AOL TIME WARNER INC
Form 10-Q/A
January 28, 2003
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SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

FORM 10-Q/A
Amendment No. 1 to

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT of 1934 for the quarterly period ended June 30, 2002 or**

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT of 1934 for the transition period from to .**

Commission file number 1-15062

AOL TIME WARNER INC.
(Exact name of registrant as specified in its charter)

Delaware	13-4099534
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

75 Rockefeller Plaza
New York, New York 10019
(212) 484-8000

(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No ¨

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Description of Class	Shares Outstanding as of July 31, 2002
Common Stock $.01 par value	4,292,109,290
Series LMCN-V Common Stock $.01 par value	171,185,826

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Restatement of Prior Financial Information

As previously disclosed, AOL Time Warner Inc. (AOL Time Warner or the Company) has been conducting an internal review of certain advertising and commerce transactions at the AOL segment under the direction of the Company s Chief Financial Officer. In connection with this internal review, the financial results for each of the quarters ended September 30, 2000 through June 30, 2002 are being restated. The total impact of the adjustments is a reduction of the Company s consolidated advertising and commerce revenues of $190 million over these eight quarterly periods, with corresponding reductions in EBITDA, operating income and net income for that same time period of $97 million, $83 million and $46 million, respectively. For the AOL segment, the impact of the adjustments is a reduction of advertising and commerce revenues of $168 million over these eight quarterly periods, with corresponding reductions in EBITDA and operating income for that same time period of $97 million and $83 million, respectively. The remaining impact on the Company s consolidated advertising and commerce revenues of $22 million represents a reduction in revenues from certain transactions related to the AOL segment in which the advertising was delivered by other AOL Time Warner segments. The adjustments represent approximately 1% of the AOL segment s total revenues for that same two-year period, approximately 3.4% of its advertising and commerce revenues, approximately 1.9% of its EBITDA and approximately 2.1% of its operating income. The largest impact of the adjustments is in the quarter ended September 30, 2000, where advertising and commerce revenues are reduced by $66 million, both EBITDA and operating income are reduced by $30 million and net income is reduced by $18 million. The restatement results in a decrease in basic earnings per share of $0.01 in both the third and fourth quarters of 2000.

The financial results presented in this report reflect the restatement of the Company s financial results. For the three months ended June 30, 2002 and 2001, the total impact of these adjustments is a reduction of the Company s consolidated advertising and commerce revenues of $0 and $42 million, respectively, with a corresponding increase (decrease) in EBITDA of $1 million and $(7) million, respectively, operating income (loss) of $3 million and $(5) million, respectively, and consolidated net income (loss) of $2 million and $(3) million, respectively. For the AOL segment, for the three months ended June 30, 2002 and 2001, the impact of these adjustments is a reduction of advertising and commerce revenues of $0 and $28 million, respectively, with a corresponding increase (decrease) in EBITDA of $1 million and $(7) million, respectively, and operating income (loss) of $3 million and $(5) million, respectively. The remaining impact on advertising and commerce revenues of $0 and $14 million for the three months ended June 30, 2002 and 2001, respectively, represents a reduction in revenues from certain transactions related to the AOL segment in which the advertising was delivered by other AOL Time Warner segments.

For the six months ended June 30, 2002 and 2001, the total impact is a reduction of the Company s consolidated advertising and commerce revenues of $12 million and $56 million, respectively, with a corresponding reduction in EBITDA of $14 million and $8 million, respectively, operating income of $10 million and $5 million, respectively, and net income of $2 million and $3 million, respectively. For the AOL segment, for the six months ended June 30, 2002 and 2001, the impact of these adjustments is a reduction of advertising and commerce revenues of $6 million and $41 million, respectively, with a corresponding reduction in EBITDA of $14 million and $8 million, respectively, and operating income of $10 million and $5 million, respectively. The remaining impact on advertising and commerce revenues of $6 million and $15 million for the six months ended June 30, 2002 and 2001, respectively, represents a reduction in revenues from certain transactions related to the AOL segment in which the advertising was delivered by other AOL Time Warner segments.

Based on the substantial work done to date, the Company does not expect any further restatements as a result of its internal review. However, as previously disclosed, the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) are investigating the financial reporting and disclosure practices of the Company. The Company cannot predict the outcome of these investigations at this time. The Company will continue its efforts to cooperate with the investigations.

Subsequent Events Resulting in Retroactive Adjustment

In addition to the restatement of prior financial information relating to certain advertising and commerce transactions at the AOL segment, this document reflects subsequent events that result in retroactive adjustments. During the third quarter of 2002, Advance/Newhouse Partnership assumed responsibility for the day-to-day operations of certain cable systems held by the Time Warner Entertainment Advance/Newhouse Partnership (TWE-A/N). As a result, the Company has deconsolidated the financial results of these systems and has retroactively presented such results as discontinued operations for all periods presented. In addition, the Company also began consolidating the financial position and results of operations of Road Runner. As permitted under generally accepted accounting principles, the Company has consolidated the results of Road Runner retroactive to the beginning of 2002. Details of the transaction resulting in the discontinued operations and the consolidation of Road Runner are provided under Restructuring of TWE-Advance/Newhouse Partnership and Road Runner on page 3 and the impact of the discontinued operations is provided under Discontinued Operations on page 5.

Except for the retroactive application of the TWE-A/N restructuring, which is discussed in the preceding paragraph, the Company has not updated the information contained herein for events and transactions occurring subsequent to the date of the original Quarterly Report on Form 10-Q for the quarter ended June 30, 2002. The Company therefore recommends that this report be read in conjunction with the Company s reports filed subsequent to the original filing date, including the Company s Quarterly Report on Form 10-Q for the quarter ended September 30, 2002.

Amended Items

The Company hereby amends the following items, financial statements, exhibits or other portions of its Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as set forth herein:

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Part I Financial Information

Item 1. ***Financial Statements*****.**

The financial information of the Company is amended to read in its entirety as set forth at pages 28 through 65 herein and is incorporated herein by reference.

Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations*****.**

The information set forth under the caption Management s Discussion and Analysis is amended to read in its entirety as set forth at pages 1 through 27 herein and is incorporated herein by reference.

Part II Other Information

Item 6. ***Exhibits and Reports on Form 8-K*****.**

The list of exhibits set forth in, and incorporated by reference from, the Exhibit Index, is amended to include the following additional exhibit, filed herewith:

99.1 Certification of Principal Executive Officer and Principal Financial Officer of the registrant pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, with respect to Amendment No. 1 on Form 10-Q/A to the registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002

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MANAGEMENT S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

INTRODUCTION

Management s discussion and analysis of results of operations and financial condition (MD&A) is provided as a supplement to the accompanying consolidated financial statements and footnotes to help provide an understanding of AOL Time Warner Inc. s (AOL Time Warner or the Company) financial condition, changes in financial condition and results of operations. The MD&A is organized as follows:

Overview. This section provides a general description of AOL Time Warner s businesses, as well as recent developments that the Company believes are important in understanding the results of operations, as well as to anticipate future trends in those operations.
Results of operations. This section provides an analysis of the Company s results of operations for the three and six months ended June 30, 2002 relative to the comparable periods in 2001. This analysis is presented on both a consolidated and segment basis. In addition, a brief description is provided of transactions and events that impact the comparability of the results being analyzed.
Financial condition and liquidity. This section provides an analysis of the Company s financial condition as of June 30, 2002 and cash flows for the six months ended June 30, 2002.
Caution concerning forward-looking statements and risk factors. This section discusses how certain forward-looking statements made by the Company throughout MD&A and in the consolidated financial statements are based on management s current expectations about future events and are inherently susceptible to uncertainty and changes in circumstances.

OVERVIEW

Description of Business

AOL Time Warner is the world s leading media and entertainment company. The Company was formed in connection with the merger of America Online, Inc. (America Online) and Time Warner Inc. (Time Warner), which was consummated on January 11, 2001 (the Merger). As a result of the Merger, America Online and Time Warner each became a wholly owned subsidiary of AOL Time Warner.

AOL Time Warner classifies its business interests into six fundamental areas: *AOL*, consisting principally of interactive services, Web properties, Internet technologies and electronic commerce services; *Cable*, consisting principally of interests in cable television systems; *Filmed Entertainment*, consisting principally of interests in filmed entertainment and television production; *Networks*, consisting principally of interests in cable television and broadcast network programming; *Music*, consisting principally of interests in recorded music and music publishing; and *Publishing*, consisting principally of interests in magazine publishing, book publishing and direct marketing.

The Company has undertaken a number of business initiatives to advance cross-divisional activities, including shared infrastructures and cross-promotions of the Company s various products and services, as well as cross-divisional and cross-platform advertising and marketing opportunities for significant advertisers. The Company s integrated Global Marketing Solutions Group develops individualized advertising programs through which major brands can reach customers over a combination of the Company s print, television and Internet media.

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Use of EBITDA

AOL Time Warner evaluates operating performance based on several factors, including its primary financial measure of operating income (loss) before noncash depreciation of tangible assets and amortization of intangible assets (EBITDA). AOL Time Warner considers EBITDA an important indicator of the operational strength and performance of its businesses, including the ability to provide cash flows to service debt and fund capital expenditures. In addition, EBITDA eliminates the uneven effect across all business segments of considerable amounts of noncash depreciation of tangible assets and amortization of certain intangible assets deemed to have finite useful lives that were recognized in business combinations accounted for by the purchase method. As such, the following comparative discussion of the results of operations of AOL Time Warner includes, among other measures, an analysis of changes in EBITDA. However, EBITDA should be considered in addition to, not as a substitute for, operating income (loss), net income (loss) and other measures of financial performance reported in accordance with generally accepted accounting principles. In addition, EBITDA should not be used as a substitute for the Company s various cash flow measures (e.g., operating cash flow and free cash flow), which are discussed in detail beginning on page 21.

Recent Developments

Investment in Time Warner Entertainment Company, L.P.

A majority of AOL Time Warner s interests in the Filmed Entertainment and Cable segments, and a portion of its interests in the Networks segment, are held through Time Warner Entertainment Company, L.P. (TWE). As of March 31, 2002, AOL Time Warner owned general and limited partnership interests in TWE consisting of 74.49% of the pro rata priority capital (Series A Capital) and residual equity capital (Residual Capital), and 100% of the junior priority capital (Series B Capital). The remaining 25.51% limited partnership interests in the Series A Capital and Residual Capital of TWE were held by MediaOne TWE Holdings, Inc., a subsidiary of AT&T Corp. (AT&T).

During the second quarter of 2002, AT&T exercised a one-time option to increase its ownership in the Series A Capital and Residual Capital of TWE. As a result, on May 31, 2002, AT&T s interest in the Series A Capital and Residual Capital of TWE increased by approximately 2.13% to approximately 27.64% and AOL Time Warner s corresponding interest in the Series A Capital and Residual Capital of TWE decreased by approximately 2.13% to approximately 72.36%. In accordance with Staff Accounting Bulletin No. 51, Accounting for Sales of Stock of a Subsidiary , AOL Time Warner has reflected the pretax impact of the dilution of its interest in TWE of approximately $690 million as an adjustment to paid-in capital (Note 6).

