded in connection with the Merger.

Of the total restructuring accrual, approximately $880 million related to work force reductions and represented employee termination benefits. Employee termination costs occurred across most Time Warner business units and ranged from senior executives to line personnel. The total number of employees initially identified to be involuntarily terminated or relocated approximated 8,200. As of December 31, 2001 approximately 5,500 of the terminations and relocations had occurred. The remaining 2,700 terminations and relocations are anticipated to occur during 2002 or are no longer expected to occur. Because certain employees can defer receipt of termination benefits for up to 24 months, cash payments will continue after the employee has been terminated. Termination payments of approximately $300 million were made in 2001. As of December 31, 2001, the remaining liability of approximately $580 million was primarily classified as a current liability in the accompanying consolidated balance sheet.

The restructuring accrual also includes approximately $460 million associated with exiting certain activities, primarily related to lease and contract termination costs. Specifically, the Company plans to consolidate certain operations and has exited other under-performing operations, including the Studio Store operations of the Filmed Entertainment segment in which various leases were terminated and the closing of the World Championship Wrestling operations of the Networks segment in which certain contractual payments were required to be paid. The restructuring accrual associated with other exiting activities specifically includes incremental costs and contractual termination obligations for items such as leasehold termination payments and other facility exit costs incurred as a direct result of these plans, which will not have future benefits. Payments related to exiting activities were approximately $165 million in 2001. As of December 31, 2001, the remaining liability of approximately $295 million was primarily classified as a current liability in the accompanying consolidated balance sheet.

Selected information relating to the restructuring costs included in the allocation of the cost to acquire Time Warner are as follows (in millions):

	Employee Termination	Other Exit Costs	Total
Initial accruals	$ 565	$ 400	$ 965
Incremental accruals	315	60	375
Cash paid	(300)	(165)	(465)
Restructuring liability as of December 31, 2001	$ 580	$ 295	$ 875

Merger-Related Costs Expensed as Incurred

During 2001, the restructuring plans also include approximately $250 million, which was expensed in accordance with generally accepted accounting principles and is included in "merger-related costs" in the accompanying consolidated statement of operations. Of the $250 million, approximately $153 million relates to employee termination benefits and $97 million relates to other exit costs. The other exit costs relate to contractual terminations for various leases and contractual commitments relating to terminated projects. The number of employees expected to be terminated at the AOL segment was 2,430. As of December 31, 2001, approximately 2,300 of the terminations had occurred. These merger-related costs were expensed as they either related to the AOL operations or otherwise did not qualify as a liability or cost assumed in the purchase of Time Warner. As of December 31, 2001, approximately $105 million of the $250 million had not been paid and is primarily classified as a current liability in the accompanying consolidated balance sheet.

	Employee Termination	Other Exit Costs	Total
Initial accruals	$ 153	$ 97	$ 250
Cash paid	(107)	(38)	(145)
Restructuring liability as of December 31, 2001	$ 46	$ 59	$ 105

4. AOL EUROPE

AOL Europe S.A. is a joint venture between AOL Time Warner and Bertelsmann AG that provides the AOL service and the CompuServe service in several European countries. In March 2000, America Online and Bertelsmann announced an agreement to restructure their interests in AOL Europe. This restructuring consisted of a put and call arrangement under which the Company could purchase or be required to purchase Bertelsmann's 49.5% interest in AOL Europe for consideration ranging from $6.75 billion to $8.25 billion.

On January 31, 2002, AOL Time Warner acquired 80% of Bertelsmann's interest in AOL Europe for $5.3 billion in cash, as a result of Bertelsmann's exercise of its put option. AOL Time Warner has committed to acquire the remaining 20% of Bertelsmann's interest for $1.45 billion in cash in July 2002. These payments have been or will be funded through debt. Additionally, in February 2002, certain redeemable preferred securities issued by AOL Europe were redeemed for $255 million. As of December 31, 2001, excluding the preferred securities redeemed in February 2002, AOL Europe had approximately $573 million of debt and $758 million of redeemable preferred securities outstanding.

5. INVESTMENT IN TWE

Partnership Structure

TWE is a Delaware limited partnership that was capitalized in 1992 to own and operate substantially all of the Filmed Entertainment, Networks and Cable businesses previously owned by subsidiaries of Time Warner. AOL Time Warner, through its wholly owned subsidiaries, collectively owns general and limited partnership interests in TWE consisting of 74.49% of the Series A Capital and Residual Capital and 100% of the Series B Capital. The remaining 25.51% limited partnership interests in the Series A Capital and Residual Capital of TWE are held by AT&T. Certain AOL Time Warner subsidiaries are the general partners of TWE.

