

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

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
(State or other jurisdiction of
incorporation or organization)

13-4099534
(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 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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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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**AOL TIME WARNER INC.
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
	<u>274</u>		<u>962</u>	<u>691</u>
Pretax impact of adjustments				
Income tax impact of adjustments	(110)		(385)	(276)
	<u>\$ 164</u>	<u>\$</u>	<u>\$ 577</u>	<u>\$ 415</u>
Impact on basic income (loss) per common share before cumulative effect of accounting change	<u>\$ 0.04</u>	<u>\$</u>	<u>\$ 0.13</u>	<u>\$ 0.10</u>
Impact on diluted income (loss) per common share before cumulative effect of accounting change	<u>\$ 0.03</u>	<u>\$</u>	<u>\$ 0.12</u>	<u>\$ 0.10</u>

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

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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			(107)	(71)
Operating income	1,520	196	2,577	(27)
Interest expense, net(a)	(441)	(344)	(817)	(655)
Other expense, net(a)	(331)	(233)	(986)	(1,135)
Minority interest income (expense)	(53)	1	(84)	6
Income (loss) before income taxes, discontinued operations and cumulative effect of accounting change	695	(380)	690	(1,811)
Income tax provision	(301)	(348)	(304)	(276)
Income (loss) before discontinued operations and cumulative effect of accounting change	394	(728)	386	(2,087)
Discontinued operations, net of tax	2	(9)	1	(19)
Income (loss) before cumulative effect of accounting change	396	(737)	387	(2,106)
Cumulative effect of accounting change			(54,235)	
Net income (loss) applicable to common shares	\$ 396	\$ (737)	\$ (53,848)	\$ (2,106)
Basic income (loss) per common share before discontinued operations and cumulative effect of accounting change	\$ 0.09	\$ (0.17)	\$ 0.09	\$ (0.48)
Discontinued Operations				
Cumulative effect of accounting change			(12.21)	
Basic net income (loss) per common share	\$ 0.09	\$ (0.17)	\$ (12.12)	\$ (0.48)
Average basic common shares	4,454.1	4,434.9	4,441.7	4,423.8
Diluted income (loss) per common share before discontinued operations and cumulative effect of accounting change	\$ 0.09	\$ (0.17)	\$ 0.09	\$ (0.48)
Discontinued Operations				
Cumulative effect of accounting change			(12.21)	
Diluted net income (loss) per common share	\$ 0.09	\$ (0.17)	\$ (12.12)	\$ (0.48)

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Average diluted common shares	4,528.2	4,606.1	4,531.2	4,598.8
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(a) Includes the following income (expenses) resulting from transactions with related companies:

Revenues	\$ 270	\$ 229	\$ 508	\$ 466
Cost of revenues	(37)	(74)	(64)	(177)
Selling, general and administrative	7	1	12	(12)
Interest income (expense), net	0	4	3	8
Other income (expense), net	(1)	(5)	(5)	(10)

See accompanying notes.

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AOL TIME WARNER INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
Six Months Ended June 30,
(Unaudited)

	<u>2002</u>	<u>2001</u>
	(restated; millions, except per share amounts)	
OPERATIONS		
Net loss	\$ (53,848)	\$ (2,106)
Adjustments for noncash and nonoperating items:		
Cumulative effect of accounting change	54,235	
Depreciation and amortization	1,429	4,360
Amortization of film costs	1,067	1,066
Loss on writedown of investments	952	674
Net gain on sale of investments	(94)	(33)
Equity in losses of investee companies after distributions	141	584
Changes in operating assets and liabilities, net of acquisitions	(276)	(2,553)
Adjustments for noncash and nonoperating items and changes in operating assets and liabilities for discontinued operations	322	271
	<u>3,928</u>	<u>2,263</u>
INVESTING ACTIVITIES		
Acquisition of Time Warner Inc. cash and equivalents		690
Other investments and acquisitions, net of cash acquired	(5,828)	(1,047)
Investments in available-for-sale securities	(4)	(171)
Capital expenditures and product development costs from continuing operations	(1,354)	(1,615)
Capital expenditures from discontinued operations	(169)	(213)
Other investment proceeds	151	1,687
Investment proceeds for available-for-sale securities	70	
	<u>(7,134)</u>	<u>(669)</u>
FINANCING ACTIVITIES		
Borrowings	13,406	6,245
Debt repayments	(8,980)	(7,834)
Redemption of mandatorily redeemable preferred securities of subsidiary	(255)	(575)
Proceeds from exercise of stock option and dividend reimbursement plans	215	727
Current period repurchases of common stock	(102)	(1,376)
Dividends paid and partnership distributions for discontinued operations, net	(47)	(49)
Dividends paid and partnership distributions for continuing operations		(4)
Principal payments on capital leases	(17)	
Other	6	19
	<u>4,226</u>	<u>(2,847)</u>
INCREASE (DECREASE) IN CASH AND EQUIVALENTS	<u>1,020</u>	<u>(1,253)</u>
CASH AND EQUIVALENTS AT BEGINNING OF PERIOD	<u>719</u>	<u>2,610</u>
CASH AND EQUIVALENTS AT END OF PERIOD	<u>\$ 1,739</u>	<u>\$ 1,357</u>

See accompanying notes.

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AOL TIME WARNER INC.
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
Six Months Ended June 30,
(Unaudited)

	<u>2002</u>	<u>2001</u>
	<u>(restated; millions)</u>	
BALANCE AT BEGINNING OF PERIOD	\$ 152,027	\$ 6,727
Issuance of common stock in connection with America Online-Time Warner merger		146,430
Reversal of America Online's deferred tax valuation allowance		4,439
	<u>152,027</u>	<u>157,596</u>
Balance at beginning of period, adjusted to give effect to the America Online-Time Warner merger	152,027	157,596
Net loss	(53,848)	(2,106)
Other comprehensive loss (a)	(388)	(3)
	<u>(54,236)</u>	<u>(2,109)</u>
Comprehensive loss	(54,236)	(2,109)
Repurchases of AOL Time Warner common stock	(102)	(1,376)
Dilution of interest in Time Warner Entertainment Company, L.P. (net of \$276 million income tax impact)	(414)	
Other, principally shares issued pursuant to stock option and benefit plans, including \$121 million and \$1.180 billion of tax benefit	395	1,942
	<u>97,670</u>	<u>156,053</u>
BALANCE AT END OF PERIOD	\$ 97,670	\$ 156,053

(a) 2002 includes a \$141 million pretax reduction (income tax impact of \$56 million), related to the write-down of certain investments, accounted for under FAS 115, from a decline in market value determined to be other-than-temporary.

See accompanying notes.

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**AOL TIME WARNER INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business

AOL Time Warner Inc. (AOL Time Warner or the Company) 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. Financial information for AOL Time Warner's various business segments is presented in Note 10.

Each of the business interests within AOL Time Warner (AOL, Cable, Filmed Entertainment, Networks, Music and Publishing) is important to management's objective of increasing shareholder value through the creation, extension and distribution of recognizable brands and copyrights throughout the world. Such brands and copyrights include (1) leading worldwide Internet services, such as the AOL and Compuserve services, leading Web properties, such as Netscape, Moviefone and MapQuest, instant messaging services, such as ICQ and AOL Instant Messenger, and music properties, such as the AOL Music Channel and Winamp, (2) Time Warner Cable, currently the second largest operator of cable television systems in the U.S., (3) the unique and extensive film, television and animation libraries owned or managed by Warner Bros. and New Line Cinema, and trademarks such as the *Looney Tunes* characters, *Batman* and *The Flintstones*, (4) leading television networks, such as The WB Network, HBO, Cinemax, CNN, TNT, TBS Superstation and Cartoon Network, (5) copyrighted music from many of the world's leading recording artists that is produced and distributed by a family of established record labels such as Warner Bros. Records, Atlantic Records, Elektra Entertainment and Warner Music International and (6) magazine franchises, such as *Time*, *People* and *Sports Illustrated*.

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 June 30, 2002, AOL Time Warner owned general and limited partnership interests in TWE consisting of 72.36% 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 27.64% 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) (Note 6).

Table of Contents**AOL TIME WARNER INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)*****Basis of Presentation*****Restatement of Prior Financial Information**

The Company is 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 of \$3 million and \$(5) million, respectively, and consolidated net income 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 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.

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AOL TIME WARNER INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Based on the substantial work done to date, the Company does not expect any further restatements as a result of its internal review. However, 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 will continue its efforts to cooperate with the investigations. The Company cannot predict the outcome of these investigations at this time.

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 TWE-Advance/Newhouse Partnership. 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, as well as the impact of the discontinued operations, are provided under Restructuring of TWE-Advance/Newhouse Partnership and Road Runner below.

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.

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 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.

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

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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 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.

Interim Financial Statements

The accompanying consolidated financial statements are unaudited but, in the opinion of management, contain all the adjustments (consisting of those of a normal recurring nature) considered necessary to present fairly the financial position and the results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the United States applicable to interim periods. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements of AOL Time Warner, included in its Annual Report on Form 10-K for the year ended December 31, 2001, as amended by Amendment No. 1 thereto on Form 10-K/A filed March 26, 2002, Amendment No. 2 thereto on Form 10-K/A filed June 28, 2002 and Amendment No. 3 thereto on Form 10-K/A filed January 28, 2003 (the 2001 Form 10-K).

Revenue Classification Changes

Reimbursement of Out-of-Pocket Expenses

In November 2001, the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) issued as interpretive guidance 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 impacts AOL Time Warner's Cable and Music segments, resulting in an increase in both revenues and costs of approximately \$109

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**AOL TIME WARNER INC.
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million in the second quarter of 2001 and an increase in both revenues and costs of approximately \$195 million for the first six months of 2001.

Emerging Issues Task Force Issue No. 01-09

In April 2001, 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 Issue No. 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 impacts AOL Time Warner's AOL, Music and Publishing segments and requires retroactive restatement of all periods presented to reflect the new accounting provisions. 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 approximately \$110 million for the first six months of 2001.