AT&T has the right, during 60-day exercise periods occurring once every 18 months, to request that TWE incorporate and register its stock in an initial public offering. If AT&T exercises such right, TWE can decline to incorporate and register its stock, in which case AT&T may cause TWE to purchase AT&T s interest at the price at which an appraiser believes such stock could be sold in an initial public offering, subject to certain adjustments. In February 2001, AT&T delivered to TWE a notice requesting that TWE reconstitute itself as a corporation and register AT&T s partnership interests for public sale. In June 2002, AT&T and TWE engaged Banc of America Securities LLC (Banc of America) to perform appraisals and make other determinations under the TWE Partnership Agreement. In July 2002, AOL Time Warner and AT&T agreed to temporarily suspend the registration rights process so that they can pursue discussion of an alternative transaction. For the time being, AOL Time

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Warner and AT&T have asked Banc of America not to deliver the determinations. The Company cannot at this time predict the outcome or effect, if any, of these discussions or the registrations rights process, if resumed.

Restructuring of TWE-Advance/Newhouse Partnership and Road Runner

As of June 30, 2002, the TWE-Advance/Newhouse Partnership (TWE-A/N) was owned approximately 64.8% by TWE, the managing partner, 33.3% by the Advance/Newhouse Partnership (Advance/Newhouse) and 1.9% indirectly by AOL Time Warner. Prior to August 1, 2002, the financial position and operating results of TWE-A/N were consolidated by AOL Time Warner and TWE, and the partnership interest owned by Advance/Newhouse was reflected in the consolidated financial statements of AOL Time Warner and TWE as minority interest. In addition, Road Runner, a high-speed cable modem Internet service provider, was owned by TWI Cable Inc. (a wholly owned subsidiary of AOL Time Warner), TWE and TWE-A/N, with AOL Time Warner owning approximately 65% on a fully attributed basis (i.e., after considering the portion attributable to the minority partners of TWE and TWE-A/N). AOL Time Warner s interest in Road Runner was accounted for using the equity method of accounting prior to August 1, 2002 because of certain approval rights held by Advance/Newhouse, a partner in TWE-A/N.

On June 24, 2002, TWE and Advance/Newhouse agreed to restructure TWE-A/N, which, on August 1, 2002 (the Debt Closing Date), resulted in Advance/Newhouse assuming responsibility for the day-to-day operations of certain TWE-A/N cable systems serving approximately 2.1 million subscribers located primarily in Florida (the Advance/Newhouse Systems). The restructuring is anticipated to be completed by the end of 2002, upon the receipt of certain regulatory approvals. On the Debt Closing Date, Advance/Newhouse and its affiliates arranged for a new credit facility to support the Advance/Newhouse Systems and assumed and repaid approximately $780 million of TWE-A/N s senior indebtedness. As of the Debt Closing Date, Advance/Newhouse assumed responsibility for the day-to-day operations of the Advance/Newhouse Systems. As a result, AOL Time Warner and TWE have deconsolidated the financial position and operating results of these systems. Additionally, all prior period results associated with the Advance/Newhouse Systems, including the historical minority interest allocated to Advance/Newhouse s interest in TWE-A/N, have been reflected as a discontinued operation for all periods presented. Under the new TWE-A/N Partnership Agreement, effective as of the Debt Closing Date, Advance/Newhouse s partnership interest tracks only the economic performance of the Advance/Newhouse Systems, including associated liabilities, while AOL Time Warner retains all of the economic interests in the other TWE-A/N assets and liabilities.

As part of the restructuring of TWE-A/N, on the Debt Closing Date, AOL Time Warner effectively acquired Advance/Newhouse s interest in Road Runner, thereby increasing its ownership to approximately 82% on a fully attributed basis. As a result of the termination of Advance/Newhouse s minority rights in Road Runner, AOL Time Warner has consolidated the financial position and results of operations of Road Runner with the financial position and results of operations of AOL Time Warner s Cable segment. As permitted under generally accepted accounting principles, the Company has consolidated the results of Road Runner retroactive to the beginning of the year.

In connection with the TWE-A/N restructuring, AOL Time Warner recognized a noncash pretax gain of approximately $1.4 billion during the third quarter of 2002, which is included as part of discontinued operations. Of this gain, approximately $1.2 billion related to the difference between the carrying value and fair value of AT&T s interest in the Advance/Newhouse Systems, with the fair value being determined by reference to the fair value of AT&T s additional interest acquired in the remaining TWE-A/N systems. However, because this gain relates in

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large part to AT&T s interest in TWE-A/N, it is substantially offset by minority interest expense, which is similarly included as part of discontinued operations. The remaining pretax gain of $188 million relates to the amount that the fair value of AOL Time Warner s acquired interest in the TWE-A/N systems remaining under the control of AOL Time Warner exceeded the carrying value of AOL Time Warner s interest in the Advance/Newhouse Systems, and primarily relates to the portion of TWE-A/N debt assumed by Advance/Newhouse in excess of its pro rata share in effective compensation for certain adverse tax consequences to the Company as a result of the restructuring. The gain is significantly less than the gain recognized by AT&T because the carrying value of AOL Time Warner s interest in TWE-A/N, including its interest in the Advance/Newhouse Systems, was recently adjusted to fair value as part of the purchase accounting for the Merger. The $188 million pretax gain is also included as part of discontinued operations during the third quarter of 2002. Exclusive of the gains associated with these transactions recognized during the third quarter of 2002, the impact of the TWE-A/N restructuring on AOL Time Warner s consolidated net income is substantially mitigated because the earnings of TWE-A/N attributable to Advance/Newhouse s historical one-third interest was reflected as minority interest expense. As stated previously, this historical minority interest expense is currently classified as part of the discontinued operations for all periods presented. Additionally, there is no impact on AOL Time Warner s consolidated net income of consolidating Road Runner since the Company had previously accounted for its interest in Road Runner under the equity method of accounting.

Sale of Columbia House

In June 2002, AOL Time Warner and Sony Corporation of America reached a definitive agreement to each sell 85% of its 50% interest in the Columbia House Company Partnerships (Columbia House) to Blackstone Capital Partners III LP (Blackstone), an affiliate of The Blackstone Group, a private investment bank. The sale has resulted in the Company recognizing a pretax gain of approximately $59 million, which is included in other expense, net, in the accompanying consolidated statement of operations. In addition, the Company has deferred an approximate $28 million gain on the sale. As a result of the sale, the Company s interest in Columbia House has been reduced to 7.5%. As part of the transaction, AOL Time Warner will continue to license music and video product to Columbia House for a five-year period (Note 4).

$10 Billion Revolving Credit Facilities

In July 2002, AOL Time Warner, together with certain of its consolidated subsidiaries, entered into two new, senior unsecured long-term revolving bank credit agreements with an aggregate borrowing capacity of $10 billion (the 2002 Credit Agreements) and terminated three financing arrangements under certain previously existing bank credit facilities with an aggregate borrowing capacity of $12.6 billion (the Old Credit Agreements) which were to expire during 2002. The 2002 Credit Agreements are comprised of a $6 billion five-year revolving credit facility and a $4 billion 364-day revolving credit facility, borrowings under which may be extended for a period up to two years following the initial term. The borrowers under the 2002 Credit Agreements include AOL Time Warner, TWE, TWE-A/N and AOL Time Warner Finance Ireland. Borrowings will bear interest at specific rates, generally based on the credit rating for each of the borrowers, which is currently equal to LIBOR plus .625%, including facility fees of .10% and .125% on the total commitments of the 364-day and five-year facilities, respectively. The 2002 Credit Agreements provide same-day funding, multi-currency capability and letter of credit availability. They contain maximum leverage and minimum GAAP net worth covenants of 4.5 times and $50 billion, respectively, for AOL Time Warner and maximum leverage covenant of 5.0 times for TWE and TWE-A/N, but do not contain any ratings-based defaults or covenants, nor an ongoing covenant or representation specifically relating to a material adverse change in the Company s financial condition or results of operations. Borrowings may be used

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for general business purposes and unused credit will be available to support commercial paper borrowings (Note 9).

RESULTS OF OPERATIONS
Transactions Affecting Comparability of Results of Operations

Significant Transactions

AOL Time Warner s results for 2002 have been impacted by the following significant transactions that cause them not to be comparable to the results reported in 2001.

Consolidation of AOL Europe, S.A. (AOL Europe). On January 31, 2002, AOL Time Warner acquired 80% of Bertelsmann AG s (Bertelsmann) 49.5% interest in AOL Europe for $5.3 billion in cash and on July 1, 2002 acquired the remaining 20% of Bertelsmann s interest for $1.45 billion in cash (Note 5). As a result of the purchase of Bertelsmann s interest in AOL Europe, AOL Time Warner has a majority interest in and began consolidating AOL Europe, retroactive to the beginning of 2002.

Consolidation of IPC Group Limited (IPC). In October 2001, AOL Time Warner s Publishing segment acquired IPC, the parent company of IPC Media, from Cinven, one of Europe s leading private equity firms, for approximately $1.6 billion.

Discontinued Operations

As previously discussed in Restructuring of TWE-Advance/Newhouse Partnership and Road Runner, the Company s results of operations have been adjusted to reflect the results of the Advance/Newhouse Systems as a discontinued operation for all periods presented. For the three and six months ended June 30, 2002,the net impact of the deconsolidation of these systems is a reduction of the Cable segment s revenues of $363 million and $715 million, respectively, EBITDA of $172 million and $333 million, respectively and operating income of $107 million and $206 million, respectively. For the three and six months ended June 30, 2001, the net impact of the deconsolidation of the Advance/Newhouse Systems is a reduction of the Cable segment s previously reported revenues of $304 million and $596 million, respectively, EBITDA of $137 million and $271 million, respectively, and operating income of $75 million and $151 million, respectively. In addition, as of June 30, 2002, the Advance/Newhouse Systems had current assets and total assets of approximately $57 million and $2.7 billion, respectively, and current liabilities and total liabilities of approximately $186 million and $748 million, respectively, including debt assumed on the Debt Closing Date. As of December 31, 2001, the Advance/Newhouse Systems had current assets and total assets of approximately $64 million and $2.7 billion, respectively, and current liabilities and total liabilities of approximately $210 million and $963 million, respectively, including debt assumed on the Debt Closing Date.

New Accounting Standards

In addition to the transactions previously discussed, in the first quarter of 2002, the Company adopted new accounting guidance in several areas, which are discussed below.

New Accounting Standard for Goodwill and Other Intangible Assets

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During 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 142 Goodwill and Other Intangible Assets (FAS 142), which requires that, effective January 1, 2002, goodwill, including the goodwill included in the carrying value of investments accounted for using the equity method of accounting, and certain other intangible assets deemed to have an indefinite useful life, cease amortizing (Note 3). The new rules also require that goodwill and certain intangible assets be assessed for impairment using fair value measurement techniques. During the first quarter of 2002, the Company completed its impairment review and recorded a $54 billion noncash pretax charge for the impairment of goodwill, substantially all of which was generated in the Merger. The charge reflects overall market declines since the Merger was announced in January 2000, is non-operational in nature and is reflected as a cumulative effect of an accounting change in the accompanying consolidated financial statements (Note 3). In order to enhance comparability, the Company compares current year results to the prior year exclusive of this charge.