As a result of the Merger, a portion of the $147 billion cost to acquire Time Warner was allocated to the underlying net assets of TWE, to the extent acquired. As a result, TWE's 2001 net loss reflects additional amortization generated by the intangible assets and goodwill established in connection with this allocation. TWE reported a net loss of $1.032 billion for 2001. Because of the priority rights over allocations of income/loss and distributions of TWE held by the AOL Time Warner General Partners, $1.015 billion of TWE's loss for 2001 was allocated to AOL Time Warner and $45 million was allocated to AT&T. However, the allocation of a portion of TWE's loss to AT&T in 2001 was almost entirely offset by the allocation to AT&T of $28 million pretax gains attributable to AT&T that were recognized in connection with the sale or exchange of various cable television systems at TWE.

6. INVESTMENTS, INCLUDING AVAILABLE-FOR-SALE SECURITIES

AOL Time Warner's investments, including available-for-sale securities, consist of:

	December 31,	
	2001	2000
	(millions)	
Equity-method investments	$ 4,298	$ 231
Cost-method investments(a)	646	2,079
Fair-value investments, including equity derivative instruments(a)	1,942	1,514
Total	$ 6,886	$ 3,824

(a) As of December 31, 2001, the fair value of AOL Time Warner's cost-method and fair-value investments, including equity derivative instruments, was approximately $2.6 billion.

The following discussion highlights developments in AOL Time Warner's investments, including available-for-sale securities and equity derivative instruments.

Investment Write-Downs

The United States economy has experienced a broad decline in the public equity markets, particularly in technology stocks, including investments held in the Company's portfolio. Similarly, the Company experienced significant declines in the value of certain privately held investments, restricted securities and investments accounted for using the equity method of accounting. As a result, the Company recorded noncash pretax charges to reduce the carrying value of certain investments that experienced other-than-temporary declines, and to reflect market fluctuations in equity derivative instruments. These charges were approximately $2.532 billion in 2001, including $49 million relating to equity derivative instruments, and $535 million in 2000, including $70 million relating to equity derivative instruments, and are included in other income (expense), net, in the accompanying consolidated statement of operations.

Included in the 2001 charge are impairments on AOL Time Warner's investment in Time Warner Telecom of approximately $1.2 billion, the Columbia House Company Partnerships, a 50%-owned equity investee, of approximately $90 million and Hughes Electronics Corp. of approximately $270 million. The value of the Time Warner Telecom investment was adjusted upward in the Merger by over $2 billion to its estimated fair value. Since that time, Time Warner Telecom's share price has declined significantly, and as of December 31, 2001 the fair value of the investment had declined below its cost basis for a period of six months or more. The Company reviewed qualitative factors in accordance with its investment policy and determined that the decline in value was other-than-temporary; therefore, a $1.2 billion impairment charge was recognized based upon the closing value of Time Warner Telecom common stock as of December 31, 2001. In addition, during the fourth quarter of 2001, the value of the Company's investment in Hughes had declined greater than 20% below the investment's cost basis for a period of six months or more. Similarly, the Company reviewed qualitative factors and determined that the decline was other-than-temporary and recognized a $270 million impairment charge based upon the fair value of the investment as of December 31, 2001, as determined by the value of Hughes common stock on that date. The impairment recognized on the Company's investment in Columbia House was based upon a fair value determined by management. The remaining impairment charges of approximately $1 billion related to over 125 separate investment positions, which were generally determined in a similar manner.

Since December 31, 2001, there has been a further decline in the fair value of AOL Time Warner's investment in Time Warner Telecom. As a result, as of March 19, 2002, the fair value of AOL Time Warner's investment in Time Warner Telecom had declined by approximately $535 million, representing a further decline from the Merger-adjusted value noted above. Consistent with its policy, management will continually evaluate whether such a decline in fair value should be considered to be other-than-temporary. Depending on the future performance of Time Warner Telecom, the Company may be required to record an additional significant noncash charge to write down its investment to fair value due to a decline that is deemed to be other-than-temporary. Any such additional charge would be unrelated to the Company's core operations and would be recorded in other income (expense), net.

Investment Gains

During 2000, AOL Time Warner recognized pretax gains on the sale of investments of $275 million. The $275 million is comprised of approximately $118 million relating to the Company's investment in Liberate Technologies, approximately $142 million relating to the Company's investment in AdForce Inc. and $15 million of other gains. The gain relating to Liberate resulted from the sale of Liberate common stock on the open market, for which the Company received cash proceeds of approximately $118 million. The Company's cost basis in the Liberate shares sold was negligible. The gains relating to AdForce resulted from the acquisition of AdForce Inc. by CMGI Inc. for $500 million in stock. Under the terms of the acquisition, the Company's shares of AdForce common stock were converted into shares of CMGI common stock. Pursuant to EITF 91-5, *"Nonmonetary Exchange of Cost-Method Investments"*, the Company recognized a gain of approximately $134 million on this transaction based upon the fair value of CMGI common stock received. Shortly after this merger, the Company sold its position in CMGI on the open market for approximately $151 million, resulting in an

additional gain of approximately $8 million. During 1999, the Company recognized $678 million in pretax gains on the sale of investments, relating to a $567 million gain on the cash sale of investments in Excite, Inc. and $111 million of other gains.