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Accounting for Business Combinations

In July 2001, the FASB issued Statements of Financial Accounting Standards (Statement) No. 141, Business Combinations and No. 142, Goodwill and Other Intangible Assets (FAS 142). These standards change the accounting for business combinations by, among other things, prohibiting the prospective use of pooling-of-interests accounting and requiring companies to stop amortizing goodwill and certain intangible assets with an indefinite useful life. Instead, goodwill and intangible assets deemed to have an indefinite useful life will be subject to an annual review for impairment. The new standards generally were effective for AOL Time Warner in the first quarter of 2002 and for purchase business combinations consummated after June 30, 2001. Upon adoption of FAS 142 in the first quarter of 2002, AOL Time Warner recorded a noncash charge of approximately \$54 billion to reduce the carrying value of its goodwill. Such charge is non-operational in nature and is reflected as a cumulative effect of accounting change in the accompanying consolidated statement of operations. For additional discussion on the impact of adopting FAS 142, see Note 3.

Impact of Significant Acquisitions

AOL Time Warner's results for 2002 have been impacted by the following acquisitions 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.

Consolidation of Road Runner. In August 2002, AOL Time Warner's Cable segment acquired Advance/Newhouse's 17% indirect ownership in Road Runner, increasing the Company's fully attributed ownership to approximately 82%. 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 2002.

If the consolidation of AOL Europe, IPC and Road Runner had occurred on January 1, 2001, for the three months ended June 30, 2001, the Company's consolidated revenues would have increased by \$354 million to \$9.307 billion, operating income would have decreased by \$247 million to an operating loss of \$51 million, net loss would have increased by \$240 million to \$977 million, and net loss per share would have increased by \$0.05 to \$0.22. For the six months ended June 30, 2001, revenues would have increased by \$696 million to \$18.479 billion, operating loss would have increased by \$516 million to \$543 million, net loss would have increased by \$491 million to \$2.597 billion, and net loss per share would have increased by \$0.11 to \$0.59.

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(Unaudited)****2. MERGER AND RESTRUCTURING COSTS***Merger Costs*

In accordance with accounting principles generally accepted in the United States, AOL Time Warner generally treats merger costs relating to business combinations accounted for using the purchase method of accounting as additional purchase price paid. However, certain merger costs do not meet the criteria for capitalization and are expensed as incurred. Certain merger costs were expensed as incurred as they either related to the operations of the acquirer, including the AOL operations with respect to the Merger, or otherwise did not qualify as a liability or cost assumed in a purchase business combination, including AOL Time Warner's acquisition of Time Warner. Merger costs both capitalized and expensed are discussed in more detail in the following paragraphs.

Merger Costs Capitalized as a Cost of Acquisition

In connection with the Merger, the Company has reviewed its operations and implemented several plans to restructure the operations of America Online and Time Warner (restructuring plans). As part of the restructuring plans, the Company accrued a restructuring liability of approximately \$1.340 billion during 2001. The restructuring accruals relate to costs to exit and consolidate certain activities of Time Warner, as well as costs to terminate employees across various Time Warner business units. Such amounts were recognized as liabilities assumed in the purchase business combination and included in the allocation of the cost to acquire Time Warner. Accordingly, such amounts resulted in additional goodwill being recorded in connection with the Merger.

Of the total restructuring accrual, approximately \$880 million related to work force reductions and represented employee termination benefits and relocation costs. Employee termination costs occurred across most Time Warner business units and ranged from senior executives to line personnel. The total number of employees initially identified to be involuntarily terminated or relocated approximated 8,200. As of June 30, 2002, approximately 6,100 of the terminations and relocations had occurred. The remaining 2,100 terminations and relocations are anticipated to occur during the remainder of 2002 or are no longer expected to occur. Because certain employees can defer receipt of termination benefits for up to 24 months, cash payments are continuing after the employee was terminated. Termination payments of approximately \$300 million were made in 2001 (\$95 million of which was paid in the second quarter and \$135 million for the first six months of 2001), an additional \$64 million was paid in the second quarter of 2002 and approximately \$168 million was paid for the first six months of 2002. In addition, for the first six months of 2002, there were noncash reductions in the restructuring accrual of approximately \$16 million (none in the second quarter), as actual termination payments were less than amounts originally estimated. As of June 30, 2002, the remaining liability of approximately \$396 million was primarily classified as a current liability in the accompanying consolidated balance sheet.

The restructuring accrual also includes approximately \$460 million associated with exiting certain activities, primarily related to lease and contract termination costs. Specifically, the Company plans to consolidate certain operations and has exited other under-performing operations, including the Studio Store operations of the Filmed Entertainment segment and the World Championship Wrestling operations of the Networks segment. The restructuring accrual associated with other exiting activities specifically includes incremental costs and contractual termination obligations for items such as lease termination payments and other facility exit costs incurred as a direct result of these plans, which will not have future benefits. Payments related to exiting activities were approximately \$165 million in 2001 (\$40 million of which was paid in the second quarter and \$60 million for the first six months

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of 2001), an additional \$30 million was paid in the second quarter of 2002 and \$66 million was paid in the first six months of 2002. In addition, for the second quarter and the first six months of 2002, there were noncash reductions in the restructuring accrual of approximately \$15 million, as actual termination payments were less than amounts originally estimated. As of June 30, 2002, the remaining liability of approximately \$214 million was primarily classified as a current liability in the accompanying consolidated balance sheet.

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

	<u>Employee Termination</u>	<u>Other Exit Costs</u>	<u>Total</u>
Initial Accruals	\$ 880	\$ 460	\$ 1,340
Cash paid 2001	(300)	(165)	(465)
Restructuring liability as of December 31, 2001	580	295	875
Cash paid 2002	(168)	(66)	(234)
Noncash reductions(a) 2002	(16)	(15)	(31)
Restructuring liability as of June 30, 2002	\$ 396	\$ 214	\$ 610

(a) Noncash reductions represent adjustments to the restructuring accrual, and a corresponding reduction in goodwill, as actual costs related to employee terminations and other exit costs were less than originally estimated.

Merger Costs Expensed as Incurred

During 2001, the restructuring plans also included approximately \$250 million, which was expensed in accordance with generally accepted accounting principles and is included in merger and restructuring costs in the accompanying consolidated statement of operations. Of the \$250 million, approximately \$153 million related to employee termination benefits and \$97 million related to other exit costs. The other exit costs relate to contractual terminations for various leases and contractual commitments relating to terminated projects, including the termination of the iPlanet alliance with Sun Microsystems Inc. The number of employees expected to be terminated at the AOL segment was 2,430. As of June 30, 2002, substantially all of the terminations had occurred. The severed employees spanned all major departments and divisions in the AOL segment, including Technology, Digital City, MapQuest, AOL Brand, Member Services, Interactive Marketing, Compuserve, Business Affairs, AIM/ICQ, Wireless Strategy, Spinner, Acquisition Marketing, iPlanet, Technology & Systems Development, AOL Products, Interactive Properties and Netscape. These Merger-related costs were expensed as they either related to the AOL operations or otherwise did not qualify as a liability or cost assumed in the purchase of Time Warner. As of June 30, 2002, approximately \$39 million of the \$250 million had not been paid and is primarily classified as a current liability in the accompanying consolidated balance sheet.

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	Employee Termination	Other Exit Costs	Total
Initial Accruals	\$ 153	\$ 97	\$ 250
Cash paid 2001	(107)	(38)	(145)
Remaining liability as of December 31, 2001	46	59	105
Cash paid 2002	(32)	(34)	(66)
Remaining liability as of June 30, 2002	\$ 14	\$ 25	\$ 39

Restructuring Costs

During the first six months of 2002, the Company has incurred and accrued other restructuring costs of \$107 million related to various contractual terminations and obligations, including certain contractual employee termination benefits. As of June 30, 2002, \$71 million has been paid against these accruals. The remaining \$36 million is primarily classified as a current liability in the accompanying consolidated balance sheet. These costs are included in merger and restructuring costs in the accompanying consolidated statement of operations.

Included in the 2002 restructuring charge is \$64 million related to lease obligations of the AOL segment for network modems that will no longer be used because network providers are upgrading their networks to newer technology. Specifically, under certain existing agreements with network providers, AOL is leasing the modems used in providing network services from a third-party. During the first quarter of 2002, a plan was established under which a network provider would upgrade and replace the AOL supplied modems. Accordingly, the Company accrued the remaining lease obligations, less estimated recoveries, for the period that these modems will no longer be in use. The remaining \$43 million of restructuring costs recorded during the six-month period ended June 31, 2002, relates to certain contractual employee termination benefits. A liability related to contractual employee termination benefits is recognized when it becomes probable that the employee will be entitled to the benefits and such benefits can be reasonably estimated.

In addition to the lease costs referred to above, there is one remaining network arrangement that continues to use AOL supplied modems, in which AOL has a remaining modem lease obligation of approximately \$65 million. AOL is currently in discussions with the network provider regarding the use of AOL supplied modems. If the network provider of this remaining network arrangement should similarly decide to replace the AOL modems, the Company could be required to recognize an additional restructuring charge in subsequent periods for the portion of the remaining lease obligation, less estimated recoveries, related to the period the AOL modems would not be in use.

3. GOODWILL AND INTANGIBLE ASSETS

As discussed in Note 1, in January 2002, AOL Time Warner adopted FAS 142, which requires companies to stop amortizing goodwill and certain intangible assets with an indefinite useful life. Instead, FAS 142 requires that goodwill and intangible assets deemed to have an indefinite useful life be reviewed for impairment upon adoption of

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FAS 142 (January 1, 2002) and annually thereafter. The Company will perform its annual impairment review during the fourth quarter of each year, commencing in the fourth quarter of 2002.

Under FAS 142, goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. Other than the allocation of premium goodwill, which is discussed below, the net book value of each of the Company's segments was generally based upon specific identification. The Company's reporting units are generally consistent with the operating segments underlying the segments identified in Note 10 Segment Information. This methodology differs from AOL Time Warner's previous policy, as provided under accounting standards existing at that time, of using undiscounted cash flows on an enterprise-wide basis to determine if goodwill was recoverable.