Reimbursement of Out-of-Pocket Expenses

In November 2001, the FASB Staff issued as interpretive guidance Emerging Issues Task Force (EITF) Topic No. D-103, Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred (Topic D-103). Topic D-103 requires that reimbursements received for out-of-pocket expenses be classified as revenue on the income statement and was effective for AOL Time Warner in the first quarter of 2002. The new guidance requires retroactive restatement of all periods presented to reflect the new accounting provisions. This change in revenue classification requires retroactive restatement of all periods presented to reflect the new accounting provisions and impacts AOL Time Warner s Cable and Music segments, resulting in an increase in both revenues and costs of approximately $109 million for the second quarter of 2001 and $195 million for the first six months of 2001.

Emerging Issues Task Force Issue No. 01-09

In April 2001, the FASB s EITF reached a final consensus on EITF Issue No. 00-25, Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor s Products, which was later codified along with other similar issues, into EITF 01-09, Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor s Products (EITF 01-09). EITF 01-09 was effective for AOL Time Warner in the first quarter of 2002. EITF 01-09 clarifies the income statement classification of costs incurred by a vendor in connection with the reseller s purchase or promotion of the vendor s products, resulting in certain cooperative advertising and product placement costs previously classified as selling expenses to be reflected as a reduction of revenues earned from that activity. The new guidance requires retroactive restatement of all periods presented to reflect the new accounting provisions and impacts AOL Time Warner s AOL, Music and Publishing segments. As a result of applying the provisions of EITF 01-09, the Company s revenues and costs each were reduced by an equal amount of approximately $48 million in the second quarter of 2001 and $110 million for the first six months of 2001.

Other Significant Transactions and Nonrecurring Items

As more fully described herein and in the related footnotes to the accompanying consolidated financial statements, the comparability of AOL Time Warner s operating results has been affected by certain significant transactions and nonrecurring items in each period.

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AOL Time Warner s operating results for the six months ended June 30, 2002 included (i) merger and restructuring costs of $107 million in the first quarter (Note 2), (ii) a noncash pretax charge of $945 million ($364 million in the second quarter) to reduce the carrying value of certain investments that experienced other-than-temporary declines in market value and to reflect changes in equity derivative instruments. The changes in equity derivative instruments resulted in noncash pretax income of $8 million (a loss of $1 million in the second quarter) (Note 4), (iii) an approximate $59 million gain in the second quarter on the sale of a portion of the Company s interest in Columbia House (Note 4) and (iv) an approximate $31 million gain in the second quarter on the redemption of a portion of the Company s interest in TiVo Inc. (TiVo) (Note 4).

For the six months ended June 30, 2001, AOL Time Warner s operating results included (i) merger-related costs of approximately $71 million in the first quarter (Note 2) and (ii) a noncash pretax charge of approximately $620 million in the first quarter to reduce the carrying value of certain investments that experienced other-than-temporary declines in market value (Note 4).

The impact of the significant transactions and nonrecurring items discussed above on the operating results for the three and six months ended June 30, 2002 and 2001 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(in millions, except per share amounts)			
Adjustments for significant and nonrecurring items:				
Merger and restructuring costs	$	$	$ 107	$ 71
Gain on sale of Columbia House	(59)		(59)	
Gain on redemption of TiVo	(31)		(31)	
Loss on write down of investments	364		945	620
Pretax impact of adjustments	274		962	691
Income tax impact of adjustments	(110)		(385)	(276)
Net income impact of adjustments	$ 164	$	$ 577	$ 415
Impact on basic income (loss) per common share before cumulative effect of accounting change	$ 0.04	$	$ 0.13	$ 0.10
Impact on diluted income (loss) per common share before cumulative effect of accounting change	$ 0.03	$	$ 0.12	$ 0.10

Revenues and EBITDA by business segment are as follows (restated; in millions):

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	Three Months Ended June 30			
	Revenues		EBITDA	
	2002	2001(a)	2002	2001
AOL	$ 2,266	$ 2,105	$ 474	$ 794
Cable	1,762	1,478	675	640
Filmed Entertainment	2,386	1,893	328	250
Networks	1,957	1,828	420	444
Music	972	935	102	87
Publishing	1,396	1,155	337	271
Corporate			(80)	(71)
Merger and restructuring costs				
Intersegment elimination	(505)	(441)	11	(22)
Total revenues and EBITDA	$ 10,234	$ 8,953	$ 2,267	$ 2,393
Depreciation and amortization (c)			(747)	(2,197)
Total revenues and operating income	$ 10,234	$ 8,953	$ 1,520	$ 196

	Six Months Ended June 30			
	Revenues		EBITDA	
	2002	2001(a)	2002	2001
AOL	$ 4,557	$ 4,200	$ 892	$ 1,477
Cable(b)	3,445	2,879	1,327	1,274
Filmed Entertainment	4,522	4,105	509	363
Networks	3,743	3,527	851	893
Music	1,919	1,839	198	181
Publishing	2,477	2,084	482	384
Corporate			(159)	(145)
Merger and restructuring costs			(107)	(71)
Intersegment elimination	(1,005)	(851)	13	(23)
Total revenues and EBITDA	$ 19,658	$ 17,783	$ 4,006	$ 4,333
Depreciation and amortization (c)			(1,429)	(4,360)
Total revenues and operating income	$ 19,658	$ 17,783	$ 2,577	$ (27)

(a) Revenues reflect the provisions of EITF 01-09 and Topic D-103 that were adopted by the Company in the first quarter of 2002, which require retroactive restatement of 2001 to reflect the new accounting provisions. As a result, the net impact of EITF 01-09 and Topic D-103 was to increase revenues and costs by equal amounts of approximately $61 million for the second quarter of 2001 and approximately $85 million for the first six months of 2001.

(b) As a result of Advance/Newhouse assuming responsibility for the day-to-day operations of the Advance/Newhouse Systems, the Cable segment s results reflect the deconsolidation of the operating results of the Advance/Newhouse Systems for all periods presented. For the three and six months ended June 30, 2002,the net impact of the deconsolidation of these systems is a reduction of the Cable segment s revenues of $363 million and $715 million, respectively, EBITDA of $172 million and $333 million, respectively, and operating income of $107 million and $206 million, respectively. For the three and six months

ended June 30, 2001, the net impact of the deconsolidation of the Advance/Newhouse Systems is a reduction of the Cable segment s previously reported revenues of $304 million and $596 million, respectively, EBITDA of $137 million and $271 million, respectively, and operating income of $75 million and $151 million, respectively. In addition, the Cable segment s results reflect the consolidation of Road Runner s operating results effective January 1, 2002.

(c) Depreciation and amortization by business segment is provided in Note 10, Segment Information.

Three Months Ended June 30, 2002 Compared to Three Months Ended June 30, 2001

Consolidated Results

Revenues. AOL Time Warner s revenues increased to $10.234 billion in 2002, compared to $8.953 billion in 2001. This overall increase in revenues was driven by an increase in Subscription revenues of 24% to $4.747

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billion and an increase in Content and Other revenues of 19% to $3.451 billion, offset in part by a decrease in Advertising and Commerce revenues of 8% to $2.036 billion.

As discussed more fully below, the increase in Subscription revenues was principally due to increases in the number of subscribers and in subscription rates at the AOL, Cable and Networks segments, as well as the impact of the acquisitions of AOL Europe and IPC and the consolidation of Road Runner. The increase in Content and Other revenues was principally due to increased revenue at the Filmed Entertainment segment related to improved international theatrical and worldwide home video results, offset in part by lower results at the AOL segment, primarily related to the termination of the iPlanet alliance with Sun Microsystems, Inc. (Sun Microsystems) in the third quarter of 2001. The decline in Advertising and Commerce revenues was due to lower advertising revenues principally related to the continued weakness in the online advertising market, which is expected to continue through at least the end of the year.

Depreciation and Amortization. Depreciation and amortization decreased to $747 million in 2002 from $2.197 billion in 2001. The decrease was due to a decrease in amortization expense to $175 million in 2002 from $1.770 billion in 2001 due to the adoption of FAS 142, which resulted in goodwill and certain intangible assets ceasing to be amortized. The decrease was offset in part by an increase in depreciation expense to $572 million in 2002 from $427 million in 2001. The increase in depreciation reflects higher levels of capital spending at the Cable segment related to the roll-out of digital services over the past three years, as well as increased capital spending that varies based on the number of new subscribers, which is depreciated over a shorter useful life. In addition, depreciation at the AOL segment increased primarily due to an increase in network assets acquired.

Operating Income. Operating income was $1.520 billion in 2002, compared to $196 million in 2001. The improvement primarily related to a decrease in amortization expense due to the adoption of FAS 142, offset in part by a decrease in EBITDA, which is discussed in detail under Business Segment Results, and an increase in depreciation expense.

Interest Expense, Net. Interest expense, net, increased to $441 million in 2002, from $344 million in 2001, due principally to incremental borrowings to purchase 80% of Bertelsmann s 49.5% interest in AOL Europe and the acquisition of IPC, offset in part by lower market interest rates in 2002.

Other Expense, Net. Other expense, net, increased to $331 million in 2002 from $233 million in 2001. Other expense, net, in each period included pretax noncash charges to reduce the carrying value of certain investments that experienced an other-than-temporary decline in value. In 2002, this charge was approximately $364 million, primarily related to AOL Time Warner s investments in Time Warner Telecom and Gateway, Inc., which was offset in part by an approximate $59 million gain on the sale of a portion of the Company s interest in Columbia House and an approximate $31 million gain on the redemption of a portion of the Company s interest in TiVo. In 2001, AOL Time Warner recorded a charge of approximately $54 million, which was almost entirely offset by pretax gains related to equity derivative instruments and the sale of certain investments. Excluding these charges and the Columbia House and TiVo gains, other expense, net, decreased by $176 million in 2002 primarily due to lower losses on equity method investees, primarily related to reduced amortization associated with the adoption of FAS 142, offset in part by the absence of prior year net pretax investment-related gains. Depending upon general market conditions and the performance of individual investments in the Company s portfolio, the Company may be required in the future to record a noncash charge to reduce the carrying value of individual investments to their fair value for other-than-temporary declines. Any such charge would be unrelated to the Company s core operations and would be recorded in other expense, net (Note 4).

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Minority Interest Income (Expense). Minority interest income (expense) was $53 million of expense in 2002, compared to $1 million of minority interest income in 2001. The 2002 expense reflects the adoption of FAS 142, which resulted in a reduction of amortization expense at the Company s partially owned consolidated investees, thereby resulting in higher income attributable to minority partners.

Income Tax Provision. The relationship between income before income taxes and income tax expense of AOL Time Warner is principally affected by certain financial statement expenses that are not deductible for income tax purposes, foreign income taxed at different rates and foreign losses with no U.S. tax benefit. AOL Time Warner had income tax expense of $301 million in 2002, compared to $348 million in 2001. While the effective tax rate in each period was comparable, slight differences are attributable to differing sources of foreign income taxed at different rates and foreign losses with no U. S. tax benefit in each period. As of June 30, 2002, the Company had net operating loss carryforwards of approximately $12.6 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.

Net Income Applicable to Common Shares and Income Per Common Share. AOL Time Warner s net income increased by $1.133 billion to $396 million in 2002, compared to a net loss of $737 million in 2001. Excluding the after-tax effect of the significant and nonrecurring items referred to earlier, normalized net income increased by $1.297 billion to $560 million in 2002 from a net loss of $737 million in 2001. Similarly, excluding the effect of significant and nonrecurring items, normalized basic and diluted net income per common share was $0.13 and $0.12, respectively in 2002 compared to a basic and diluted net loss per common share of $0.17 in 2001. The increase in earnings primarily reflects reduced amortization associated with the adoption of FAS 142, offset in part by an overall decrease in AOL Time Warner s EBITDA and increased depreciation expense, interest expense, net, other expense net, and minority interest expense.