In addition to the gains discussed above, during 2001, 2000 and 1999, AOL Time Warner recognized pretax gains related to the sale or exchange of a number of other investments within AOL Time Warner's investment portfolio. These amounts were $34 million in 2001, $117 million in 2000 and $14 million in 1999.

All of the investment gains have been classified in other income (expense), net in the accompanying consolidated statements of operations.

Equity-Method Investments

At December 31, 2001, companies accounted for using the equity method and the ownership percentage held by AOL Time Warner on a fully attributed basis (i.e., after considering the portion attributable to the minority partners of TWE and TWE-A/N) include: AOL Europe, AOL Latin America, AOL Canada, Time Warner Telecom, Road Runner, Courtroom Television Network LLC, Columbia House, and Comedy Partners, L.P.

A summary of combined financial information as reported by the equity investees of AOL Time Warner is set forth below:

	Years Ended December 31,		
	2001	2000	1999
	(millions)		
Operating Results:			
Revenues	$ 4,741	$ 860	$ 503
Operating loss	(1,323)	(633)	(51)
Net loss	(1,753)	(630)	(62)
Balance Sheet:			
Current assets	1,626	508	286
Total assets	8,150	780	481
Current liabilities	3,761	390	201
Total liabilities	7,500	396	214
Total shareholders' equity (deficit) or partners' capital	650	384	267

The above table represents the combined financial information of entities in which AOL Time Warner has an investment accounted for using the equity method of accounting. These amounts are not the amounts reflected on the Company's accompanying consolidated financial statements. Consistent with AOL Time Warner's accounting policy for investments accounted for using the equity method of accounting, as described in Note 1, AOL Time Warner has recorded $918 million of expense, in other income (expense), net, in the accompanying consolidated statement of operations, representing the Company's share in the pretax income (loss) of the investees. Similarly, the Company has included $4.298 billion in "Investments, including available-for-sale securities" on the accompanying consolidated balance sheet, representing AOL Time Warner's investment in and amounts due to and from the equity investee.

As discussed in Note 1, under the purchase method of accounting, the cost to acquire Time Warner was allocated to its underlying net assets, including investments accounted for using the equity method of accounting, based on their estimated fair values. As a result, AOL Time Warner's investments accounted for using the equity method of accounting were adjusted upward by approximately $4.1 billion, including over $2 billion relating to its investment in Time Warner Telecom and over $1 billion relating to investments in certain cable television joint ventures. These adjustments, which approximate the difference between AOL Time Warner's carrying value in the investees and the Company's underlying equity in the net assets of the investees, will be amortized on a straight-line basis over a weighted-average useful life of 14 years. However, as discussed in Note 1, FAS 142 provides, among other things, for the nonamortization of goodwill included in the carrying value of certain investments accounted for under the equity method of accounting, beginning in the first quarter of 2002.

Available-For-Sale Securities

As of December 31, 2001, included in fair value securities are available-for-sale securities with a fair value of $1.911 billion. The gross unrealized gains of $136 million and gross unrealized losses of $26 million have been recorded, net of deferred taxes of $44 million, in the accompanying consolidated statement of shareholders' equity as a component of accumulated other comprehensive income (loss).

As of December 31, 2000, included in fair value securities are available-for-sale securities with a fair value of $507 million. The gross unrealized gains of $188 million and gross unrealized losses of $89 million have been recorded, net of deferred taxes of $38 million, in the accompanying consolidated statement of shareholders' equity as a component of accumulated other comprehensive income (loss).

7. LONG-TERM DEBT AND OTHER FINANCING ARRANGEMENTS

Long-Term Debt

Long-term debt consists of:

	Weighted Average Interest Rate at December 31, 2001	Maturities	2001 Committed Capacity	2001 Unused Capacity	Outstanding Debt at December 31, 2001	Outstanding Debt at December 31, 2000
					(millions)	
Bank credit agreement debt and commercial paper programs	2.31%	2002-2004	$ 14,608	$ 9,663	$ 4,945	$ —
Fixed-rate public debt(a)	6.88%	2002-2036	17,615	—	17,615	1,322
Other fixed-rate obligations(b)	—	—	280	—	280	91
Variable-rate senior notes	—	—	—	—	—	—
Total			32,503	9,663	22,840	1,413
Debt due within one year(c)			(48)	—	(48)	(2)
Total long-term debt			$ 32,455	$ 9,663	$ 22,792	$ 1,411

(a) Includes Zero-Coupon Convertible Subordinated Notes held at AOL, which are reflected net of unamortized original issuance discount, of $1.363 billion in 2001 and $1.322 billion in 2000.

(b) Includes obligations under capital leases.

(c) Debt due within one year relates to other fixed-rate obligations.

Bank Credit Agreements and Commercial Paper Programs

$7.5 Billion Revolving Credit Facility

Certain AOL Time Warner consolidated subsidiaries, including TWE and TWE-A/N, have a revolving credit facility (the "Bank Credit Agreement") that permits borrowings in an aggregate amount of up to $7.5 billion, with no scheduled reduction in credit availability prior to maturity in November 2002.