Upon adoption of FAS 142 in the first quarter of 2002, AOL Time Warner recorded a noncash charge of approximately \$54 billion to reduce the carrying value of its goodwill. Such charge is nonoperational in nature and is reflected as a cumulative effect of accounting change in the accompanying consolidated statement of operations. In calculating the impairment charge, the fair value of the impaired reporting units underlying the segments were estimated using either a discounted cash flow methodology, recent comparable transactions or a combination thereof.

The FAS 142 goodwill impairment is associated solely with goodwill resulting from the Merger. The amount of the impairment primarily reflects the decline in the Company's stock price since the Merger was announced and valued for accounting purposes in January of 2000. Prior to performing the review for impairment, FAS 142 required that all goodwill deemed to be related to the entity as a whole be assigned to all of the Company's reporting units, including the reporting units of the acquirer. This differs from the previous accounting rules where goodwill was assigned only to the businesses of the company acquired. As a result, a portion of the goodwill generated in the Merger has been reallocated to the AOL segment.

The amount of goodwill allocated to the AOL segment related entirely to goodwill resulting from the Merger. Overall goodwill resulting from the Merger was calculated based upon a purchase price of approximately \$147 billion, including transaction costs. In accordance with EITF 99-12, Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination, the purchase price was determined using the fair value of the AOL Time Warner securities issued to acquire Time Warner at the time of the announcement of the Merger in January 2000. The fair value of these securities was significantly higher than the fair value of the AOL Time Warner securities in January 2001, when the transaction closed and the Company allocated the purchase price to the fair value of the assets and liabilities acquired. As a result, a portion of the purchase price in excess of the fair value of the assets and liabilities acquired represented the difference between the value ascribed to the AOL Time Warner securities issued in the transaction and the fair value of the Time Warner businesses on the closing date. As noted above, in accordance with the accounting rules in place at that time, this excess, or premium goodwill, was initially allocated only to the Time Warner segments mostly based upon their relative fair values. Upon the adoption of FAS 142, the premium goodwill was reallocated to all of the segments of AOL Time Warner (including the AOL segment) based upon relative fair values.

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A summary of changes in the Company's goodwill during the first six months of 2002, and total assets at June 30, 2002, by business segment is as follows (in millions):

	Goodwill			Total
	January 1, 2002(1)	Acquisitions & Adjustments(2)	Impairments(3)	June 30, 2002
AOL	\$ 27,729	\$ 7,060	\$	\$ 34,789
Cable	33,259		(22,976)	10,283
Filmed Entertainment(4)	9,110	(107)	(4,091)	4,912
Networks(5)	33,562	22	(13,077)	20,507
Music	5,477	29	(4,796)	710
Publishing	18,283	(137)	(9,259)	8,887
Corporate				2,232
Total	\$ 127,420	\$ 6,867	\$ (54,199)	\$ 80,088

(1) Reflects the reallocation of goodwill to the AOL reporting unit under FAS 142.

(2) Adjustments primarily relate to the Company's preliminary purchase price allocation for several acquisitions. Specifically, the ultimate goodwill associated with certain acquisitions (including IPC, Business 2.0, Synapse, AOL Europe, and This Old House) continues to be adjusted as the value of the assets and liabilities (including merger liabilities) acquired are finalized.

(3) The impairment charge does not include approximately (\$36) million related to goodwill impairments associated with equity investees.

(4) Includes impairments at Warner Bros. (\$2.851 billion) and at the Turner filmed entertainment businesses (\$1.240 billion).

(5) Includes impairments at the Turner cable networks (\$10.933 billion), HBO (\$1.933 billion) and The WB Network (\$211 million).

As of June 30, 2002 and December 31, 2001, the Company's intangible assets and related accumulated amortization consisted of the following (in millions):

	As of June 30, 2002			As of December 31, 2001		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
<i>Intangible assets subject to amortization:</i>						
Music catalogues and copyrights	\$ 3,180	\$ (241)	\$ 2,939	\$ 3,080	\$ (153)	\$ 2,927
Film library	3,559	(293)	3,266	3,559	(196)	3,363
Customer lists and other intangible assets	1,808	(678)	1,130	1,519	(520)	999
Total	\$ 8,547	\$ (1,212)	\$ 7,335	\$ 8,158	\$ (869)	\$ 7,289
<i>Intangible assets not subject to amortization:</i>						
Cable television franchises	\$ 28,449	\$ (1,878)	\$ 26,571	\$ 28,452	\$ (1,878)	\$ 26,574
Sports franchises	500	(20)	480	500	(20)	480
Brands, trademarks and other intangible assets	11,091	(320)	10,771	10,974	(320)	10,654
Total	\$ 40,040	\$ (2,218)	\$ 37,822	\$ 39,926	\$ (2,218)	\$ 37,708

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The Company recorded amortization expense of \$175 million during the second quarter of 2002 compared to \$1.770 billion during the second quarter of 2001. The Company recorded amortization expense of \$339 million for the first six months of 2002 compared to \$3.534 billion for the first six months of 2001. Based on the current amount of intangible assets subject to amortization, the estimated amortization expense for each of the succeeding 5 years are as follows: 2002: \$680 million; 2003: \$646 million; 2004: \$634 million; 2005: \$568 million; and 2006: \$435 million. As acquisitions and dispositions occur in the future and as purchase price allocations are finalized, these amounts may vary.

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During the first six months of 2002, the Company acquired the following intangible assets (in millions):

		Weighted Average Amortization Period
Music catalogues and copyrights	\$ 100	15 years
Customer lists and other intangible assets subject to amortization	289	6 years
Cable television franchises	10	Indefinite
Brands, trademarks and other intangible assets not subject to amortization	117	Indefinite
Total	\$ 516	

The 2001 results on a historical basis do not reflect the provisions of FAS 142. Had AOL Time Warner adopted FAS 142 on January 1, 2001, the net income (loss) and basic and diluted net income (loss) per common share would have been changed to the adjusted amounts indicated below:

	Three Months Ended June 30, 2001		
	(restated; millions, except per share amounts)		
	Net income (loss)	Net income (loss) per basic common share	Net income (loss) per diluted common share
As reported	\$ (737)	\$ (0.17)	\$ (0.17)
Impact of dilutive shares on net loss			0.01
Add: Goodwill amortization	1,304	0.30	0.28
Add: Intangible amortization	364	0.08	0.08
Add: Equity investee goodwill amortization	141	0.03	0.03
Minority interest impact	(62)	(0.01)	(0.01)
Income tax impact (a)	(177)	(0.04)	(0.04)
Adjusted	\$ 833	\$ 0.19	\$ 0.18

(a) Because goodwill is nondeductible for tax purposes, the income tax impact reflects only the ceasing of intangible amortization and equity investee goodwill amortization.

	Six Months Ended June 30, 2001		
	(restated; millions, except per share amounts)		
	Net income (loss)	Net income (loss) per basic common share	Net income (loss) per diluted common share
As reported	\$ (2,106)	\$ (0.48)	\$ (0.48)
Impact of dilutive shares on net loss			0.02
Add: Goodwill amortization	2,579	0.58	0.56
Add: Intangible amortization	728	0.17	0.16
Add: Equity investee goodwill amortization	284	0.06	0.06

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Minority interest impact	(79)	(0.02)	(0.02)
Income tax impact (a)	(373)	(0.08)	(0.08)
	<u> </u>	<u> </u>	<u> </u>
Adjusted	\$ 1,033	\$ 0.23	\$ 0.22
	<u> </u>	<u> </u>	<u> </u>

(a) Because goodwill is nondeductible for tax purposes, the income tax impact reflects only the ceasing of intangible amortization and equity investee goodwill amortization.

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The Company's investments are comprised of fair value investments, including available-for-sale investments accounted for using the cost method of accounting and investments accounted for using the equity method of accounting. A judgmental aspect of accounting for investments involves determining whether an investment has sustained an other-than-temporary decline in its value, the investment is written down to its fair value, by a charge to earnings. Such evaluation is dependent on the specific facts and circumstances. Factors that are considered by the Company in determining whether an other-than-temporary decline in value has occurred include: the market value of the security in relation to its costs basis; the financial condition of the investee; and the intent and ability to retain the investment for a sufficient period of time to allow for recovery in the market value of the investment.

In evaluating the factors above for available-for-sale securities, management presumes a decline in value to be other-than-temporary if the quoted market price of the security is 20% or more below the investment's cost basis for a period of six months or more (the 20% criteria) or the quoted market price of the security is 50% or more below the security's cost basis at any quarter end (the 50% criteria). However, the presumption of an other-than-temporary decline in these instances may be overcome if there is persuasive evidence indicating that the decline is temporary in nature (e.g., strong operating performance of investee, historical volatility of investee, etc.). Additionally, there may be instances where impairment losses are recognized even if the 20% and 50% criteria are not satisfied (e.g., plan to sell the security in the near term and the fair value is below the Company's cost basis).

For investments accounted for using the cost or equity method of accounting, management evaluates information (e.g., budgets, business plans, financial statements, etc.) in addition to quoted market price, if any, in determining whether an other-than-temporary decline in value exists. Factors indicative of an other-than-temporary decline include recurring operating losses, credit defaults and subsequent rounds of financings at an amount below the cost basis of an investment. This list is not all inclusive and management weighs all quantitative and qualitative factors in determining if an other-than-temporary decline in value of an investment has occurred.