Management Evaluation

As noted above, the acquisitions of AOL Europe and IPC, the consolidation of Road Runner, as well as the implementation of FAS 142 significantly impacted the comparability of AOL Time Warner s 2002 results. In addition, other significant transactions and nonrecurring items occurred in 2002, which also impacted the comparability of the Company s results. As such, in reviewing the performance of its businesses, management also evaluates the Company s results assuming that the acquisitions of AOL Europe and IPC, the consolidation of Road Runner and the adoption of FAS 142 occurred as of the beginning of 2001. In addition, management evaluates results excluding the previously discussed other significant transactions and nonrecurring items. Giving effect to these items, the Company s total revenues would have increased 10% (from $9.307 billion to $10.234 billion), EBITDA would have increased 2% (from $2.227 billion to $2.267 billion), operating income would have declined 5% (from $1.607 billion to $1.520 billion) and net income would have decreased 6% (from $592 million to $558 million).

Business Segment Results

AOL. Revenues increased 8% to $2.266 billion in 2002, compared to $2.105 billion in 2001. EBITDA decreased 40% to $474 million in 2002, compared to $794 million in 2001.

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Revenues benefited from a 39% increase in Subscription revenues (from $1.284 billion to $1.786 billion), offset in part by a 39% decrease in Advertising and Commerce revenues (from $673 million to $412 million) and a 54% decrease in Content and Other revenues (from $148 million to $68 million).

The growth in subscription revenues was primarily related to the acquisition of AOL Europe, as well as domestic revenue growth. Domestically, subscription revenues increased 18% and were principally driven by membership growth. The number of AOL brand subscribers in the U.S. was 26.5 million at June 30, 2002 compared to 23.4 million at June 30, 2001. The average monthly subscription revenue per domestic subscriber for the quarter increased 5% to $18.18 as compared to $17.26 in the prior year quarter. This increase is due to the standard unlimited rate increase of $1.95 per month to $23.90 (effective beginning in July 2001) and the Bring Your Own Access (BYOA) plan of $5 to $14.95 (which began rolling out in October 2001). These domestic rate plan increases were offset in part by new member acquisition programs and member service and retention programs that offer incentives in the form of discounts and free months to AOL s members.

The majority of AOL s domestic subscribers are on standard unlimited pricing plans. AOL has entered into certain bundling programs with computer manufacturers (OEMs) that generally do not result in subscription revenues during introductory periods as well as the sale of bulk subscriptions at a discounted rate to AOL s selected strategic partners for distribution to their employees. As of June 30, 2002, of the 26.5 million domestic AOL members, approximately 79% were on standard unlimited pricing plans (including 12% under various free trial, member service and retention programs), 16% were on lower priced plans, including BYOA, bulk employee programs with strategic partners, and limited usage plans (weighted average monthly rate of approximately $11.50), with the remaining 5% on OEM bundled plans.

The number of AOL brand subscribers in Europe was 6.0 million at June 30, 2002 and the average monthly subscription revenue per European subscriber for the second quarter of 2002 was $14.07. This compares to AOL brand subscribers in Europe of 4.8 million at June 30, 2001 and average monthly subscription revenue per European subscriber for the second quarter of 2001 of $12.78. The average monthly subscription revenue per European subscriber in 2002 was impacted by price increases implemented earlier this year in various European countries offering the AOL service.

The decline in Advertising and Commerce revenues resulted from a decline in advertising revenues (from $606 million to $342 million) as commerce revenues remained relatively flat. The decline in advertising revenues is principally due to continued weakness in the online advertising market, which is expected to continue at least through the end of this year, slightly offset by contributions from AOL Europe. Also contributing to the decline in advertising revenues was a decline in revenues recognized from commitments received in prior periods. Domestic contractual commitments received in prior periods contributed advertising revenue of $220 million in the 2002 period as compared to $463 million in the comparable prior year period. This advertising revenue decline was in part mitigated by an increase in intercompany sales of advertising to other business segments of AOL Time Warner ($50 million in 2002 versus $29 million in 2001). During the quarter, advertising commitments declined to $859 million as of June 30, 2002 from $1.019 billion as of March 31, 2002. This compares to advertising commitments of $1.760 billion as of June 30, 2001 and $2.299 billion as of March 31, 2001. The Company expects to recognize a majority of the existing advertising commitments over the next four quarters.

The decrease in Content and Other revenues is primarily due to the termination of AOL s iPlanet alliance with Sun Microsystems in the third quarter of 2001, which contributed approximately $86 million of revenue and approximately $58 million of EBITDA during the second quarter of 2001. This was offset in part by $26 million of network revenues which are derived primarily through network services provided to Road Runner, which began in November 2001.

The decline in EBITDA is primarily due to the advertising revenue shortfall, the absence of revenues from the iPlanet alliance, an increase in domestic marketing expenses and the acquisition of AOL Europe. AOL Europe

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has EBITDA losses of $32 million in the 2002 period, which are included in the AOL segment s results, compared to $149 million in the 2001 period prior to the consolidation of AOL Europe s results. The increase in advertising revenue generated from intercompany sales of advertising to other business segments of AOL Time Warner was more than offset by costs associated with increased intercompany advertising purchased by AOL on properties of other AOL Time Warner business segments ($73 million in 2002 versus $41 million in 2001).

The current year results are significantly impacted by the acquisition of AOL Europe as discussed above. Accordingly, management also evaluates the current period results assuming the operations of AOL Europe were consolidated beginning January 1, 2001. Assuming such consolidation as of January 1, 2001, AOL s revenues would have declined by 1% to $2.266 billion in 2002, compared to $2.299 billion in 2001. Subscription revenues would have increased by 20% to $1.786 billion in 2002, compared to $1.489 billion in 2001, Advertising and Commerce revenues would have decreased 40% to $412 million in 2002, compared to $687 million in 2001, Content and Other revenues would have decreased 45% to $68 million in 2002, compared to $123 million in 2001, and EBITDA would have decreased 27% to $474 million in 2002, compared to $645 million in 2001.

Cable. Revenues increased 19% to $1.762 billion in 2002, compared to $1.478 billion in 2001. EBITDA increased 5% to $675 million in 2002 from $640 million in 2001. Depreciation expense increased to $295 million in 2002 from $220 million in 2001.

Revenues increased due to a 17% increase in Subscription revenues (from $1.362 billion to $1.591 billion) and a 47% increase in Advertising and Commerce revenues (from $116 million to $171 million). The increase in Subscription revenues was due to higher basic cable rates, an increase in subscribers to high-speed data services, an increase in digital cable subscribers and, to a lesser degree, an increase in basic cable subscribers as well as the impact of the consolidation of Road Runner in 2002. Digital cable subscribers increased by 54% to 3.9 million and high-speed data subscribers increased by 75% to 2.5 million in 2002 over the prior year comparable period. The increase in Advertising and Commerce revenues was primarily related to advertising purchased by programming vendors to promote their channels, including new channel launches, ($41 million in 2002 versus $1 million in 2001) and the intercompany sale of advertising to other business segments of AOL Time Warner ($31 million in 2002 versus $18 million in 2001). The Company expects advertising sales to programming vendors to sequentially decline, resulting in declines in such advertising in the second half of 2002 as compared to the prior year.

EBITDA increased principally as a result of the revenue gains, offset in part by increases in programming and other operating costs and the consolidation of Road Runner in 2002. The increase in video programming costs of 22% relates to general programming rate increases across both basic and digital services, the addition of new programming services and higher basic and digital subscriber levels. Programming costs are expected to continue to increase as general programming rates increase and digital services continue to be rolled out. Other operating costs increased as a result of increased costs associated with the roll out of new services, higher property taxes associated with the upgrade of cable plants and higher development spending in the Interactive Personal Video division. The increase in depreciation reflects higher levels of capital spending related to the roll-out of digital services over the past three years.

As noted above, the consolidation of Road Runner effective January 1, 2002 significantly impacted the comparability of the Cable segment s 2002 results by increasing revenues and decreasing EBITDA. As such, management of the Company also evaluates the results of the Cable segment assuming that the results of Road Runner were included in both periods. Assuming that the results of Road Runner were included in both periods, total revenues would have increased 17% (from $1.502 billion to $1.762 billion), Subscription revenues would have

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increased 15% (from $1.385 billion to $1.591 billion) and EBITDA would have increased 13% (from $598 million to $675 million).

Filmed Entertainment. Revenues increased 26% to $2.386 billion in 2002, compared to $1.893 billion in 2001. EBITDA increased 31% to $328 million in 2002, compared to $250 million in 2001.

Revenues and EBITDA increased at both Warner Bros. and the filmed entertainment businesses of Turner Broadcasting System, Inc. (the Turner filmed entertainment businesses), which include New Line Cinema, Castle Rock and the former film and television libraries of Metro-Goldwyn-Mayer, Inc. and RKO pictures.

For Warner Bros., the revenue increase was primarily related to the worldwide home video release of *Harry Potter and the Sorcerer s Stone*, the domestic home video release of *Ocean s Eleven*, as well as the continued international theatrical success of those films and the theatrical success of the second quarter release of *Scooby Doo*, offset in part by reduced commerce revenues related to the closure of its Studio Stores. For the Turner filmed entertainment businesses, revenues increased primarily due to New Line Cinema s continued theatrical success of *The Lord of the Rings: The Fellowship of the Ring* and *Blade II*.

For Warner Bros., EBITDA increased principally due to the strong revenue growth. For the Turner filmed entertainment businesses, EBITDA increased primarily due to the revenue increase as well as an absence of losses on certain theatrical releases in 2001.

Networks. Revenues increased 7% to $1.957 billion in 2002, compared to $1.828 billion in 2001. EBITDA declined 5% to $420 million in 2002 from $444 million in 2001.

Revenues grew primarily due to a 7% increase in Subscription revenues with growth at both the cable networks of TBS (the Turner cable networks) and HBO, a 5% increase in Advertising and Commerce revenues (from $679 million to $710 million) with growth at both the Turner cable networks and The WB Network and a 21% increase in Content and Other revenues with growth at HBO, offset in part by declines at the Turner cable networks. EBITDA decreased due to lower results at the Turner cable networks, offset in part by improved results at HBO and, to a lesser degree, The WB Network.

For the Turner cable networks, Subscription revenues benefited from higher domestic rates and an increase in the number of domestic subscribers, led by TNT, CNN, Turner Classic Movies, TBS and Cartoon Network cable networks. Advertising and Commerce revenues increased marginally (from $557 million to $569 million) due to a slight recovery in the cable television advertising market and a small increase in intercompany sales of advertising to other business segments of AOL Time Warner ($25 million in 2002 versus $24 million in 2001). For HBO, Subscription revenues benefited from an increase in the number of subscribers and higher rates. Content and Other revenues benefited from higher home video sales of HBO s original programming and higher licensing and syndication revenue from the broadcast comedy series, *Everybody Loves Raymond*. For The WB Network, the increase in Advertising and Commerce revenues (from $122 million to $141 million) was driven by higher rates.