$5 Billion Commercial Paper Program and Senior Unsecured Revolving Credit Facility

In April 2001, AOL Time Warner established a $5 billion commercial paper program which is supported by a $5 billion, 364-day ("initial term") senior unsecured revolving credit facility (the "$5 billion revolving credit facility"), borrowings under which may be repaid for a period up to two years following the initial term. The $5 billion revolving credit facility is available to support the commercial paper program and for general corporate purposes.

£1.1 Billion (approximately $1.6 Billion) Revolving Credit Facilities

In October 2001, AOL Time Warner established two £550 million (approximately $784 million each), 364-day ("initial term"), revolving credit facilities, which may be repaid for a period up to two years following the initial term.

Stock Option Proceeds Facility

AOL Time Warner maintains a revolving credit facility that provides for borrowings against future stock option proceeds and has been used principally to fund stock repurchases. At December 31, 2001, borrowing availability under the Stock Option Proceeds Credit Facility was $828 million, of which up to $15 million is reserved solely for the payment of interest and fees thereunder. There were no outstanding borrowings under the facility at December 31, 2001.

Film Financing Facility

New Line Cinema, from time to time, will utilize a film financing facility, which provides for borrowings of up to approximately $451 million. At December 31, 2001, $379 million was currently outstanding, all of which was reflected on the accompanying consolidated balance sheet ($30 million included in current liabilities; $349 million included in long-term debt).

$75 Million Revolving Credit Facility

The Company has a revolving credit facility that backs letters of credit totaling up to $75 million. At December 31, 2001, there were no borrowings against these letters of credit. In February 2002, the size of this facility was increased to $85 million.

Fixed-Rate Public Debt

$10 Billion Shelf Registration Statement

In January 2001, AOL Time Warner filed a shelf registration statement with the SEC, which allows AOL Time Warner to offer and sell from time to time, debt securities, preferred stock, series common stock, common stock and/or warrants to purchase debt and equity securities in amounts up to $10 billion in initial aggregate public offering prices. Proceeds from any offerings will be used for general corporate purposes, including investments, capital expenditures, repayment of debt and financing acquisitions. On April 19, 2001, AOL Time Warner issued an aggregate of $4 billion principal amount of debt securities under this shelf registration statement at various fixed interest rates and maturities of 5, 10 and 30 years. The net proceeds to the Company were $3.964 billion and were used primarily to pay down borrowings under the Bank Credit Agreement.

Convertible Notes

During December 1999, America Online sold $2.3 billion principal at maturity of Zero-Coupon Convertible Subordinated Notes due December 6, 2019 and received net proceeds of approximately $1.2 billion. The Zero-Coupon Notes have a 3% yield to maturity and are convertible into AOL Time Warner's common stock at a conversion rate of 5.8338 shares of common stock for each $1,000 principal amount of the Zero-Coupon Notes. The Zero-Coupon Notes may be redeemed at the option of AOL Time Warner on or after December 6, 2002 at the redemption prices set forth in the Zero-Coupon Notes. The holders can require AOL Time Warner to repurchase the Zero-Coupon Notes on December 6, 2004 at the redemption prices set forth in the Zero-Coupon Notes. As of December 31, 2001 and 2000, the accreted value, net of unamortized discount, was $1.363 billion and $1.322 billion, respectively.

On November 17, 1997, America Online sold $350 million of 4% Convertible Subordinated Notes due November 15, 2002, which could be redeemed at the option of America Online on or after November 14, 2000, in whole or in part, at the redemption prices set forth in the Notes. On November 15, 2000, America Online exercised its option to redeem the entire amount of the Notes. Under the redemption prices set forth in the Notes, America Online was obligated to redeem the outstanding Notes at a price of 101.6%

(expressed as a percentage of principal amount) together with accrued interest at the date of redemption. At the election of the noteholders, the entire outstanding principal of the Notes as of the redemption date was converted into approximately 37.7 million shares of America Online's common stock.

Other Publicly Issued Debt

From 1992 through 1998, AOL Time Warner and certain of its subsidiaries had various public debt offerings. The maturities of these outstanding offerings ranged from 10 to 40 years and the interest rates range from 6.125% to 10.15%. At December 31, 2001, the total debt outstanding from these offerings was approximately $12.252 billion.

Variable-Rate Senior Notes

Time Warner had $600 million principal amount of Floating Rate Reset Notes due December 30, 2031 that were redeemable at the election of the holders on December 30, 2001 (the "Five-Year Floating Rate Notes"). The Five-Year Floating Rate Notes bore interest at a floating rate equal to LIBOR less 25 basis points until December 30, 2001 at which time, if not redeemed, the interest rate would be reset at a fixed rate equal to 6.59% plus a margin based upon the credit risk of TW Companies, as borrower, at such time.

During the fourth quarter of 2001, AOL Time Warner, through TW Companies, redeemed the Five-Year Floating Rate Notes for approximately $693 million. In connection with the Merger and as required under the purchase method of accounting for business combinations, the Five-Year Floating Rate Notes were adjusted upward to a fair value of $687 million upon consummation of the Merger. As a result, a loss of approximately $6 million was recognized on the redemption. The loss has been included in other income (expense), net in the accompanying consolidated statement of operations for 2001.