Investment Write-Downs

The United States economy has experienced a broad decline in the public equity markets, particularly in technology stocks, including investments held in the Company's portfolio. Similarly, the Company experienced significant declines in the value of certain privately held investments, restricted securities and investments accounted for using the equity method of accounting. As a result, the Company recorded noncash pretax charges to reduce the carrying value of certain investments that experienced other-than-temporary declines of approximately \$364 million in the second quarter of 2002, including \$1 million of losses relating to equity derivative instruments, and \$945 million for the six months ended June 30, 2002, including \$8 million of gains relating to equity derivative instruments, which are included in other expense, net, in the accompanying consolidated statement of operations. The Company recorded noncash pretax charges of \$54 million for the second quarter of 2001 and \$674 million for the first six months of 2001, which are included in other expense, net, in the accompanying consolidated statement of operations. In addition, the 2001 second quarter charge was almost entirely offset by approximately \$16 million of pretax gains related to equity derivative instruments and approximately \$34 million of pretax gains on the sale of certain securities.

Included in the noncash pretax charges noted above for the three and six months ended June 30, 2002 is a charge of approximately \$201 million and \$772 million, respectively, to reduce AOL Time Warner's investment in Time Warner Telecom Inc. (Time Warner Telecom), and \$101 million in the second quarter relating to an investment in Gateway Inc. for declines deemed to be other-than-temporary. Time Warner Telecom is a leading fiber facilities-based provider of metropolitan and regional optical broadband networks and services to business

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customers. The value of the Time Warner Telecom investment was adjusted upward in the Merger by over \$2 billion to its estimated fair value. Since the date of the Merger, Time Warner Telecom's share price has declined significantly, resulting in impairment charges of approximately \$1.2 billion in the fourth quarter of 2001 and approximately \$772 million for the first six months of 2002. As of June 30, 2002, the remaining carrying value of the Company's investment in Time Warner Telecom is approximately \$85 million.

Management determined that the decline in fair value of its investments in Time Warner Telecom and Gateway Inc. as of June 30, 2002 were other-than-temporary in accordance with its policy. Since the fair value of each investment was 50% below its respective cost basis as of June 30, 2002 and no qualitative factors indicated that the decline was temporary, the Company concluded that impairment had occurred.

As of June 30, 2002, Time Warner Telecom was owned 44% by AOL Time Warner, 14% by Advance/Newhouse Partnership and 42% by other third parties. AOL Time Warner's interest in Time Warner Telecom is being accounted for using the equity method of accounting. For the three months ended June 30, 2002, Time Warner Telecom had revenues, operating loss and net loss of approximately \$185 million, \$4 million and \$31 million, respectively. For the six months ended June 30, 2002, Time Warner Telecom had revenues, operating loss and net loss of approximately \$353 million, \$23 million and \$74 million, respectively.

As of June 30, 2002, AOL Time Warner has total investments, excluding equity-method investments, of \$1.953 billion for which the carrying value exceeded their estimated fair value by approximately \$350 million. This is primarily due to unrealized losses of approximately \$400 million based on a carrying value of approximately \$1.2 billion related to the Company's investment in Hughes Electronics Corp. (Hughes). At this time, management has concluded that the decline in fair value of the Company's investment in Hughes is temporary, primarily based on the determination that the fair value of the investment in Hughes, based upon quoted market price, was less than the Company's cost basis in the investment for a period of less than three months. However, depending upon general market conditions and the performance of individual investments, including Hughes and investments accounted for under the equity method of accounting, 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 income (expense), net.

Sale of Columbia House

The Columbia House Company Partnerships (Columbia House) was a 50-50 joint venture between AOL Time Warner and Sony Corporation of America (Sony). In June 2002, AOL Time Warner and Sony reached a definitive agreement to each sell 85% of its 50% interest in Columbia House to Blackstone Capital Partners III LP (Blackstone), an affiliate of The Blackstone Group, a private investment bank. Under the terms of the sale agreement, the Company received proceeds of approximately \$125 million in cash and a subordinated note receivable from Columbia House Holdings, Inc., a majority owned subsidiary of Blackstone, with a face amount of approximately \$35 million. 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. The deferred gain primarily relates to the estimated fair value of the portion of the proceeds received as a note receivable, which will be deferred until such time as the realization of such note becomes more fully assured. 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.

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Redemption of an Interest in TiVo

During the second quarter of 2002, approximately 1.6 million shares of preferred stock of TiVo Inc. (TiVo) held by the Company were redeemed. As a part of this transaction, the Company also sold certain rights and licenses for developed technology to TiVo. In return, the Company received proceeds of approximately \$44 million of cash and recognized a gain of approximately \$31 million, which is included in other expense, net, in the accompanying consolidated statement of operations.

AOL Latin America Convertible Debt

America Online Latin America, Inc. (AOL Latin America) is a joint venture among AOL Time Warner, the Cisneros Group and Banco Itaú (a leading Brazilian bank) that provides online services and support principally to customers in Brazil, Mexico and Argentina. In August 2000, AOL Latin America successfully completed an initial public offering of approximately 25 million shares of its Class A common stock, representing approximately 10% of the ownership interest in AOL Latin America at the time of the offering.

In March 2002, AOL Time Warner announced that it will make available to AOL Latin America up to \$160 million throughout 2002 to fund the operations of AOL Latin America. In exchange for this investment, AOL Time Warner will receive senior convertible notes. Each note will carry a fixed interest rate of 11% per annum (payable quarterly), will have a five-year maturity and will be convertible into AOL Latin America convertible preferred stock, which is convertible into Class A common stock of AOL Latin America at a conversion price of \$3.624 per share (20% above the market price at the time of investment). Assuming the conversion of all of the Company's investments in convertible securities of AOL Latin America, including the full \$160 million principal amount of notes, AOL Time Warner's economic interest in AOL Latin America would increase to approximately 50%. AOL Latin America has the option to redeem the notes after 18 months and the option to make interest payments in either cash or additional shares of convertible preferred stock. As of June 30, 2002, AOL Time Warner had provided AOL Latin America approximately \$45 million of this committed amount.

5. AOL EUROPE

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

On January 31, 2002, AOL Time Warner acquired 80% of Bertelsmann's 49.5% interest in AOL Europe for \$5.3 billion in cash as a result of Bertelsmann's exercise of its initial put option. On July 1, 2002, AOL Time Warner acquired the remaining 20% of Bertelsmann's interest for \$1.45 billion in cash. As a result of the purchase of Bertelsmann's interest in AOL Europe, AOL Time Warner has a majority interest and began consolidating AOL Europe, retroactive to the beginning of 2002. Previously, the Company owned a 49.5% preferred interest in AOL Europe and accounted for its investment in AOL Europe using the equity method of accounting. At January 31, 2002, AOL Europe had \$573 million of debt which was subsequently refinanced with AOL Time Warner debt carrying lower interest rates. Additionally, in February 2002, certain redeemable preferred securities previously issued by AOL Europe were redeemed for \$255 million. AOL Europe's remaining \$725 million of preferred

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securities are redeemable in April 2003 in cash, AOL Time Warner common stock, or a combination thereof, at the discretion of the Company (Note 9).

As of January 1, 2002, AOL Europe had total assets of approximately \$150 million, consisting principally of approximately \$88 million in receivables and approximately \$52 million in cash and equivalents. In addition, AOL Europe had approximately \$2.0 billion of total liabilities, including \$573 million of debt, approximately \$415 million of other current liabilities and approximately \$1 billion of redeemable preferred securities, including \$255 million of redeemable preferred securities redeemed in February 2002. The assets and liabilities of AOL Europe are included in the AOL segment. In connection with the allocation of the price paid by AOL Time Warner to acquire the additional interest in AOL Europe, the AOL segment recognized approximately \$7.0 billion of goodwill and approximately \$230 million of subscriber lists, which will be amortized over a useful life of 5 years with no residual value. The allocation of the purchase price is preliminary because the Company has yet to complete its valuation process for these intangible assets.

6. INVESTMENT IN TWE

TWE is a Delaware limited partnership that was capitalized in 1992 to own and operate substantially all of the Filmed Entertainment-Warner Bros., Networks-HBO and The WB Network, and Cable businesses previously owned by subsidiaries of AOL Time Warner. As of March 31, 2002, AOL Time Warner, through its wholly owned subsidiaries, collectively owned general and limited partnership interests in TWE consisting of 74.49% of the Series A Capital and Residual Capital and 100% of the Series B Capital. The remaining 25.51% limited partnership interests in the Series A Capital and Residual Capital of TWE were held by AT&T. Certain AOL Time Warner subsidiaries are the general partners of TWE (the General Partners).

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. The option allowed AT&T to obtain up to an additional 6.33% of Series A Capital and Residual Capital interests determined based on the compounded annual growth rate of TWE's adjusted Cable EBITDA, as defined in the option agreement, over the life of the option, and whether AT&T or TWE elected to have the exercise price paid with partnership interests rather than cash. On April 19, 2002, AT&T delivered to TWE a notice that the option would be exercised on a cashless basis, effective May 31, 2002. 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 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 equity. The loss recognized by AOL Time Warner on AT&T's option exercise was determined by comparing the fair value of the consideration received from AT&T which is \$0, to the net book value of the interest in TWE being surrendered to AT&T. Due to the Company's 100% ownership of the Series B Capital, AOL Time Warner's economic interest in TWE exceeds 72.36%.

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

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Partnership Agreement. In July 2002, AOL Time Warner and AT&T agreed to temporarily suspend the registration process so that they can pursue discussion of an alternative transaction. For the time being, AOL Time 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 registration rights process, if resumed.

The TWE partnership agreement provides for special allocations of income, loss and distributions of partnership capital, including priority distributions in the event of liquidation. As a result of the Merger, a portion of the \$147 billion cost to acquire Time Warner was allocated to the underlying net assets of TWE, to the extent acquired. TWE reported net income of \$863 million, excluding a \$22 billion noncash charge related to the cumulative effect of an accounting change, for the first six months of 2002 and a net loss of \$582 million for the first six months of 2001. Because of the priority rights over allocations of income and distributions of TWE held by the General Partners, \$805 million of TWE's income for the six months ended June 30, 2002 was allocated to AOL Time Warner and \$58 million was allocated to AT&T. For 2001, \$540 million of TWE's loss for the six months ended June 30, 2001 was allocated to AOL Time Warner and \$42 million was allocated to AT&T.