For the Turner cable networks, the decrease in EBITDA was principally due to higher programming, marketing and newsgathering costs, partially offset by the increased revenues. In addition, EBITDA was negatively impacted by reserves established on receivables from Adelphia Communications, a major cable television operator (Adelphia). For HBO, the increase in EBITDA was principally due to the increase in revenues and reduced costs relating to the finalization of certain licensing agreements, offset in part by reserves established on receivables from

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Adelphia and the write-off of development costs. For The WB Network, the improvement in EBITDA was principally due to the increase in revenues, offset in part by higher programming costs.

Music. Revenues increased 4% to $972 million in 2002, compared to $935 million in 2001. EBITDA increased 17% to $102 million in 2002 from $87 million in 2001.

Revenues increased primarily due to increases in DVD manufacturing and merchandising sales, and the impact of the acquisition of Word Entertainment in January 2002, offset in part by the negative effect of changes in foreign currency exchange rates on international revenues and lower industry-wide domestic recorded music sales.

The increase in EBITDA is due primarily to the higher revenues and the impact of various cost-saving and restructuring programs. As of June 30, 2002, the Music segment had increased its domestic album market share to 17.6%, compared to 17.1% at June 30, 2001.

Publishing. Revenues increased 21% to $1.396 billion in 2002, compared to $1.155 billion in 2001. EBITDA increased 24% to $337 million in 2002 from $271 million in 2001.

The increase in revenues is due to a 44% increase in Subscription revenues, 13% increase in Advertising and Commerce revenues (from $754 million to $850 million) and a 20% increase in Content and Other revenues. The growth in Subscription revenues was primarily due to the acquisitions of IPC in October 2001 and Synapse Group Inc. (Synapse) in December 2001, as well as lower commission payments to subscription agents. The growth in Advertising and Commerce revenues was primarily due to revenues recognized by IPC and Synapse. This was offset in part by lower commerce revenues from Time Life s direct marketing business and weakness in the magazine advertising market. The increase in Content and Other revenues is due primarily to increased sales at the AOL Time Warner Book Group driven by new releases in the quarter.

The growth in EBITDA is due primarily to the increase in revenue, including the impact of the acquisitions of IPC and Synapse, overall cost savings, and reduced costs relating to the final settlement of certain liabilities associated with the closure of American Family Enterprises (AFE), offset in part by additional reserves established on receivables from newsstand distributors.

As noted above, the acquisition of IPC in October 2001 significantly impacted the comparability of the Publishing segment s 2002 results by significantly increasing both revenues and EBITDA. As such, management of the Company also evaluates the results of the Publishing segment assuming that the results of IPC were included in both periods. Assuming that the results of IPC were included in both periods, total revenues would have increased 8% (from $1.291 billion to $1.396 billion), Subscription revenues would have increased 12% (from $354 million to $395 million), Advertising and Commerce revenues would have increased 6% (from $805 million to $850 million) and EBITDA would have increased 14% (from $296 million to $337 million).

Six Months Ended June 30, 2002 Compared to Six Months Ended June 30, 2001

Consolidated Results

Revenues. AOL Time Warner s revenues increased to $19.658 billion in 2002, compared to $17.783 billion in 2001. The overall increase in revenues was driven by an increase in Subscription revenues of 23% to $9.214

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billion and an increase in Content and Other revenues of 9% to $6.624 billion, offset in part by a decrease in Advertising and Commerce revenues of 9% to $3.820 billion.

As discussed more fully below, the increase in Subscription revenues was principally due to increases in the number of subscribers and in subscription rates at the AOL, Cable and Networks segments, as well as the impact of the acquisitions of AOL Europe and IPC and the consolidation of Road Runner. The increase in Content and Other revenues was principally due to increased revenue at the Filmed Entertainment segment related to improved international theatrical and worldwide home video results, offset in part by lower results at the AOL segment, primarily related to the termination of the iPlanet alliance with Sun Microsystems. The decline in Advertising and Commerce revenues was principally due to lower advertising revenues related to the first quarter weakness in the overall advertising market and continued weakness in the online advertising market. The weakness in the online advertising market is expected to continue through at least the end of the year.

Depreciation and Amortization. Depreciation and amortization decreased to $1.429 billion in 2002 from $4.360 billion in 2001. The decrease was due to a decrease in amortization expense to $339 million in 2002 from $3.534 billion in 2001 due to the adoption of FAS 142, which resulted in goodwill and certain intangible assets ceasing to be amortized. The decrease was offset in part by an increase in depreciation expense to $1.090 billion in 2002 from $826 million in 2001. The increase in depreciation reflects higher levels of capital spending at the Cable segment related to the roll-out of digital services over the past three years, as well as increased capital spending that varies based on the number of new subscribers, which is depreciated over a shorter useful life. In addition, depreciation at the AOL segment increased primarily due to an increase in network assets acquired.

Operating Income (Loss). Operating income was $2.577 billion in 2002, compared to an operating loss of $27 million in 2001. The improvement primarily related to a decrease in amortization expense due to the adoption of FAS 142, offset in part by a decrease in EBITDA, which is discussed in detail under Business Segment Results, and an increase in depreciation expense.

Interest Expense, Net. Interest expense, net, increased to $817 million in 2002, from $655 million in 2001, due principally to incremental borrowings to purchase 80% of Bertelsmann s 49.5% interest in AOL Europe and the acquisition of IPC, offset in part by lower market interest rates in 2002.

Other Expense, Net. Other expense, net, decreased to $986 million in 2002 from $1.135 billion in 2001. Other expense, net, in each period included pretax noncash charges to reduce the carrying value of certain investments that experienced an other-than-temporary decline in value. In 2002, this charge was approximately $945 million, primarily related to AOL Time Warner s investments in Time Warner Telecom and Gateway, which was offset in part by an approximate $59 million gain on the sale of a portion of the Company s interest in Columbia House and an approximate $31 million gain on the redemption of a portion of the Company s interest in TiVo. In 2001, AOL Time Warner recorded a charge of approximately $674 million, which was offset in part by approximately $54 million of pretax gains related to equity derivative instruments and the sale of certain investments. Excluding these charges and the Columbia House and TiVo gains, other expense, net, decreased by $384 million in 2002 primarily due to lower losses on equity method investees, primarily related to reduced amortization associated with the adoption of FAS 142, offset in part by the absence of prior year net pretax investment-related gains. Depending upon general market conditions and the performance of individual investments in the Company s portfolio, the Company may be required in the future to record a noncash charge to reduce the carrying value of individual investments to their fair value for other-than-temporary declines. Any such charge would be unrelated to the Company s core operations and would be recorded in other expense, net.

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Minority Interest Income (Expense). Minority interest income (expense) was $84 million of expense in 2002, compared to $6 million of minority interest income in 2001. The 2002 expense reflects the accretion on the preferred securities of AOL Europe and the adoption of FAS 142, which resulted in a reduction of amortization expense at the Company s partially owned consolidated investees, thereby resulting in higher income attributable to minority partners.

Income Tax Provision. The relationship between income before income taxes and income tax expense of AOL Time Warner is principally affected by certain financial statement expenses that are not deductible for income tax purposes, foreign income taxed at different rates and foreign losses with no U.S. tax benefit. AOL Time Warner had income tax expense of $304 million in 2002, compared to $276 million in 2001. While the effective tax rate in each period was comparable, slight differences are attributable to differing sources of foreign income taxed at different rates and foreign losses with no U.S. tax benefit in each period. As of June 30, 2002, the Company had net operating loss carryforwards of approximately $12.6 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.

Net Income (Loss) Applicable to Common Shares and Income (Loss) Per Common Share Before the Cumulative Effect of an Accounting Change. AOL Time Warner s income before the cumulative effect of an accounting change increased by $2.493 billion to $387 million in 2002, compared to a net loss of $2.106 billion in 2001. Excluding the after-tax effect of the significant and nonrecurring items referred to earlier, normalized net income increased by $2.655 billion to $964 million in 2002 from a net loss of $1.691 billion in 2001. Similarly, excluding the effect of significant and nonrecurring items, normalized basic and diluted net income per common share was $0.22 and $0.21, respectively, in 2002 compared to a basic and diluted net loss per common share of $0.38 in 2001. The increase in earnings primarily reflects reduced amortization associated with the adoption of FAS 142 and a slight decline in other expense, net, offset in part by an overall decrease in EBITDA and increased depreciation expense, interest expense, net and minority interest expense.

Management Evaluation

As noted above, the acquisitions of AOL Europe and IPC, the consolidation of Road Runner, as well as the implementation of FAS 142 significantly impacted the comparability of AOL Time Warner s 2002 results. In addition, other significant transactions and nonrecurring items occurred in both periods, which also impacted the comparability of the Company s results. As such, in reviewing the performance of its businesses, management also evaluates the Company s results assuming that the acquisitions of AOL Europe and IPC, the consolidation of Road Runner and the adoption of FAS 142 occurred as of the beginning of 2001. In addition, management evaluates results excluding the previously discussed other significant transactions and nonrecurring items. Giving effect to these items, the Company s total revenues would have increased 6% (from $18.479 billion to $19.658 billion), EBITDA would have increased 2% (from $4.027 billion to $4.113 billion), operating income would have declined 5% (from $2.815 billion to $2.684 billion) and net income would have increased 1% (from $955 million to $963 million).

Business Segment Results

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AOL. Revenues increased 9% to $4.557 billion in 2002, compared to $4.200 billion in 2001. EBITDA decreased 40% to $892 million in 2002, compared to $1.477 billion in 2001.

Revenues benefited from a 38% increase in Subscription revenues (from $2.536 billion to $3.503 billion), which was offset in part by a 34% decrease in Advertising and Commerce revenues (from $1.364 billion to $907 million) and a 51% decrease in Content and Other revenues (from $300 million to $147 million).

The growth in subscription revenues was primarily related to the acquisition of AOL Europe, as well as domestic revenue growth. Domestically, subscription revenues increased 17% and were principally driven by membership growth. The number of AOL brand subscribers in the U.S. was 26.5 million at June 30, 2002 compared to 23.4 million at June 30, 2001. The average monthly subscription revenue per domestic subscriber for the six-month period increased 5% to $18.11 as compared to $17.28 in the prior six-month period. This increase is due to the standard unlimited rate increase of $1.95 per month to $23.90 (effective beginning in July 2001) and the BYOA plan of $5 to $14.95 (which began rolling out in October 2001). These domestic rate plan increases were offset in part by new member acquisition programs and member service and retention programs that offer incentives in the form of discounts and free months to AOL s members.

The majority of AOL s domestic subscribers are on standard unlimited pricing plans. AOL has entered into certain bundling programs with computer manufacturers (OEMs) that generally do not result in subscription revenues during introductory periods as well as the sale of bulk subscriptions at a discounted rate to AOL s selected strategic partners for distribution to their employees. As of June 30, 2002, of the 26.5 million domestic AOL members, approximately 79% were on standard unlimited pricing plans (including 12% under various free trial, member service and retention programs), 16% were on lower priced plans, including BYOA, bulk employee programs with strategic partners, and limited usage plans (weighted average monthly rate of approximately $11.20), with the remaining 5% on OEM bundled plans.