Interest Expense and Maturities

Interest expense amounted to $1.546 billion in 2001, $55 million in 2000 and $23 million in 1999. The weighted average interest rate on AOL Time Warner's total debt, including TWE's debt, was 5.91% at December 31, 2001 and 3.28% at December 31, 2000.

Annual repayments of long-term debt for the five years subsequent to December 31, 2001 consist of $4.808 billion due in 2002 (including $4.161 billion of bank debt and commercial paper), $857 million due in 2003, $1.903 billion due in 2004, $508 million due in 2005 and $1.550 billion due in 2006. AOL Time Warner has the intent and ability under its various credit facilities to continue to refinance its borrowings on a long-term basis.

Other Financing Arrangements

From time to time, the Company enters into various other financing arrangements with special purpose entities ("SPEs"). These arrangements include facilities which provide for the accelerated receipt of cash on certain accounts receivables and backlog licensing contracts and the leasing of certain aircraft and property. The Company employs these arrangements because they provide a cost-efficient form of financing, including certain tax benefits, as well as an added level of diversification of funding sources. The Company is able to realize cost efficiencies under these arrangements since the assets securing the financing are held by a legally separate, bankruptcy-remote SPE and provide direct security for the funding being provided. These facilities generally have relatively short-term maturities (1 to 5 years), which is taken into account in determining the maximum efficiency for the Company's overall capital structure. The Company's maturity profile of its outstanding debt and other financing arrangements is relatively long-term, with a weighted maturity of approximately 11 years. The assets and financing associated with these arrangements, which are discussed in more detail in the following paragraphs, generally qualify for off-balance sheet treatment.

Accounts Receivable Securitization Facilities

AOL Time Warner has certain accounts receivable securitization facilities which provide for the accelerated receipt of approximately $1.5 billion of cash on available accounts receivables. As of December 31, 2001, AOL Time Warner had unused capacity under these facilities of approximately $330 million, representing the amount of cash that could be generated through the sale of additional qualifying accounts receivable. In connection with each of these securitization facilities, AOL Time Warner sells, on a revolving and nonrecourse basis, certain of its accounts receivables ("Pooled Receivables") to a qualifying SPE, which in turn sells a percentage ownership interest in the Pooled Receivables to third-party commercial paper conduits sponsored by financial institutions. These securitization transactions are accounted for as a sale in accordance FAS 140, because the Company relinquished control of the receivables. Accordingly, accounts receivable sold under these facilities are excluded from receivables in the accompanying consolidated balance sheet.

As proceeds for the accounts receivable sold to the SPE, AOL Time Warner receives cash, for which there is no obligation to repay, and an interest-bearing note receivable, which is included in receivables on the accompanying consolidated balance sheet. In addition, AOL Time Warner services the Pooled Receivables on behalf of the SPE. Income received by AOL Time Warner in exchange for this service is equal to the prevailing market rate for such services and has not been material in any period. The notes receivable, which have been adjusted to reflect the portion that is not expected to be collectible, bear an interest rate that varies with the prevailing market interest rates. The notes receivable may become uncollectible to the extent that credit losses on the underlying receivables

exceed certain thresholds. For this reason and because the accounts receivables underlying the retained ownership interest that are sold to the SPE are generally short term in nature, the fair value of the notes receivable approximated their carrying value at December 31, 2001. The notes receivable related to the sale of Pooled Receivables to an SPE reflected on AOL Time Warner's consolidated balance sheet were $1.035 billion at December 31, 2001. Additional net proceeds received from AOL Time Warner's accounts receivable by utilizing its accounts receivable securitization programs were $70 million in 2001. Because the accounts receivable securitization facilities relate to segments that were part of Time Warner, there were no proceeds during 2000 and 1999.

Backlog Securitization Facility

AOL Time Warner, through TWE, also has a backlog securitization facility, which effectively provides for the accelerated receipt of up to $500 million of cash on available licensing contracts. Assets securitized under this facility consist of cash contracts for the licensing of theatrical and television product for broadcast network and syndicated television exhibition, under which revenues have not been recognized because such product is not available for telecast until a later date ("Backlog Contracts"). In connection with this securitization facility, AOL Time Warner sells, on a revolving and nonrecourse basis, certain of its Backlog Contracts ("Pooled Backlog Contracts") to a SPE, which in turn sells a percentage ownership interest in the Pooled Backlog Contracts to a third-party commercial paper conduit sponsored by a financial institution. As of December 31, 2001, AOL Time Warner had unused capacity under this facility of approximately $58 million, representing the amount of cash that could be generated through the sale of additional Backlog Contracts.