The assets and cash flows of TWE are restricted by the TWE partnership and credit agreements. As such, they are unavailable for use by the partners except through the payment of certain fees, reimbursements, cash distributions and loans, which are subject to limitations.

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7. INVENTORIES

Inventories and film costs consist of:

	June 30, 2002	December 31, 2001
	(millions)	
Programming costs, less amortization	\$ 2,429	\$ 2,536
Magazines, books, recorded music and other merchandise	479	553
Film costs-Theatrical:		
Released, less amortization	827	847
Completed and not released	241	356
In production	555	381
Development and pre-production	316	290
Film costs-Television:		
Released, less amortization	205	162
Completed and not released	26	95
In production	2	59
Development and pre-production	6	2
Total inventories and film costs(a)	5,086	5,281
Less current portion of inventory	1,668	1,791
Total noncurrent inventories and film costs	\$ 3,418	\$ 3,490

- (a) Does not include \$3.266 billion and \$3.363 billion of net film library costs as of June 30, 2002 and December 31, 2001, respectively, which are included in intangible assets subject to amortization on the accompanying consolidated balance sheet. See Note 3.
- (b) Current inventory as of June 30, 2002 is comprised of programming inventory at the Networks segment (approximately \$1.189 billion), books from the Publishing segment (approximately \$226 million), videocassettes, DVDs, and compact discs from the Filmed Entertainment and Music segments (approximately \$209 million), and general merchandise, primarily at the AOL segment (approximately \$44 million).

8. LONG-TERM DEBT

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. The securities under both issuances are guaranteed on an unsecured basis by each of America Online and Time Warner. In addition, Time Warner Companies, Inc. (TW Companies) and Turner Broadcasting System, Inc. (TBS) have guaranteed, on an unsecured basis, Time Warner's guarantee of the securities.

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

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Time Warner, TWE, TWE-A/N and AOL Time Warner Finance Ireland. The obligations of each of AOL Time Warner and AOL Time Warner Finance Ireland are guaranteed by America Online, Time Warner, TBS and TW Companies, directly or indirectly. The obligation of AOL Time Warner Finance Ireland is guaranteed by AOL Time Warner. The obligations of TWE and TWE-A/N are not guaranteed. Borrowings will bear interest at specific rates, generally based on the credit rating for each of the borrowers, currently equal to LIBOR plus .625% including facility fees of .10% and .125% on the total commitments of the 364-day and five-year facility, 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.

9. MANDATORILY REDEEMABLE PREFERRED SECURITIES

AOL Europe has 725,000 shares of redeemable preferred securities outstanding with a liquidation preference of \$725 million. Dividends are accreted at an annual rate of 6% and the total accumulated dividends as of June 30, 2002 were approximately \$54 million. These securities and related dividends are classified as Minority Interest in the accompanying consolidated balance sheet. The preferred shares are required to be redeemed no later than April 1, 2003 in cash, AOL Time Warner stock or a combination thereof, at the Company's discretion.

In 1995, the Company, through TW Companies, issued approximately 23 million Company-obligated mandatorily redeemable preferred securities of a wholly owned subsidiary (Preferred Trust Securities) for aggregate gross proceeds of \$575 million. The sole assets of the subsidiary that was the obligor on the Preferred Trust Securities were \$592 million principal amount of 8⁷/₈% subordinated debentures of TW Companies due December 31, 2025. Cumulative cash distributions were payable on the Preferred Trust Securities at an annual rate of 8⁷/₈%. The Preferred Trust Securities were mandatorily redeemable for cash on December 31, 2025, and TW Companies had the right to redeem the Preferred Trust Securities, in whole or in part, on or after December 31, 2000, or in other certain circumstances.

On February 13, 2001, TW Companies redeemed all 23 million shares of the Preferred Trust Securities. The redemption price was \$25 per security, plus accrued and unpaid distributions thereon equal to \$0.265 per security. The total redemption price of \$581 million was funded with borrowings under the Old Credit Agreements.

10. SEGMENT INFORMATION

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.

Information as to the operations of AOL Time Warner in different business segments is set forth below based on the nature of the products and services offered. AOL Time Warner evaluates performance based on several

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factors, of which the primary financial measure is operating income (loss) before noncash depreciation of tangible assets and amortization of intangible assets (EBITDA).

The accounting policies of the business segments are the same as those described in the summary of significant accounting policies under Note 1 in the Company's 2001 Form 10-K. Intersegment sales are accounted for at fair value as if the sales were with third parties.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001(a)	2002	2001(a)
	(restated; millions)			
Revenues				
AOL	\$ 2,266	\$ 2,105	\$ 4,557	\$ 4,200
Cable (b)	1,762	1,478	3,445	2,879
Filmed Entertainment Networks	2,386	1,893	4,522	4,105
Music	972	935	1,919	1,839
Publishing	1,396	1,155	2,477	2,084
Intersegment elimination	(505)	(441)	(1,005)	(851)
Total revenues	\$ 10,234	\$ 8,953	\$ 19,658	\$ 17,783

- (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 and \$85 million for the three and six months ended June 30, 2001, respectively.
- (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 restructuring of TWE-A/N, which resulted in the deconsolidation of the operating results of the Advance/Newhouse Systems for all periods presented. For the three months ended June 30, 2002 and 2001, the net impact of the deconsolidation of these systems is a reduction of the Cable segment's revenues of \$363 million and \$304 million, respectively. For the six months ended June 30, 2002 and 2001, the net impact of the deconsolidation of these systems is a reduction of the Cable segment's revenues of \$715 million and \$596 million, respectively. In addition, the Cable segment's results reflect the consolidation of Road Runner's operating results effective January 1, 2002.

Intersegment Revenues

In the normal course of business, the AOL Time Warner segments enter into transactions with one another. The most common types of intercompany transactions include:

- The Filmed Entertainment segment generating content revenue by licensing television and theatrical programming to the Networks segment;
- The Networks segment generating subscription revenues by selling cable network programming to the Cable segment; and
- The AOL, Cable, Networks and Publishing segments generating advertising and commerce revenue by cross-promoting the products and services of all AOL Time Warner segments.

These intercompany transactions are recorded by each segment at fair value as if the transactions were with third parties and, therefore, impact segment performance. While intercompany transactions are treated like third-party transactions to determine segment performance, the revenues (and corresponding expenses recognized by the segment that is counterparty to the transaction) are eliminated in consolidation and, therefore, do not themselves impact consolidated results. Revenues recognized by AOL Time Warner's segments on intercompany transactions are as follows:

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Three Months Ended June 30, Six Months Ended June 30,

	2002	2001	2002	2001
(restated; millions)				
Intercompany Revenues				
AOL	\$ 75	\$ 29	\$ 155	\$ 50
Cable	36	18	66	21
Filmed Entertainment.	133	187	303	368
Networks	135	128	268	269
Music	112	68	188	125
Publishing	14	11	25	18
Total intercompany revenues	\$ 505	\$ 441	\$ 1,005	\$ 851

Included in the total intercompany revenues above are intercompany advertising and commerce revenues, as follows:

Three Months Ended June 30, Six Months Ended June 30,

	2002	2001	2002	2001
(restated; millions)				
Intercompany Advertising and Commerce Revenues				
AOL	\$ 50	\$ 29	\$ 104	\$ 50
Cable	31	18	58	21
Filmed Entertainment				
Networks	37	36	77	77
Music				
Publishing	14	11	25	18
Total intercompany advertising and commerce revenues	\$ 132	\$ 94	\$ 264	\$ 166

Three Months Ended June 30, Six Months Ended June 30,

	2002	2001	2002	2001
(restated; millions)				
EBITDA(a)				
AOL	\$ 474	\$ 794	\$ 892	\$ 1,477
Cable(b)	675	640	1,327	1,274
Filmed Entertainment.	328	250	509	363
Networks	420	444	851	893
Music	102	87	198	181
Publishing	337	271	482	384
Corporate	(80)	(71)	(159)	(145)
Merger and restructuring costs			(107)	(71)
Intersegment elimination	11	(22)	13	(23)
Total EBITDA	\$ 2,267	\$ 2,393	\$ 4,006	\$ 4,333

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- (a) EBITDA represents operating income (loss) before noncash depreciation of tangible assets and amortization of intangible assets. After deducting depreciation and amortization, for the three months ended June 30, AOL Time Warner's operating income was \$1.520 billion, in 2002 and \$196 million in 2001. For the six months ended June 30, AOL Time Warner's operating income (loss) was \$2.577 billion in 2002 and \$(27) million in 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 months ended June 30, 2002 and 2001, the net impact of the deconsolidation of these systems is a reduction of the Cable segment's EBITDA of \$172 million and \$137 million respectively. For the six months ended June 30, 2002 and 2001, the net impact of the deconsolidation of these systems is a reduction of the Cable segment's EBITDA of \$333 million and \$271 million, respectively. In addition, the Cable segment's results reflect the consolidation of Road Runner's operating results effective January 1, 2002.

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(restated; millions)			
Depreciation of Property, Plant and Equipment				
AOL	\$ 159	\$ 98	\$ 287	\$ 199
Cable	295	220	569	414
Filmed Entertainment.	19	23	38	45
Networks	42	39	81	78
Music	28	24	56	46
Publishing	23	17	46	33
Corporate	6	6	13	11
	\$ 572	\$ 427	\$ 1,090	\$ 826
	(restated; millions)			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(restated; millions)			
Amortization of Intangible Assets(a)				
AOL	\$ 41	\$ 32	\$ 82	\$ 66
Cable	2	620	2	1,236
Filmed Entertainment.	47	119	95	237
Networks	8	479	11	953
Music	45	209	88	415
Publishing	32	231	61	464
Corporate		80		163
	\$ 175	\$ 1,770	\$ 339	\$ 3,534

(a) Includes amortization relating to business combinations accounted for by the purchase method, substantially all of which arose in the \$147 billion acquisition of Time Warner in 2001.