The number of AOL brand subscribers in Europe was 6.0 million at June 30, 2002 and the average monthly subscription revenue per European subscriber for the first six months of 2002 was $13.82. This compares to AOL brand subscribers in Europe of 4.8 million at June 30, 2001 and average monthly subscription revenue per European subscriber for the first six months of 2001 of $12.52. The average monthly subscription revenue per European subscriber in 2002 was impacted by price increases implemented earlier this year in various European countries offering the AOL service.

The decline in Advertising and Commerce revenues resulted from a decline in advertising revenues (from $1.214 billion to $731 million) offset in part by an increase in commerce revenues from the expansion of AOL s merchandise business. The decline in advertising revenues was principally due to continued weakness in the online advertising market, which is expected to continue at least through the end of this year, offset in part by the acquisition of AOL Europe. Also contributing to the decline in advertising revenues was a decline in revenues recognized from commitments received in prior periods. Domestic contractual commitments received in prior periods contributed advertising revenue of $505 million in the 2002 period as compared to $827 million in the comparable prior year period. This advertising revenue decline was in part mitigated by an increase in intercompany sales of advertising to other business segments of AOL Time Warner ($104 million in 2002 versus $50 million in 2001). During the six-month period, advertising commitments declined to $859 million as of June 30, 2002 from $1.450 billion as of December 31, 2001. This compares to advertising commitments of $1.760 billion as of June 30, 2001, and $2.598 billion as of December 31, 2000. The Company expects to recognize a majority of the existing advertising commitments over the next four quarters.

The decrease in Content and Other revenues is primarily due to the termination of AOL s iPlanet alliance with Sun Microsystems in the third quarter of 2001, which contributed approximately $174 million of revenue and approximately $120 million of EBITDA during the first six months of 2001. This was offset in part by $52 million of revenues which were derived primarily through network services provided to Road Runner, which began in November 2001.

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The decline in EBITDA is primarily due to the advertising revenue decline, the absence of revenues from the iPlanet alliance, an increase in domestic marketing expenses and the acquisition of AOL Europe, offset in part by the continued decline in network costs on a per hour basis and other cost management initiatives entered into during 2001. AOL Europe has EBITDA losses of $125 million in the 2002 period, which are included in the AOL segment s results, compared to $326 million in the 2001 period prior to the consolidation of AOL Europe s results. The increase in advertising revenue generated from intercompany sales of advertising to other business segments of AOL Time Warner was more than offset by costs associated with increased intercompany advertising purchased by AOL on properties of other AOL Time Warner business segments ($148 million in 2002 versus $77 million in 2001).

The current year results are significantly impacted by the acquisition of AOL Europe as discussed above. Accordingly, management also evaluates the current period results assuming the operations of AOL Europe were consolidated beginning January 1, 2001. Assuming such consolidation as of January 1, 2001, AOL s revenues would have been relatively flat ($4.557 billion in 2002 compared to $4.588 billion in 2001). Subscription revenues would have increased by 20% to $3.503 billion in 2002, compared to $2.930 billion in 2001, Advertising and Commerce revenues would have decreased 35% to $907 million in 2002, compared to $1.395 billion in 2001, Content and Other revenues would have decreased 44% to $147 million in 2002, as compared to $263 million in 2001, and EBITDA would have decreased 23% to $892 million in 2002, compared to $1.151 billion in 2001.

Cable. Revenues increased 20% to $3.445 billion in 2002, compared to $2.879 billion in 2001. EBITDA increased 4% to $1.327 billion in 2002 from $1.274 billion in 2001. Depreciation expense increased to $569 million in 2002 from $414 million in 2001.

Revenues increased due to a 17% increase in Subscription revenues (from $2.669 billion to $3.121 billion) and a 54% increase in Advertising and Commerce revenues (from $210 million to $324 million). The increase in Subscription revenues was due to higher basic cable rates, an increase in subscribers to high-speed data services, an increase in digital cable subscribers and, to a lesser degree, an increase in basic cable subscribers, as well as the impact of the consolidation of Road Runner in 2002. Digital cable subscribers increased by 54% to 3.9 million and high-speed data subscribers increased by 75% to 2.5 million in 2002 over the prior year comparable period. The increase in Advertising and Commerce revenues was primarily related to advertising purchased by programming vendors to promote their channels, including new channel launches, ($82 million in 2002 versus $17 million in 2001), and the intercompany sale of advertising to other business segments of AOL Time Warner ($58 million in 2002 versus $21 million in 2001). The Company expects advertising sales to programming vendors to sequentially decline, resulting in declines in such advertising in the second half of 2002 as compared to the prior year.

EBITDA increased principally as a result of the revenue gains, offset in part by increases in programming and other operating costs and the consolidation of Road Runner in 2002. The increase in video programming costs of 25% relates to general programming rate increases across both basic and digital services, the addition of new programming services and higher basic and digital subscriber levels. Programming costs are expected to continue to increase as general programming rates increase and digital services continue to be rolled out. Other operating costs increased as a result of increased costs associated with the roll out of new services, higher property taxes associated with the upgrade of cable plants and higher development spending in the Interactive Personal Video division. The increase in depreciation expense reflects higher levels of capital spending related to the roll-out of digital services over the past three years.

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As noted above, the consolidation of Road Runner effective January 1, 2002 significantly impacted the comparability of the Cable segment s 2002 results by increasing revenues and decreasing EBITDA. As such, management of the Company also evaluates the results of the Cable segment assuming that the results of Road Runner were included in both periods. Assuming that the results of Road Runner were included in both periods, total revenues would have increased 18% (from $2.929 billion to $3.445 billion), Subscription revenues would have increased 15% (from $2.717 billion to $3.121 billion) and EBITDA would have increased 12% (from $1.184 billion to $1.327 billion).

Filmed Entertainment. Revenues increased 10% to $4.522 billion in 2002, compared to $4.105 billion in 2001. EBITDA increased 40% to $509 million in 2002, compared to $363 million in 2001.

Revenues and EBITDA increased at Warner Bros. while revenues declined and EBITDA increased at the Turner filmed entertainment businesses, which include New Line Cinema, Castle Rock and the former film and television libraries of Metro-Goldwyn-Mayer, Inc. and RKO pictures.

For Warner Bros., the revenue increase was primarily related to the worldwide theatrical and home video release of *Harry Potter and the Sorcerer s Stone* and the worldwide theatrical and domestic home video release of *Ocean s Eleven*. Warner Bros. revenues also benefited from higher worldwide consumer products licensing results, offset in part by reduced commerce revenues related to the closure of its Studio Stores. For the Turner filmed entertainment businesses, revenues decreased primarily due to lower television revenues related to the absence in 2002 of significant syndication revenues to broadcast *Seinfeld* and lower pay-television and basic cable television revenues due to the timing of TV availabilities for film product. This was offset in part by New Line Cinema s continued theatrical success of *The Lord of the Rings: The Fellowship of the Ring*, as well as the theatrical successes of *John Q* and *Blade II*, which were released in 2002.

For Warner Bros., EBITDA increased principally due to improvements in the mix of theatrical product, primarily the profitability of *Harry Potter and the Sorcerer s Stone*. For the Turner filmed entertainment businesses, EBITDA increased primarily due to continued theatrical success of *The Lord of the Rings: The Fellowship of the Ring* as well as the absence of losses on certain theatrical releases in 2001.

Networks. Revenues increased 6% to $3.743 billion in 2002, compared to $3.527 billion in 2001. EBITDA declined 5% to $851 million in 2002 from $893 million in 2001.

Revenues grew primarily due to an 8% increase in Subscription revenues with growth at both the Turner cable networks and HBO and an 18% increase in Content and Other revenues with growth at HBO, offset in part by decreases at the Turner cable networks. Advertising and Commerce revenues were essentially flat ($1.276 billion in 2002 compared to $1.268 billion in 2001) with increases at The WB Network and flat revenues at the Turner cable networks. EBITDA decreased due to lower results at the Turner cable networks and The WB Network, offset in part by improved results at HBO.

For the Turner cable networks, Subscription revenues benefited from higher domestic rates and an increase in the number of domestic subscribers, led by TNT, CNN, Turner Classic Movies, TBS and Cartoon Network cable networks. Advertising and Commerce revenues were essentially flat ($1.024 billion in 2002 compared to $1.029 billion in 2001) reflecting the slight recovery in the cable television advertising market during the second quarter of 2002, which was offset in part by a slight decline in intercompany sales of advertising to other business segments of

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AOL Time Warner ($56 million in 2002 versus $57 million in 2001). For HBO, Subscription revenues benefited from an increase in the number of subscribers and higher rates. Content and Other revenues benefited from higher home video sales of HBO s original programming and higher licensing and syndication revenue from the broadcast comedy series *Everybody Loves Raymond*. For The WB Network, the increase in Advertising and Commerce revenues was driven by higher rates.

For the Turner cable networks, the decrease in EBITDA was principally due to higher programming, marketing and newsgathering costs, partially offset by the increased Subscription revenues. In addition, EBITDA was negatively impacted by reserves established on receivables from Adelphia. For The WB Network, the EBITDA decline was principally due to higher program license fees offset in part by higher Advertising and Commerce revenues and a slight decrease in marketing costs. For HBO, the increase in EBITDA was principally due to the increase in revenues and reduced costs relating to the finalization of certain licensing agreements, offset in part by reserves established on receivables from Adelphia and the write-off of development costs.

Music. Revenues increased 4% to $1.919 billion in 2002, compared to $1.839 billion in 2001. EBITDA increased 9% to $198 million in 2002 from $181 million in 2001.

Revenues increased primarily due to increases in DVD manufacturing and merchandising sales, increases in the Music segment s worldwide recorded music sales and the impact of the acquisition of Word Entertainment in January 2002, offset in part by the negative effect of changes in foreign currency exchange rates.

The increase in EBITDA is due primarily to the higher revenues and the impact of various cost-saving and restructuring programs. As of June 30, 2002, the Music segment had increased its domestic album market share to 17.6%, compared to 17.1% at June 30, 2001.

Publishing. Revenues increased 19% to $2.477 billion in 2002, compared to $2.084 billion in 2001. EBITDA increased 26% to $482 million in 2002 from $384 million in 2001.

The increase in revenues is due to a 36% increase in Subscription revenues, 12% increase in Advertising and Commerce revenues (from $1.362 billion to $1.523 billion) and a 25% increase in Content and Other revenues. The growth in both Subscription revenues and Advertising and Commerce revenues was primarily due to the acquisitions of IPC in October 2001 and Synapse in December 2001. This was offset in part by lower commerce revenues from Time Life s direct marketing business and the continued overall weakness in the magazine advertising market. The increase in Content and Other revenues is due primarily to increased sales at the AOL Time Warner Book Group due to the carryover successes of 2001 bestsellers and the success of several 2002 releases.

The growth in EBITDA is due primarily to the increase in revenues, including the impact of the acquisitions of IPC and Synapse, overall cost savings, and reduced costs relating to the final settlement of certain liabilities associated with the closure of AFE, offset in part by additional reserves established on receivables from newsstand distributors.

As noted above, the acquisition of IPC in October 2001 significantly impacted the comparability of the Publishing segment s 2002 results by significantly increasing both revenues and EBITDA. As such, management of the Company also evaluates the results of the Publishing segment assuming that the results of IPC were included in both periods. Assuming that the results of IPC were included in both periods, total revenues would have increased 6% (from $2.342 billion to $2.477 billion), Subscription revenues would have increased 3% (from $624 million to

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$643 million), Advertising and Commerce revenues would have increased 5% (from $1.457 billion to $1.523 billion) and EBITDA would have increased 14% (from $423 million to $482 million).