Because the Backlog Contracts securitized under this facility consist of cash contracts for the licensing of theatrical and television product that have already been produced, the recognition of revenue for such completed product is dependent only upon the commencement of the availability period for telecast under the terms of the licensing agreements. Accordingly, the proceeds received under the program are classified as deferred revenues in long-term liabilities in the accompanying consolidated balance sheet. The amount of related deferred revenue reflected on AOL Time Warner's accompanying consolidated balance sheet was $442 million at December 31, 2001. This amount represents only the amount of backlog contracts sold under this facility and does not represent the amount of total filmed entertainment backlog contracts outstanding, which was approximately $3.8 billion at December 31, 2001.

Real Estate and Aircraft Operating Leases

AOL Time Warner has entered into certain arrangements for the lease of certain aircraft and property, including the Company's future corporate headquarters at Columbus Circle in New York City (the "AOL Time Warner Center") and a new productions and operations support center for the Turner cable networks in Atlanta (the "Turner Project"). Each of these properties will be funded through SPEs that are wholly owned by third parties and these leasing arrangements will be accounted for by AOL Time Warner as operating leases. Pursuant to FASB Statement No. 13, "Accounting for Leases," and related interpretations, for operating leases, the leased asset and the total obligation over the life of the lease are not reflected on the balance sheet. Instead, the lease payments are reflected as a charge to operating income generally as payments are made. For tax purposes, however, these properties are treated as an asset of AOL Time Warner. As such, the Company receives a tax deduction for depreciation of the asset and interest paid on the amounts used to fund the use of the asset.

As of December 31, 2001, the total amount of costs incurred and related borrowings made by SPEs related to the real estate and aircrafts totaled approximately $355 million. While the Turner Project is substantially complete, the total cost of the AOL Time Warner Center is expected to be approximately $800 million. Under the terms of the lease agreements, the Company has provided a guarantee of certain costs incurred by the SPEs. The amount of such guarantees at December 31, 2001 have been included in Note 18 in the amount of Commitments.

Rating Triggers and Financial Covenants

Each of the Company's bank credit agreements and financing arrangements with SPEs discussed above, contain customary covenants. A breach of such covenants in the bank credit agreements that continues beyond any grace period can constitute a default, which can limit the ability to borrow and can give rise to a right of the lenders to terminate the applicable facility and/or require immediate payment of outstanding debt. A breach of such covenants in the financing arrangements in SPEs that continues beyond any grace period can constitute a termination event which can limit the facility as a source of liquidity; however, there would be no claims on the Company for the receivables or backlog contracts previously sold. As of December 31, 2001 and through the date of this filing, the Company was in compliance with all covenants. As mentioned previously, the Company expects to take a noncash charge of approximately $54 billion upon adoption of FAS 142. This charge will not result in a violation of any of the Company's debt covenants. Additionally, in the event that the Company's credit ratings decrease, the cost of maintaining the facilities and of borrowing increases and, conversely, if the ratings improve, such costs decrease.

8. INCOME TAXES

Domestic and foreign pretax income (loss) are as follows:

	Years Ended December 31,		
	2001	2000	1999
	(restated; millions)		
Domestic	$ (4,868)	$ 1,830	$ 1,654
Foreign	112	3	(20)
Total	$ (4,756)	$ 1,833	$ 1,634

Current and deferred income taxes (tax benefits) provided are as follows:

	Years Ended December 31,		
	2001	2000	1999
	(restated; millions)		
Federal:			
Current(a)	$ 802	$ 621	$ 473
Deferred(c)	(914)	4	51
Foreign:			
Current(b)	180	2	2
Deferred	45	1	2
State and Local:			
Current(a)	195	84	79
Deferred(c)	(169)	—	—
Total	$ 139	$ 712	$ 607

(a) Excludes current federal and state and local tax benefits of approximately $976 million in 2001, $724 million in 2000 and $551 million in 1999 resulting from the exercise of stock options and vesting of restricted stock awards, which were credited directly to paid-in-capital.

(b) Includes foreign withholding taxes of $124 million in 2001, $2 million in 2000 and $1 million in 1999.

(c) Excludes deferred federal and state and local tax benefits of approximately $470 million in 2001 resulting from the exercise of stock options and vesting of restricted stock awards, which were credited directly to paid-in-capital.

The differences between income taxes expected at the U.S. federal statutory income tax rate of 35% and income taxes provided are as set forth below.

	Year Ended December 31,		
	2001	2000	1999
	(restated; millions)		
Taxes on income at U.S. federal statutory rate	$ (1,665)	$ 642	$ 572
State and local taxes, net of federal tax benefits	17	55	51
Nondeductible goodwill amortization	1,803	11	4
Other nondeductible expenses	18	8	3
Foreign losses with no U.S. tax benefit	—	—	7
Foreign income taxed at different rates, net of U.S. foreign tax credits	(38)	8	4
Other	4	(12)	(34)
Total	$ 139	$ 712	$ 607

Deferred income taxes reflect the net effects of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of AOL Time Warner's net deferred tax (asset) liability are as follows:

	December 31,	
	2001	2000
	(millions)	
Assets acquired in business combinations	$ 16,294	$ —
Depreciation and amortization	1,591	—
Unrealized appreciation of certain marketable securities	—	38
Unremitted earnings of foreign subsidiaries	101	11
Other	569	108
Deferred tax liabilities	18,555	157
Tax attribute carryforwards	4,685	4,049
Accrued liabilities	440	38
Receivable allowances and return reserves	380	—
Investments, primarily related to other-than temporary declines in value	1,449	187
Other	370	332
Valuation allowance(a)	—	(4,439)
Deferred tax assets	7,324	167
Net deferred tax liability (asset)(b)	$ 11,231	$ (10)

(a) Prior to the Merger, the Company recorded a valuation allowance against certain of its deferred tax assets. At that time, it was more likely than not that a portion of these deferred tax benefits would not be realized. As a result of the Merger, the valuation allowance was reversed against additional paid-in-capital because the Company believes that these stock-option related deferred tax benefits will be realized.

(b) The $10 million net deferred tax asset in 2000 is recorded in "other assets" on the accompanying consolidated balance sheet.

U.S. income and foreign withholding taxes have not been recorded on permanently reinvested earnings of certain foreign subsidiaries aggregating approximately $1.1 billion at December 31, 2001. Determination of this amount of unrecognized deferred U.S. income tax liability with respect to such earnings in not practicable.

U.S. federal tax attribute carryforwards at December 31, 2001 consisted of approximately $12 billion of net operating losses and approximately $64 million of alternative minimum tax credits. The utilization of these carryforwards as an available offset to future taxable income is subject to limitations under U.S. federal income tax laws. If the net operating losses are not utilized, they expire in varying amounts, starting in 2010 through 2021. To the extent that net operating loss carryforwards, when realized, relate to stock option deductions, the resulting benefits will be credited to shareholders' equity.

9. STOCK-BASED COMPENSATION PLANS

Effect of America Online-Time Warner Merger on Stock-Based Compensation Plans

In connection with Time Warner's agreement to merge with America Online entered into in January 2000, all Time Warner stock options and restricted stock outstanding at that time became fully vested, pursuant to the terms of Time Warner's stock option and restricted stock plans. In addition, on January 11, 2001, the date the Merger was consummated, each outstanding equity security of Time Warner was converted into 1.5 units of an equivalent equity security of AOL Time Warner.

Stock Option Plans

AOL Time Warner has various stock option plans under which AOL Time Warner may grant options to purchase AOL Time Warner common stock to employees of AOL Time Warner and TWE. Such options have been granted to employees of AOL Time Warner and TWE with exercise prices equal to, or in excess of, fair market value at the date of grant. Accordingly, in accordance with APB 25 and related interpretations, compensation cost generally is not recognized for its stock option plans. Generally, the options become exercisable over a four-year vesting period and expire ten years from the date of grant. Had compensation cost for AOL Time Warner's stock option plans been determined based on the fair value method set forth in FAS 123, AOL Time Warner's net income (loss) and basic and diluted net income (loss) per common share would have been changed to the pro forma amounts indicated below:

	Years Ended December 31,		
	2001	2000	1999
	(millions, except per share amounts)		
Net income (loss):			
As reported	$ (4,934)	$ 1,121	$ 1,027
Pro forma	$ (6,365)	$ 468	$ 553
Net income (loss) per basic common share:			
As reported	$ (1.11)	$ 0.48	$ 0.47
Pro forma	$ (1.44)	$ 0.20	$ 0.25
Net income (loss) per diluted common share:			
As reported	$ (1.11)	$ 0.43	$ 0.40
Pro forma	$ (1.44)	$ 0.18	$ 0.22

For purposes of applying FAS 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2001, 2000 and 1999: dividend yields of 0% in all periods; expected volatility of 59.3%, 46.3% and 65%, respectively; risk-free interest rates of 4.83%, 6.22% and 5.49%, respectively; and expected lives of 5 years for all periods. The weighted average fair value of an option granted during the year was $24.89 ($14.93, net of taxes), $21.07 ($12.64, net of taxes) and $23.25 ($13.95, net of taxes) for the years ended December 31, 2001, 2000 and 1999, respectively. During 2001, AOL Time Warner granted options to certain executives at exercise prices exceeding the market price of AOL Time Warner common stock on the date of grant. These above-market options had a weighted average exercise price and fair value of $67.32 and $16.68 ($10.01, net of taxes), respectively, in 2001. Above market options granted in 2000 and 1999 were not significant. A summary of stock option activity under all plans is as follows:

	Thousands of Shares	Weighted-Average Exercise Price
Balance at January 1, 1999	451,618	$ 4.66
1999 Activity:		
Granted	102,179	51.23
Exercised	(135,022)	2.64
Cancelled	(35,699)	19.43
Balance at December 31, 1999	383,076	16.42
2000 Activity:		
Granted(a)	67,209	56.61
Exercised	(44,170)	6.10
Cancelled	(23,269)	39.94
Balance at December 31, 2000	382,846	$ 23.23
2001 Activity:		
Options exchanged for outstanding Time Warner options in connection with the Merger	190,535	22.78
Granted(a)	193,257	47.53
Exercised	(108,860)	8.55
Cancelled	(30,463)	51.07
Balance at December 31, 2001	627,315	$ 31.88

(a) In 2001, a special Founder's Grant was issued to most individuals who were employees of AOL Time Warner during the year the Merger was consummated, only a portion of which is expected to be recurring in the future.