As discussed in Note 3, when FAS 142 is initially applied, all goodwill recognized on the Company's consolidated balance sheet on that date is reviewed for impairment using the new guidance. Before performing the review for impairment, the new guidance requires that all goodwill deemed to relate to the entity as a whole be assigned to all of the Company's reporting units (generally, the AOL Time Warner operating segments), including the reporting units of the acquirer. This differs from the previous accounting rules, which required goodwill to be assigned only to the businesses of the company acquired. As a result, a portion of the goodwill generated in the Merger was reallocated to the AOL segment resulting in a change in segment assets. Following are AOL Time Warner's assets by business segment, reflecting the reallocation of goodwill in accordance with FAS 142, as of June 30, 2002 and December 31, 2001:

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	June 30, 2002	December 31, 2001
(restated; millions)		
Assets		
AOL	\$ 40,306	\$ 34,021
Cable	48,569	71,265
Filmed Entertainment	15,885	20,646
Networks	31,688	44,580
Music	7,337	12,399
Publishing	14,103	23,374
Corporate	2,232	2,219
	\$ 160,120	\$ 208,504

11. COMMITMENTS AND CONTINGENCIES**Securities Matters**

As of August 13, 2002, twenty class action lawsuits have been filed, naming as defendants the Company, certain current and former executives of the Company and, in three instances, America Online. Seventeen of these were filed in the United States District Court for the Southern District of New York, two were filed in the United States District Court for the Eastern District of Virginia and one in the United States District Court for the Eastern District of Texas (the AOL Time Warner Shareholder Litigation). The complaints purport to be made on behalf of certain shareholders of the Company and allege that the Company made material misrepresentations and/or omissions of material fact in violation of Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act), Rule 10b-5 promulgated thereunder, and Section 20(a) of the Exchange Act. Plaintiffs claim that the Company failed to disclose America Online's declining advertising revenues and that the Company and America Online inappropriately inflated advertising revenues in a series of transactions. Certain of the lawsuits also allege that certain of the individual defendants and other insiders at the Company improperly sold their personal holdings of AOL Time Warner stock. Three of the lawsuits, in addition to the above allegations, allege that the Company failed to disclose that the Merger was not generating the synergies anticipated at the time of the announcement of the Merger and, further, that the Company inappropriately delayed writing down more than \$50 billion of goodwill. The lawsuits seek an unspecified amount in compensatory damages. The Company intends to defend against the lawsuits vigorously. The Company is unable to predict the outcome of the cases or reasonably estimate a range of possible loss.

On July 23, 2002, *Pfeiffer v. Case et al.*, a shareholder derivative action, was filed in New York State Supreme Court for the County of New York, and on August 7, 2002, *Hall v. Case et al.*, also a shareholder derivative action, was filed in the United States District Court for the Southern District of New York. Both suits name the directors and certain officers of the Company as defendants, as well as the Company as a nominal defendant. The complaints allege that defendants breached their fiduciary duties by causing the Company to issue corporate statements that did not accurately disclose that America Online had declining advertising revenues, that the Merger was not generating the synergies anticipated at the time of the announcement of the Merger, and that the Company inappropriately delayed writing down more than \$50 billion of goodwill, thereby exposing the Company to potential liability for alleged violations of federal securities laws. The lawsuits further allege that certain of the defendants improperly sold their personal holdings of AOL Time Warner securities. The lawsuits request that all proceeds from any improper sales of AOL Time Warner common stock and any improper salaries or payments be returned to the

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Company. The Company intends to defend against the lawsuits vigorously. The Company is unable to predict the outcome of the cases or reasonably estimate a range of possible loss.

In addition, the Securities and Exchange Commission and the Department of Justice are investigating the financial reporting and disclosure practices of the Company. The Company cannot predict the outcome of the investigations at this time. The Company will continue its efforts to cooperate with the investigations.

Other Matters

On January 22, 2002, Netscape, a wholly-owned subsidiary of America Online, sued Microsoft Corporation (Microsoft) in the United States District Court for the District of Columbia for antitrust violations under Sections 1 and 2 of the Sherman Act, as well as for other common law violations. Among other things, the complaint alleges that Microsoft's actions to maintain its monopoly in the market for Intel-compatible personal computer operating systems worldwide injured Netscape, consumers and competition in violation of Section 2 of the Sherman Act and continues to do so. The complaint also alleges that Microsoft's actions constitute illegal monopolization and attempted monopolization of a worldwide market for Web browsers and that Microsoft has engaged in illegal practices by tying its Web browser, Internet Explorer, to Microsoft's operating system in various ways. The complaint seeks damages for the injuries inflicted upon Netscape, including treble damages and attorneys' fees, as well as injunctive relief to remedy the anti-competitive behavior alleged. On March 29, 2002, Microsoft filed its answer to the complaint denying all claims and allegations. On June 17, 2002, the Judicial Panel on Multi-District Litigation transferred the case to the United States District Court for the District of Maryland for all pretrial proceedings. Due to the preliminary status of the matter, it is not possible for the Company at this time to provide a view on its probable outcome or to provide a reasonable estimate as to the amount that might be recovered through this action.

America Online has been named as defendant in several putative class action lawsuits brought by consumers and Internet service providers (ISP), alleging certain injuries to have been caused by installation of AOL versions 5.0 and 6.0 software. Subject to the final approval of the court, the parties have entered into settlement agreements covering the consumer and ISP AOL version 5.0 installation claims on terms that are not material to the Company's financial condition or results of operations. The claims related to AOL version 6.0 remain pending. The remaining cases are in preliminary stages, but the Company believes that they are without merit and

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intends to defend them vigorously. The Company is unable, however, to predict the outcome of these cases, or reasonably estimate a range of possible loss given their current status.

The Department of Labor has closed its investigation into the applicability of the Fair Labor Standards Act (FLSA) to America Online's Community Leader program without taking any action against the Company. However, putative classes of former and current Community Leader volunteers have brought lawsuits in several states against America Online alleging violations of the FLSA and comparable state statutes on the basis that they were acting as employees rather than volunteers in serving as Community Leaders and are entitled to wages. An additional putative class action lawsuit has been filed against the Company, America Online and AOL Community, Inc. alleging violations of the Employee Retirement Income Security Act (ERISA) on the basis that the plaintiffs were acting as employees rather than volunteers and are entitled to pension, welfare or other employee benefits under ERISA. Although the Company does not believe that these lawsuits regarding Community Leader volunteers have any merit and intends to defend against them vigorously, the Company is unable to predict the outcome of the cases, or reasonably estimate a range of possible loss due to the preliminary nature of the matters.

In *Six Flags Over Georgia LLC et al. v. Time Warner Entertainment Company et al.*, following a trial in December 1998, the jury returned a verdict for plaintiffs and against defendants, including TWE, on plaintiffs' claims for breaches of fiduciary duty. The jury awarded plaintiffs approximately \$197 million in compensatory damages and \$257 million in punitive damages, and interest began accruing on those amounts at the Georgia annual statutory rate of twelve percent. The Company paid the compensatory damages with accrued interest during the first quarter of 2001. Payment of the punitive damages portion of the award with accrued interest was stayed by the United States Supreme Court on March 1, 2001 pending the disposition of a certiorari petition with that Court, which was filed by TWE on June 15, 2001. On October 1, 2001, the United States Supreme Court granted TWE's petition, vacated the decision by the Georgia Court of Appeals affirming the punitive damages award, and remanded the matter to the Georgia Court of Appeals for further consideration. The Georgia Court of Appeals affirmed and reinstated its earlier decision regarding the punitive damage award on March 29, 2002. On April 18, 2002, the defendants filed a petition for certiorari to the Georgia Supreme Court seeking review of the decision of the Georgia Court of Appeals and a decision on whether the court will hear the appeal is expected later in 2002.

On April 8, 2002, three former employees of certain subsidiaries of the Company filed *Henry Spann et al. v. AOL Time Warner Inc. et al.*, a purported class action, in the United States District Court for the Central District of California. Plaintiffs have named as defendants, among others, the Company, Time Warner Entertainment Company, L.P., Warner-Elektra-Atlantic Corporation, WEA Manufacturing Inc., Warner Bros. Records Inc., Atlantic Recording Corporation, various pension plans sponsored by the companies and the administrative committees of those plans. Plaintiffs allege that defendants miscalculated the proper amount of pension benefits owed to them and other class members as required under the plans in violation of ERISA. The Company believes the lawsuit has no merit and intends to defend against it vigorously. Due to its preliminary status, the Company is unable to predict the outcome of the case or reasonably estimate a range of possible loss.

The Company is subject to a number of state and federal class action lawsuits, as well as an action brought by a number of state Attorneys General alleging unlawful horizontal and vertical agreements to fix the prices of compact discs by the major record companies. Although the Company cannot predict the outcomes, the Company does not expect that the ultimate outcomes of these cases will have a material adverse impact on the Company's consolidated financial statements or results of operations.

The costs and other effects of pending or future litigation, governmental investigations, legal and administrative cases and proceedings (whether civil or criminal), settlements, judgments and investigations, claims

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

and changes in those matters (including those matters described above), and developments or assertions by or against the Company relating to intellectual property rights and intellectual property licenses, could have a material adverse effect on the Company's business, financial condition and operating results.

12. ADDITIONAL FINANCIAL INFORMATION**Cash Flows**

Additional financial information with respect to cash (payments) and receipts are as follows:

	Six Months Ended June 30,	
	2002	2001
	(millions)	
Cash payments made for interest	\$ (734)	\$ (705)
Interest income received	71	113
Cash interest expense, net	\$ (663)	\$ (592)
Cash payments made for income taxes	\$ (147)	\$ (229)
Income tax refunds received	37	25
Cash taxes, net	\$ (110)	\$ (204)

Interest Expense, Net

Interest expense, net, consists of:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(millions)			
Interest income	\$ 41	\$ 45	\$ 78	\$ 113
Interest expense	(482)	(389)	(895)	(768)
Total interest expense, net	\$ (441)	\$ (344)	\$ (817)	\$ (655)

Other Expense, Net

Other expense, net, consists of:

Three Months Ended June 30,		Six Months Ended June 30,	
2002	2001	2002	2001

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	(millions)			
Net investment losses(a)	\$ (269)	\$ (6)	\$ (850)	\$ (645)
Losses on equity investees	(54)	(247)	(115)	(485)
Gains related to the exchange of unconsolidated cable television systems at TWE		39		39
Losses on asset securitization programs	(11)	(16)	(22)	(36)
Miscellaneous	3	(3)	1	(8)
Total other expense, net	\$ (331)	\$ (233)	\$ (986)	\$ (1,135)

- (a) Includes a noncash pretax charge to reduce the carrying value of certain investments for other-than-temporary declines in value of approximately \$364 million and \$945 million for the three and six months ended June 30, 2002, respectively and approximately \$674 million for the six months ended June 30, 2001 (Note 4).