FINANCIAL CONDITION AND LIQUIDITY
June 30, 2002

Current Financial Condition

At June 30, 2002, AOL Time Warner had $28.0 billion of debt, $1.7 billion of cash and equivalents, a portion of which was used to acquire the remaining 20% of Bertelsmann s interest in AOL Europe on July 1, 2002 (net debt of $26.3 billion, defined as total debt less cash and cash equivalents) and $97.7 billion of shareholders equity, compared to $22.8 billion of debt, $719 million of cash and equivalents (net debt of $22.1 billion) and $152.0 billion of shareholders equity at December 31, 2001. In addition, AOL Europe also had approximately $779 million, including accrued dividends, of redeemable preferred securities outstanding, which is classified as Minority Interest in the accompanying consolidated balance sheet. These securities are required to be redeemed by the Company in April 2003 in cash, AOL Time Warner common stock, or a combination thereof, at the discretion of the Company. The Company s outstanding utilization under its accounts receivable and backlog securitization facilities was approximately $1.8 billion as of June 30, 2002 and $1.6 billion as of December 31, 2001.

On April 8, 2002, the Company issued the remaining $6.0 billion principal amount of debt in a public offering under AOL Time Warner s $10 billion shelf registration statement. In July 2002, the Company entered into $10 billion of revolving credit facilities and terminated approximately $12.6 billion in previously existing credit facilities, and made a $1.45 billion cash payment to acquire the remaining 20% of Bertelsmann s interest in AOL Europe. Taking into account these transactions, the Company had approximately $6.7 billion of committed, available funding. The Company has no scheduled debt maturities for the remainder of 2002. The Company s total committed capacity at June 30, 2002, under its accounts receivable and backlog securitization facilities was approximately $1.980 billion. Approximately $800 million of committed capacity under the Company s securitization facilities will mature in the third quarter of 2002. The Company intends to renew these securitization facilities prior to their maturity but there can be no assurance that it will be able to do so.

As discussed in more detail below, management believes that AOL Time Warner s operating cash flow, cash and equivalents, borrowing capacity under committed bank credit agreements and commercial paper programs are sufficient to fund its capital and liquidity needs for the foreseeable future.

Cash Flows

Operating Activities

Cash provided by operations increased to $3.928 billion for the first six months of 2002 as compared to $2.263 billion in 2001. This year over year growth in cash flow from operations was driven primarily by over $1.5 billion of improvements in working capital, lower income taxes and a decrease in payments to settle restructuring and merger-related liabilities, offset in part by a decrease in EBITDA and an increase in interest payments. The improvements in working capital are related to reduced working capital needs in the current period compared to increased working capital needs in the prior period. Working capital needs are subject to wide fluctuations based on the timing of cash transactions related to production schedules, the acquisition of programming, collection of sales proceeds and similar items. The current period benefits are largely expected to reverse in the second half of the year.

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During the first six months of 2002, cash provided by operations of $3.928 billion reflected $4.006 billion of EBITDA, less $663 million of net interest payments, $110 million of net income taxes paid and $402 million of payments to settle merger and restructuring liabilities. Cash flow from operations also reflects a reduction in other working capital requirements of $1,097 billion.

During the first six months of 2001, cash provided by operations of $2.263 billion reflected $4.333 billion of EBITDA, less $592 million of net interest payments, $204 million of net income taxes paid and $788 million of payments to settle restructuring and merger-related liabilities. Cash flow from operations also reflects an increase in working capital requirements of $486 million.

Investing Activities

Cash used by investing activities was $7.134 billion in the first six months of 2002, compared to cash used by investing activities of $669 million in 2001. The year over year increase in cash used by investing activities is primarily due to the increased cash used for acquisitions and investments, principally the acquisition of 80% of Bertelsmann s interest in AOL Europe. Also contributing to the increase is the absence in 2002 of proceeds from the sale of short-term investments that occurred in the first six months of 2001 (primarily money market investments held by the America Online at the time of the Merger).

During the first six months of 2002, cash used by investing activities of $7.134 billion reflected approximately $5.832 billion of cash used for acquisitions and investments, including $5.3 billion which related to the acquisition of 80% of Bertelsmann s interest in AOL Europe. In addition, cash used by investing activities in 2002 included $1.523 billion of capital expenditures and product development costs, offset in part by $221 million of proceeds received from the sale of investments.

During the first six months of 2001, cash used by investing activities of $669 million reflected $1.218 billion of cash used for acquisitions and investments and $1.828 billion of capital expenditures and product development costs, offset in part by $690 million of cash acquired in the Merger and $1.687 billion of proceeds received from the sale of investments. The proceeds received from the sale of investments in 2001 was due primarily to the sale of short-term investments previously held by America Online.

Financing Activities

Cash provided by financing activities was $4.226 billion for the first six months of 2002 as compared to cash used by financing activities of $2.847 billion in 2001. The year over year increase in cash provided by financing activities is principally due to incremental borrowings in the current period used to finance the acquisition of 80% of Bertelsmann s interest in AOL Europe compared to net repayments on borrowings and the repurchase of AOL Time Warner common stock in the prior period.

During the first six months of 2002, cash provided from financing activities of $4.226 billion resulted from approximately $4.426 billion of net incremental borrowings, primarily used to acquire 80% of Bertelsmann s interest in AOL Europe, and $215 million of proceeds received principally from the exercise of employee stock options, offset in part by the redemption of redeemable preferred securities at AOL Europe for $255 million, the repurchase of AOL Time Warner common stock for total cash of $102 million, $47 million of dividends and partnership distributions and $17 million of principal payments on capital leases.

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During the first six months of 2001, cash used by financing activities of $2.847 billion primarily resulted from $1.589 billion of net payments on borrowings, the repurchase of AOL Time Warner common stock for an aggregate cost of $1.376 billion, the redemption of mandatorily redeemable preferred securities of a subsidiary for $575 million and $53 million of dividends and partnership distributions, offset in part by $727 million of proceeds received principally from the exercise of employee stock options.

Free Cash Flow

AOL Time Warner evaluates operating performance based on several measures including free cash flow, which is defined as cash provided by operations less capital expenditures and product development costs, dividend payments and partnership distributions, and principal payments on capital leases. Free cash flow in 2002 was $2.341 billion, compared to $382 million in 2001. The comparability of AOL Time Warner s free cash flow has been affected by certain significant unusual and nonrecurring items in each period. Specifically, AOL Time Warner s free cash flow has been impacted by the cash impact of the significant and nonrecurring items previously discussed. In addition, free cash flow has been impacted by payments made in settling other merger and restructuring liabilities. For the first six months of 2002, these items aggregated approximately $402 million of cash payments. For 2001, these items aggregated approximately $788 million. Excluding the effect of these nonrecurring items and discontinued operations, free cash flow increased to $2.636 billion in 2002 from $1.180 billion in 2001, primarily due to improved cash flows from the Company s filmed entertainment businesses, reduced taxes paid, lower capital expenditures and product development costs and improvements in working capital, offset in part by a decrease in EBITDA and increase in interest paid. In addition, excluding the effect of nonrecurring items, the free cash flow during the first six months of 2002 represented a 64% conversion of EBITDA to free cash flow, compared to a 27% conversion ratio in 2001. Part of the growth in free cash flow was related to the timing of various cash payments and receipts which are expected to have an offsetting impact on free cash flow generation in future quarters. As a result, the Company expects a reduction in the rate that it converts EBITDA to free cash flow during the second half of 2002.

TWE Cash Flow Restrictions

The assets and cash flows of TWE are restricted by certain borrowing and partnership agreements and are unavailable to AOL Time Warner except through the payment of certain fees, reimbursements, cash distributions and loans, which are subject to limitations. Under its bank credit agreements, TWE is permitted to incur additional indebtedness to make loans, advances, distributions and other cash payments to AOL Time Warner, subject to its individual compliance with the cash flow coverage and leverage ratio covenants contained therein.

Common Stock Repurchase Program

In January 2001, AOL Time Warner s Board of Directors authorized a common stock repurchase program that allows AOL Time Warner to repurchase, from time to time, up to $5 billion of common stock over a two-year period. During the first six months of 2002, the Company repurchased approximately 4 million shares at an aggregate cost of $102 million. These repurchases increased the cumulative shares purchased under this common stock repurchase program to approximately 79.4 million shares at an aggregate cost of $3.148 billion. In an effort to maintain financial flexibility, the pace of share repurchases under this program has slowed in 2002. As such, the Company does not expect that its repurchases of common stock for the remainder of the year will be significant.

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$10 Billion Shelf Registration Statement

In January 2001, AOL Time Warner filed a shelf registration statement with the SEC, which allowed 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. 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. On April 8, 2002, AOL Time Warner issued the remaining $6 billion principal amount of debt securities under this shelf registration statement at various fixed interest rates and maturities of 3, 5, 10 and 30 years. The net proceeds to the Company were approximately $3.964 billion under the first issuance and approximately $5.930 billion under the second issuance, both of which were used for general corporate purposes, including, but not limited to, the repayment of outstanding commercial paper and bank debt (Note 8).

$10 Billion Revolving Credit Facilities

In July 2002, AOL Time Warner, together with certain of its consolidated subsidiaries, entered into two new, senior unsecured long-term revolving bank credit agreements with an aggregate borrowing capacity of $10 billion (the 2002 Credit Agreements) and terminated three financing arrangements under certain previously existing bank credit facilities with an aggregate borrowing capacity of $12.6 billion (the Old Credit Agreements) which were to expire during 2002. The 2002 Credit Agreements are comprised of a $6 billion five-year revolving credit facility and a $4 billion 364-day revolving credit facility, borrowings under which may be extended for a period up to two years following the initial term. The borrowers under the 2002 Credit Agreements include AOL Time Warner, TWE, TWE-A/N and AOL Time Warner Finance Ireland. Borrowings will bear interest at specific rates, generally based on the credit rating for each of the borrowers, which is currently equal to LIBOR plus ..625%, including facility fees of .10% and .125% on the total commitments of the 364-day and five-year facilities, respectively. The 2002 Credit Agreements provide same-day funding, multi-currency capability and letter of credit availability. They contain maximum leverage and minimum GAAP net worth covenants of 4.5 times and $50 billion, respectively, for AOL Time Warner and maximum leverage covenant of 5.0 times for TWE and TWE-A/N, but do not contain any ratings-based defaults or covenants, nor an ongoing covenant or representation specifically relating to a material adverse change in the Company s financial condition or results of operations. Borrowings may be used for general business purposes and unused credit will be available to support commercial paper borrowings (Note 8).

Capital Expenditures and Product Development Costs

AOL Time Warner s capital expenditures and product development costs amounted to $1.523 billion and $1.828 billion for the six months ended June 30, 2002 and 2001, respectively. Capital expenditures and product development costs from continuing operations were $1.354 billion in 2002, compared to $1.615 billion in 2001. Capital expenditures and product development costs from continuing operations principally relate to the Company s Cable segment ($806 million in 2002 as compared to $928 million in 2001), which over the past several years has been engaged in a plan to upgrade the technological capability and reliability of its cable television systems and develop new services. Also contributing to capital expenditures and product development costs are product development costs incurred by the AOL segment which amounted to $120 million and $179 million for the six months ended June 30, 2002 and 2001, respectively.