The following table summarizes information about stock options outstanding at December 31, 2001:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/01 (thousands)	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable at 12/31/01 (thousands)	Weighted-Average Exercise Price
Under $10.00	**130,162**	**4.47**	**$ 3.75**	**120,999**	**$ 3.52**
$10.01 to $ 15.00	**116,696**	**4.24**	**$ 12.39**	**101,305**	**$ 12.55**
$15.01 to $ 20.00	**12,426**	**4.61**	**$ 16.64**	**12,091**	**$ 16.63**
$20.01 to $ 30.00	**22,320**	**5.90**	**$ 23.27**	**21,953**	**$ 23.29**
$30.01 to $ 45.00	**46,510**	**8.37**	**$ 38.42**	**13,931**	**$ 38.76**
$45.01 to $ 50.00	**193,053**	**8.56**	**$ 48.12**	**42,505**	**$ 47.35**
$50.01 to $ 60.00	**84,548**	**8.42**	**$ 56.61**	**26,256**	**$ 56.80**
$60.01 to $ 90.00	**21,490**	**8.29**	**$ 68.08**	**6,793**	**$ 68.94**
$90.01 to $158.73	**110**	**7.96**	**$ 96.80**	**62**	**$ 99.01**
Total	**627,315**	**6.64 years**	**$ 31.88**	**345,895**	**$ 20.03**

Restricted Stock Plans

AOL Time Warner also has various restricted stock plans for employees and non-employee directors of the Board. Under these plans, shares of common stock are granted which do not vest until the end of a restriction period, generally between three to five years. During 2001, AOL Time Warner issued approximately 157,000 shares of restricted stock at a weighted-average fair value of $43.43. Compensation cost recognized in connection with restricted stock grants was not material.

10. ADDITIONAL FINANCIAL INFORMATION

Additional financial information with respect to cash flows is as follows:

	Years Ended December 31,		
	2001	2000	1999
	(millions)		
Cash payments made for interest	$ 1,396	$ 15	$ 16
Cash payments made for income taxes	388	14	—
Income tax refunds received	48	—	—
Interest income received	197	330	161

Interest Expense, Net

	Years Ended December 31,		
	2001	2000	1999
	(millions)		
Interest income	$ 193	$ 330	$ 161
Interest expense	(1,546)	(55)	(23)
Total interest income (expense), net	$ (1,353)	$ 275	$ 138

Other Income (Expense), Net

	Years Ended December 31		
	2001	2000	1999
	(millions)		
Investment gain (losses)(a)(b)	$ (1,218)	$ (177)	$ 681
Write-down of investment in Time Warner Telecom	(1,213)	—	—
Write-down of investment in Columbia House	(90)	—	—
Losses on equity investees	(948)	(36)	(5)
Losses on accounts receivable securitization programs	(70)	—	—
Miscellaneous	(28)	5	1
Total other income (expense), net	$ (3,567)	$ (208)	$ 677

(a) For 2001, includes a $1.229 billion noncash charge, excluding the write-downs of Time Warner Telecom and Columbia House, to reduce the carrying value of certain investments in AOL Time Warner's investment portfolio, primarily due to declines in the market values deemed to be other-than-temporary, and to reflect market fluctuations in equity derivative instruments.

(b) For 2000 includes a $535 million noncash pretax charge to reduce the carrying value of certain investments in AOL Time Warner's investment portfolio, primarily due to declines in the market values deemed to be other-than-temporary, and to reflect market fluctuations in equity derivative instruments, pretax gains of approximately $275 million related to the sale of certain other investments. For 1999, includes a $567 million pretax gain on the sale of investments in Excite, Inc.

Other Current Liabilities

	December 31,	
	2001	2000
	(millions)	
Accrued expenses	$ 5,474	$ 1,047
Accrued compensation	904	111
Accrued income taxes	65	—
Total	$ 6,443	$ 1,158

REPORT OF INDEPENDENT AUDITORS

The Board of Directors

AOL Time Warner Inc.

We have audited the accompanying consolidated balance sheet of AOL Time Warner Inc. ("AOL Time Warner") as of December 31, 2001 and 2000, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001. Our audits also included the financial statement schedule and supplementary information listed in the index at Item 14 (a). These financial statements, schedule and supplementary information are the responsibility of AOL Time Warner's management. Our responsibility is to express an opinion on these financial statements, schedule and supplementary information based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of AOL Time Warner at December 31, 2001 and 2000, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule and supplementary information, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 1 to the accompanying consolidated financial statements, AOL Time Warner has restated its financial statements for the years ended December 31, 2001 and 2000.

ERNST & YOUNG LLP

New York, New York

January 28, 2002