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AOL TIME WARNER INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Other Current Liabilities

Other current liabilities consist of:

	June 30, 2002	December 31, 2001
	(millions)	
Accrued expenses	\$ 5,385	\$ 5,474
Accrued compensation	648	904
Accrued income taxes	154	65
Total other current liabilities	\$ 6,187	\$ 6,443

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AOL TIME WARNER INC.
SUPPLEMENTARY INFORMATION
CONDENSED CONSOLIDATING FINANCIAL STATEMENTS
(Unaudited)

America Online, Inc. (America Online), Time Warner Inc. (Time Warner), Time Warner Companies, Inc. (TW Companies) and Turner Broadcasting System, Inc. (TBS and, together with America Online, Time Warner and TW Companies, the Guarantor Subsidiaries) are wholly owned subsidiaries of AOL Time Warner Inc. (AOL Time Warner). AOL Time Warner, America Online, Time Warner, TW Companies and TBS have fully and unconditionally, jointly and severally, and directly or indirectly, guaranteed all of the outstanding publicly traded indebtedness of each other. Set forth below are condensed consolidating financial statements of AOL Time Warner, including each of the Guarantor Subsidiaries, presented for the information of each company's public debtholders. The following condensed consolidating financial statements present the results of operations, financial position and cash flows of (I) America Online, Time Warner, TW Companies and TBS (in each case, reflecting investments in its consolidated subsidiaries under the equity method of accounting), (ii) the direct and indirect non-guarantor subsidiaries of AOL Time Warner and (iii) the eliminations necessary to arrive at the information for AOL Time Warner on a consolidated basis. These condensed consolidating financial statements should be read in conjunction with the accompanying consolidated financial statements of AOL Time Warner.

Consolidating Statement of Operations
For The Three Months Ended June 30, 2002
(Restated)

	AOL Time Warner	America Online	Time Warner	TW Companies	TBS	Non- Guarantor Subsidiaries	Eliminations	AOL Time Warner Consolidated
	(millions)							
Revenues	\$	\$ 1,784	\$	\$	\$ 233	\$ 8,245	\$ (28)	\$ 10,234
Cost of revenues		(1,031)			(130)	(4,863)	28	(5,996)
Selling, general and administrative	(10)	(468)	(8)	(4)	(23)	(2,030)		(2,543)
Amortization of goodwill and other intangible assets		(3)				(172)		(175)
Merger and restructuring costs		2				(2)		
Operating income (loss)	(10)	284	(8)	(4)	80	1,178		1,520
Equity in pretax income (loss) of consolidated subsidiaries	831	(49)	767	700	178		(2,427)	
Interest (expense) income, net	(150)	2	(22)	(97)	(30)	(144)		(441)
Other expense, net	24	(114)	(3)	(30)	(2)	(151)	(55)	(331)
Minority interest expense						(53)		(53)
Income before income taxes, discontinued operations and cumulative effect of accounting change	695	123	734	569	226	830	(2,482)	695
Income tax provision	(301)	(96)	(269)	(207)	(87)	(307)	966	(301)
Income before discontinued operations and cumulative effect of accounting change	394	27	465	362	139	523	(1,516)	394
Discontinued operations, net of tax	2		2	2		2	(6)	2
Income before cumulative effect of accounting change	396	27	467	364	139	525	(1,522)	396
Cumulative effect of accounting change								
Net income	\$ 396	\$ 27	\$ 467	\$ 364	\$ 139	\$ 525	\$ (1,522)	\$ 396



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AOL TIME WARNER INC.
SUPPLEMENTARY INFORMATION
CONDENSED CONSOLIDATING FINANCIAL STATEMENTS (Continued)
(Unaudited)

Consolidating Statement of Operations
For The Three Months Ended June 30, 2001
(Restated)

	<u>AOL Time Warner</u>	<u>America Online</u>	<u>Time Warner</u>	<u>TW Companies</u>	<u>TBS</u>	<u>Non-Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>AOL Time Warner Consolidated</u>
	(millions)							
Revenues	\$	\$ 1,576	\$	\$	\$ 223	\$ 7,191	\$ (37)	\$ 8,953
Cost of revenues		(771)			(112)	(3,941)	37	(4,787)
Selling, general and administrative	(9)	(342)	(8)	(3)	(34)	(1,804)		(2,200)
Amortization of goodwill and other intangible assets	(84)	(3)			(93)	(1,590)		(1,770)
Merger and restructuring costs								
Operating income (loss)	(93)	460	(8)	(3)	(16)	(144)		196
Equity in pretax income (loss) of consolidated subsidiaries	(232)	187	(863)	(546)	(94)		1,548	
Interest income (expense), net	(57)	15	(3)	(93)	(38)	(168)		(344)
Other income (expense), net	2	(15)	1	(9)	(3)	(153)	(56)	(233)
Minority interest expense			(6)			7		1
Income (loss) before income taxes and discontinued operations	(380)	647	(879)	(651)	(151)	(458)	1,492	(380)
Income tax provision	(348)	(256)	(152)	(132)	(78)	(321)	939	(348)
Loss before discontinued operations	(728)	391	(1,031)	(783)	(229)	(779)	2,431	(728)
Discontinued operations, net of tax	(9)		(9)	(9)		(9)	27	(9)
Net income (loss)	\$ (737)	\$ 391	\$ (1,040)	\$ (792)	\$ (229)	\$ (788)	\$ 2,458	\$ (737)

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AOL TIME WARNER INC.
SUPPLEMENTARY INFORMATION
CONDENSED CONSOLIDATING FINANCIAL STATEMENTS (Continued)
(Unaudited)

Consolidating Statement of Operations
For The Six Months Ended June 30, 2002
(Restated)

	AOL Time Warner	America Online	Time Warner	TW Companies	TBS	Non-Guarantor Subsidiaries	Eliminations	AOL Time Warner Consolidated
	(millions)							
Revenues	\$	\$ 3,603	\$	\$	\$ 431	\$ 15,695	\$ (71)	\$ 19,658
Cost of revenues		(2,031)			(230)	(9,486)	71	(11,676)
Selling, general and administrative	(17)	(943)	(17)	(8)	(71)	(3,903)		(4,959)
Amortization of goodwill and other intangible assets		(7)				(332)		(339)
Merger and restructuring costs	(28)	(72)				(7)		(107)
Operating income (loss)	(45)	550	(17)	(8)	130	1,967		2,577
Equity in pretax income (loss) of consolidated subsidiaries	962	(176)	824	779	347		(2,736)	
Interest income (expense), net	(242)	11	(53)	(198)	(59)	(276)		(817)
Other expense, net	15	(146)	(5)	(108)	(2)	(659)	(81)	(986)
Minority interest expense						(84)		(84)
Income before income taxes, discontinued operations and cumulative effect of accounting change	690	239	749	465	416	948	(2,817)	690
Income tax provision	(304)	(140)	(283)	(175)	(160)	(362)	1,120	(304)
Income before discontinued operations and cumulative effect of accounting change	386	99	466	290	256	586	(1,697)	386
Discontinued operations, net of tax	1		1	1		1	(3)	1
Loss before cumulative effect of accounting change	387	99	467	291	256	587	(1,700)	387
Cumulative effect of accounting change	(54,235)		(54,235)	(42,062)	(12,173)	(52,048)	160,518	(54,235)
Net income (loss)	\$ (53,848)	\$ 99	\$ (53,768)	\$ (41,771)	\$ (11,917)	\$ (51,461)	\$ 158,818	\$ (53,848)

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AOL TIME WARNER INC.
SUPPLEMENTARY INFORMATION
CONDENSED CONSOLIDATING FINANCIAL STATEMENTS (Continued)
(Unaudited)

Consolidating Statement of Operations
For The Six Months Ended June 30, 2001
(Restated)

	AOL Time Warner	America Online	Time Warner	TW Companies	TBS	Non- Guarantor Subsidiaries	Eliminations	AOL Time Warner Consolidated
	(millions)							
Revenues	\$	\$ 3,176	\$	\$	\$ 420	\$ 14,251	\$ (64)	\$ 17,783
Cost of revenues		(1,624)			(175)	(8,018)	64	(9,753)
Selling, general and administrative	(17)	(732)	(16)	(7)	(78)	(3,602)		(4,452)
Amortization of goodwill and other intangible assets	(167)	(7)			(149)	(3,211)		(3,534)
Merger-related costs		(67)				(4)		(71)
Operating income (loss)	(184)	746	(16)	(7)	18	(584)		(27)
Equity in pretax income (loss) of consolidated subsidiaries	(1,571)	356	(2,049)	(1,349)	(299)		4,912	
Interest income (expense), net	(56)	56	(24)	(222)	(86)	(323)		(655)
Other expense, net		(613)	(27)	(33)	(8)	(398)	(56)	(1,135)
Minority interest expense						6		6
Income (loss) before income taxes and discontinued operations	(1,811)	545	(2,116)	(1,611)	(375)	(1,299)	4,856	(1,811)
Income tax provision	(276)	(212)	(161)	(142)	(126)	(488)	1,129	(276)
Loss before discontinued operations	(2,087)	333	(2,277)	(1,753)	(501)	(1,787)	5,985	(2,087)
Discontinued operations, net of tax	(19)		(19)	(19)		(19)	57	(19)
Net income (loss)	\$ (2,106)	\$ 333	\$ (2,296)	\$ (1,772)	\$ (501)	\$ (1,806)	\$ 6,042	\$ (2,106)