AOL Time Warner s Cable segment generally capitalizes expenditures for tangible fixed assets having a useful life of greater than one year. Capitalized costs typically include direct material, direct labor, overhead and

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interest. Sales and marketing costs, as well as the costs of repairing or maintaining existing fixed assets, are expensed as incurred. Types of capitalized expenditures at the Cable segment include plant upgrades, initial drops, converters and cable modems. With respect to converters and cable modems, the Cable segment capitalizes direct installation charges only upon the initial deployment of such assets. All costs incurred in the re-deployment of these assets are expensed as incurred. Similarly, once a given household has been wired, all costs incurred in subsequent disconnects and reconnects applicable to that household are expensed as incurred. Depreciation on these assets is provided generally using the straight-line method over their estimated useful life. For converters and modems, such life is generally 3-5 years and for plant upgrades, such useful life is up to 16 years. As of June 30, 2002, the total net book value of capitalized labor and overhead costs associated with the installation of converters and modems was approximately $200 million.

Included in the AOL segment s product development costs are costs incurred for the production of technologically feasible computer software that generates additional functionality to its existing software products. Capitalized costs typically include direct labor and related overhead for software produced by AOL as well as the cost of software purchased from third parties. Costs incurred on a product prior to the determination that the product is technologically feasible, as well as maintenance costs of established products, are expensed as incurred. All costs in the software development process which are experimental in nature are classified as research and development and are expensed as incurred until technological feasibility has been established. Once technological feasibility has been established, such costs are capitalized until the software has completed testing and is mass-marketed. Amortization is provided on a product-by-product basis using the greater of the straight-line method or the current year revenue as a percentage of total revenue estimates for the related software product, not to exceed five years, commencing the month after the date of the product release. The total net book value related to capitalized software costs was approximately $335 million as of June 30, 2002.

Filmed Entertainment Backlog

Backlog represents the amount of future revenue not yet recorded from cash contracts for the licensing of theatrical and television product for pay cable, basic cable, network and syndicated television exhibition. Backlog for all of AOL Time Warner s Filmed Entertainment companies was approximately $3.5 billion at June 30, 2002, compared to approximately $3.8 billion at December 31, 2001 (including amounts relating to the licensing of film product to AOL Time Warner s Networks segment of approximately $992 million at June 30, 2002 and approximately $1.231 billion at December 31, 2001).

CAUTION CONCERNING FORWARD-LOOKING STATEMENTS AND RISK FACTORS

The SEC encourages companies to disclose forward-looking information so that investors can better understand a company s future prospects and make informed investment decisions. This document contains such forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, particularly statements anticipating future growth in revenues, EBITDA and cash flow. Words such as anticipates, estimates, expects, projects, intends, plans, believes and words and terms of similar substance used in connection with any discussion of future operating or financial performance identify such forward-looking statements. Those forward-looking statements are based on management s present expectations and beliefs about future events. As with any projection or forecast, they are inherently susceptible to uncertainty and changes in circumstances, and the Company is under no obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of such changes, new information, future events or otherwise.

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AOL Time Warner operates in highly competitive, consumer-driven and rapidly changing Internet, media and entertainment businesses. These businesses are affected by government regulation, economic, strategic, political and social conditions, consumer response to new and existing products and services, technological developments and, particularly in view of new technologies, the continued ability to protect intellectual property rights. AOL Time Warner s actual results could differ materially from management s expectations because of changes in such factors. Other factors and risks could adversely affect the operations, business or financial results of AOL Time Warner or its business segments in the future and could also cause actual results to differ from those contained in the forward-looking statements, including those identified in AOL Time Warner s other filings with the SEC and the following:

For AOL Time Warner s America Online businesses, the ability to develop new products and services to remain competitive; the ability to develop, adopt or have access to new technologies; the ability to successfully implement its broadband strategy; the ability to have access to distribution channels controlled by third parties; the ability to retain and grow the subscriber base; the ability to provide adequate server, network and system capacity; increased costs and business disruption resulting from the financial difficulties being experienced by a number of AOL s network service providers including WorldCom; the risk of unanticipated increased costs for network services; increased competition from providers of Internet services; the ability to renew existing advertising or marketing commitments, including the ability to renew or replace individual large multi-period online advertising commitments with similar commitments or with shorter term advertising sales, which are generally affected more by the current unfavorable state of overall online advertising market conditions; the ability to maintain or renew large advertising arrangements (during the six months ended June 30, 2002, the ten most significant third party advertising customers of America Online represented 42% of total America Online domestic advertising revenues as compared to 29% for the six months ended June 30, 2001); the ability to maintain or enter into new electronic commerce, advertising, marketing or content arrangements; the risk that the online advertising market will not improve at all or at a rate comparable to improvements in the general advertising market; the ability to maintain and grow market share in the enterprise software industry; the risks from changes in U.S. and international regulatory environments affecting interactive services; and the ability to continue to expand successfully internationally.

For AOL Time Warner s cable business, more aggressive than expected competition from new technologies and other types of video programming distributors, including DBS and DSL; increases in government regulation of basic cable or equipment rates or other terms of service (such as digital must-carry, open access or common carrier requirements); government regulation of other services, such as broadband cable modem service; increased difficulty in obtaining franchise renewals; the failure of new equipment (such as digital set-top boxes) or services (such as digital cable, high-speed online services, telephony over cable or video-on-demand) to appeal to enough consumers or to be available at prices consumers are willing to pay, to function as expected and to be delivered in a timely fashion; fluctuations in spending levels by advertisers and consumers; the ability to enter into new program vendor advertising arrangements; and greater than expected increases in programming or other costs.

For AOL Time Warner s filmed entertainment businesses generally, their ability to continue to attract and select desirable talent and scripts at manageable costs; general increases in production costs; fragmentation of consumer leisure and entertainment time (and its possible negative effects on the broadcast and cable networks, which are significant customers of these businesses); continued popularity of merchandising; the potential repeal of the Sonny Bono Copyright Term Extension Act; the uncertain impact of technological developments which may facilitate piracy of the Company s copyrighted works; and risks associated with foreign currency

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AOL TIME WARNER INC.
MANAGEMENT S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION (Continued)

exchange rates. With respect to feature films, the increasing marketing costs associated with theatrical film releases in a highly competitive marketplace; with respect to television programming, a decrease in demand for television programming provided by non-affiliated producers; and with respect to home video, the ability to maintain relationships with significant customers in the rental and sell-through markets.

For AOL Time Warner s network businesses, greater than expected programming or production costs; public and cable operator resistance to price increases (and the negative impact on premium programmers of increases in basic cable rates); increased regulation of distribution agreements; the sensitivity of network advertising to economic cyclicality and to new media technologies; the impact of consolidation among cable and satellite distributors; piracy of programming by means of Internet peer-to-peer file sharing; the impact of personal video recorder ad-stripping functions on advertising sales; the development of new technologies that alter the role of programming networks and services; and greater than expected fragmentation of consumer viewership due to an increased number of programming services or the increased popularity of alternatives to television.

For AOL Time Warner s music business, its ability to continue to attract and select desirable talent at manageable costs; the popular demand for particular artists and albums; the timely completion of albums by major artists; its ability to continue to enforce its intellectual property rights in digital environments; piracy of programming by means of Internet peer-to-peer file sharing; its ability to develop a successful business model applicable to a digital online environment; the potential repeal of Subsection (6) of California Labor Code Section 2855 regarding the maximum length of personal service contracts; the potential repeal of the Sonny Bono Copyright Term Extension Act; risks associated with foreign currency exchange rates; and the overall strength of global music sales.

For AOL Time Warner s print media and publishing businesses, fluctuations in spending levels by advertisers and consumers; unanticipated increases in paper, postal and distribution costs (including costs resulting from financial pressure on the U.S. Postal Service); increased costs and business disruption resulting from instability in the newsstand distribution channel; the introduction and increased popularity of alternative technologies for the provision of news and information; and the ability to continue to develop new sources of circulation.

For AOL Time Warner generally, the risks related to the continued successful operation of the businesses of AOL Time Warner on an integrated basis and the possibility that the Company will not be able to continue to realize the benefits of the combination of these businesses; lower than expected valuations associated with the cash flows and revenues at the AOL Time Warner segments may result in the inability of the Company to realize the value of recorded intangibles and goodwill at those segments.

In addition, the Company s overall financial strategy, including growth in operations, maintaining its financial ratios and a strong balance sheet, could be adversely affected by increased interest rates, decreased liquidity in the capital markets (including any reduction in its ability to access either the capital markets for debt securities or bank financings), failure to meet earnings expectations, significant acquisitions or other transactions, economic slowdowns and changes in the Company s plans, strategies and intentions.

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AOL TIME WARNER INC.
CONSOLIDATED BALANCE SHEET
(Unaudited)

	June 30, 2002	December 31, 2001
	(restated; millions, except per share amounts)	
ASSETS		
Current assets		
Cash and equivalents	$ 1,739	$ 719
Receivables, less allowances of $2.224 and $1.889 billion	5,012	6,054
Inventories	1,668	1,791
Prepaid expenses and other current assets	1,782	1,687
Total current assets	10,201	10,251
Noncurrent inventories and film costs	3,418	3,490
Investments, including available-for-sale securities	5,475	6,886
Property, plant and equipment	13,199	12,669
Intangible assets subject to amortization	7,335	7,289
Intangible assets not subject to amortization	37,822	37,708
Goodwill	80,088	127,420
Other assets	2,582	2,791
Total assets	$ 160,120	$ 208,504
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 2,144	$ 2,266
Participations payable	1,407	1,253
Royalties and programming costs payable	1,573	1,515
Deferred revenue	1,479	1,451
Debt due within one year	87	48
Other current liabilities	6,187	6,443
Total current liabilities	12,877	12,976
Long-term debt	27,935	22,792
Deferred income taxes	10,816	11,231
Deferred revenue	1,113	1,048
Other liabilities	4,511	4,839
Minority interests	5,198	3,591
Shareholders equity		
Series LMCN-V Common Stock, $0.01 par value, 171.2 million shares outstanding in each period	2	2
AOL Time Warner Common Stock, $0.01 par value, 4.289 and 4.258 billion shares outstanding	42	42
Paid-in capital	155,051	155,172
Accumulated other comprehensive income (loss), net	(339)	49
Retained earnings	(57,086)	(3,238)
Total shareholders equity	97,670	152,027
Total liabilities and shareholders equity	$ 160,120	$ 208,504

See accompanying notes.

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AOL TIME WARNER INC.
CONSOLIDATED STATEMENT OF OPERATIONS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(restated; millions, except per share amounts)			
Revenues:				
Subscriptions	$ 4,747	$ 3,839	$ 9,214	$ 7,478
Advertising and commerce	2,036	2,209	3,820	4,208
Content and other	3,451	2,905	6,624	6,097
Total revenues(a)	10,234	8,953	19,658	17,783
Costs of revenues(a)	(5,996)	(4,787)	(11,676)	(9,753)
Selling, general and administrative(a)	(2,543)	(2,200)	(4,959)	(4,452)
Amortization of goodwill and other intangible assets	(175)	(1,770)	(339)	(3,534)
Merger and restructuring costs				