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AOL TIME WARNER INC.
SUPPLEMENTARY INFORMATION
CONDENSED CONSOLIDATING FINANCIAL STATEMENTS (Continued)
(Unaudited)

Consolidating Balance Sheet
June 30, 2002
(Restated)

	<u>AOL Time Warner</u>	<u>America Online</u>	<u>Time Warner</u>	<u>TW Companies</u>	<u>TBS</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>AOL Time Warner Consolidated</u>
	(millions)							
ASSETS								
Current assets								
Cash and equivalents	\$ 1,054	\$ 15	\$	\$ 1,300	\$ 16	\$ 594	\$ (1,240)	\$ 1,739
Receivables, net	840	353	7	9	132	4,493	(822)	5,012
Inventories					164	1,504		1,668
Prepaid expenses and other current assets	10	182			5	1,585		1,782
Total current assets	1,904	550	7	1,309	317	8,176	(2,062)	10,201
Noncurrent inventories and film costs					301	3,105	12	3,418
Investments in amounts due to and from consolidated subsidiaries	108,547	13,606	89,395	71,090	18,220		(300,858)	
Investments, including available-for-sale securities	68	1,938	269	(11)	93	4,067	(949)	5,475
Property, plant and equipment	50	1,109	7		76	11,957		13,199
Intangible assets subject to amortization						7,335		7,335
Intangible assets not subject to amortization					641	37,181		37,822
Goodwill and other intangible assets	9,829	22,014			2,821	45,424		80,088
Other assets	119	488	1	47	91	1,836		2,582
Total assets	\$ 120,517	\$ 39,705	\$ 89,679	\$ 72,435	\$ 22,560	\$ 119,081	\$ (303,857)	\$ 160,120
LIABILITIES AND SHAREHOLDERS EQUITY								
Current liabilities								
Accounts payable	\$ 10	\$ 9	\$ 2	\$	\$ 4	\$ 2,119	\$	\$ 2,144
Participations payable						1,407		1,407
Royalties and programming costs payable					12	1,561		1,573
Deferred revenue		808			1	670		1,479
Debt due within one year						947	(860)	87
Other current liabilities	461	980	29	154	142	4,487	(66)	6,187
Total current liabilities	471	1,797	31	154	159	11,191	(926)	12,877
Long-term debt	12,254	1,571	1,469	6,024	788	7,068	(1,239)	27,935
Debt due to (from) affiliates	(797)				1,647	955	(1,805)	
Deferred income taxes	10,816	(4,099)	14,914	12,799	2,195	15,004	(40,813)	10,816
Deferred revenue		28				1,085		1,113
Other liabilities	103	24	411		241	3,732		4,511
Minority interests						5,198		5,198
Shareholders equity								
Due (to) from AOL Time Warner and subsidiaries		5,762	8,507	2,658	(1,906)	(13,811)	(1,210)	

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Other shareholders equity	<u>97,670</u>	<u>34,622</u>	<u>64,347</u>	<u>50,800</u>	<u>19,436</u>	<u>88,659</u>	<u>(257,864)</u>	<u>97,670</u>
Total shareholders equity	<u>97,670</u>	<u>40,384</u>	<u>72,854</u>	<u>53,458</u>	<u>17,530</u>	<u>74,848</u>	<u>(259,074)</u>	<u>97,670</u>
Total liabilities and shareholders equity	<u>\$ 120,517</u>	<u>\$ 39,705</u>	<u>\$ 89,679</u>	<u>\$ 72,435</u>	<u>\$ 22,560</u>	<u>\$ 119,081</u>	<u>\$ (303,857)</u>	<u>\$ 160,120</u>

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AOL TIME WARNER INC.
SUPPLEMENTARY INFORMATION
CONDENSED CONSOLIDATING FINANCIAL STATEMENTS (Continued)
(Unaudited)

Consolidating Balance Sheet
December 31, 2001
(Restated)

	AOL Time Warner	America Online	Time Warner	TW Companies	TBS	Non- Subsidiaries Guarantor	Eliminations	AOL Time Warner Consolidated
	(millions)							
ASSETS								
Current assets								
Cash and equivalents	\$ (10)	\$ 41	\$	\$ 1,837	\$ 86	\$ 499	\$ (1,734)	\$ 719
Receivables, net	36	555	19	10	114	5,320		6,054
Inventories					170	1,621		1,791
Prepaid expenses and other current assets	15	254			6	1,412		1,687
Total current assets	41	850	19	1,847	376	8,852	(1,734)	10,251
Noncurrent inventories and film costs					267	3,211	12	3,490
Investments in amounts due to and from consolidated subsidiaries	159,387	2,635	174,094	135,182	34,071		(505,369)	
Investments, including available-for-sale securities		2,667	268	96	94	4,654	(893)	6,886
Property, plant and equipment	47	1,022	7		83	11,510		12,669
Intangible assets subject to amortization						7,289		7,289
Intangible assets not subject to amortization					641	37,067		37,708
Goodwill and other intangible assets	9,759	134			6,720	110,807		127,420
Other assets	97	380	69	47	83	2,115		2,791
Total assets	\$ 169,331	\$ 7,688	\$ 174,457	\$ 137,172	\$ 42,335	\$ 185,505	\$ (507,984)	\$ 208,504
LIABILITIES AND SHAREHOLDERS EQUITY								
Current liabilities								
Accounts payable	\$ 18	\$ 82	\$ 1	\$	\$ 16	\$ 2,149	\$	\$ 2,266
Participations payable						1,253		1,253
Royalties and programming costs payable						1,515		1,515
Deferred revenue		739			1	711		1,451
Debt due within one year						48		48
Other current liabilities	248	1,074	34	154	167	4,806	(40)	6,443
Total current liabilities	266	1,895	35	154	184	10,482	(40)	12,976
Long-term debt	5,697	1,488	2,066	6,040	791	8,445	(1,735)	22,792
Debt due to affiliates					1,647	158	(1,805)	
Deferred income taxes	11,231	(4,135)	15,366	13,285	2,162	15,458	(42,136)	11,231
Deferred revenue		64				984		1,048
Other liabilities	110	30	376		198	4,125		4,839
Minority interests						3,591		3,591
Shareholders equity								
Due (to) from AOL Time Warner and subsidiaries		907	10,685	4,928	(1,620)	(12,756)	(2,144)	
Other shareholders equity	152,027	7,439	145,929	112,765	38,973	155,018	(460,124)	152,027
Total shareholders equity	152,027	8,346	156,614	117,693	37,353	142,262	(462,268)	152,027
Total liabilities and shareholders equity	\$ 169,331	\$ 7,688	\$ 174,457	\$ 137,172	\$ 42,335	\$ 185,505	\$ (507,984)	\$ 208,504



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AOL TIME WARNER INC.
SUPPLEMENTARY INFORMATION
CONDENSED CONSOLIDATING FINANCIAL STATEMENTS (Continued)
(Unaudited)

Consolidating Statement of Cash Flows
For The Six Months Ended June 30, 2002
(Restated)

	<u>AOL Time Warner</u>	<u>America Online</u>	<u>Time Warner</u>	<u>TW Companies</u>	<u>TBS</u>	<u>Non-Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>AOL Time Warner Consolidated</u>
	(millions)							
OPERATIONS								
Net income (loss)	\$ (53,848)	\$ 99	\$ (53,768)	\$ (41,771)	\$ (11,917)	\$ (51,461)	\$ 158,818	\$ (53,848)
Adjustments for noncash and nonoperating items:								
Cumulative effect of accounting change	54,235		54,235	42,062	12,173	52,048	(160,518)	54,235
Depreciation and amortization	7	266	1		12	1,143		1,429
Amortization of film costs						1,067		1,067
Loss on write down of investments		145		103		704		952
Net gain on sale of investments		(35)				(59)		(94)
Excess (deficiency) of distributions over equity in pretax income of consolidated subsidiaries	(536)	152	(490)	(572)	(215)		1,661	
Change in investment in segment	2,459		3,132	2,529	308		(8,428)	
AOL Europe capitalization		(5,710)				5,710		
Equity in losses of investee companies after distributions		58		5		78		141
Changes in operating assets and liabilities, net of acquisitions	(708)	359	(331)	(717)	(125)	(947)	2,193	(276)
Adjustments for noncash and nonoperating items, and changes in operating assets and liabilities for discontinued operations						322		322
Cash provided (used) by operations	1,609	(4,666)	2,779	1,639	236	8,605	(6,274)	3,928
INVESTING ACTIVITIES								
Other investments and acquisitions		(75)				(5,753)		(5,828)
Investments in available-for-sale securities						(4)		(4)
Change in investment in segment	(6,381)		(4)	53			6,332	
Capital expenditures and product development costs from continuing operations		(217)			(20)	(1,117)		(1,354)
Capital expenditures from discontinued operations						(169)		(169)
Change in due to/from parent						(3)	3	
Other investment proceeds		5				146		151
Investment proceeds from available-for-sale securities.		70						70

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Cash provided (used) by investing activities	(6,381)	(217)	(4)	53	(20)	(6,900)	6,335	(7,134)
FINANCING ACTIVITIES								
Borrowings	8,676	20	3,100			2,296	(686)	13,406
Debt repayments	(2,959)		(3,700)			(3,501)	1,180	(8,980)
Change in due to/from parent		4,854	(2,178)	(2,229)	(286)	(103)	(58)	
Redemption of mandatorily redeemable preferred securities of subsidiary						(255)		(255)
Proceeds from exercise of stock option and dividend reimbursement plans	215							215
Repurchases of common stock	(102)							(102)
Dividends paid and partnership distributions from discontinued operations						(47)		(47)
Principal payments on capital leases		(17)						(17)
Change in investment in segment			3				(3)	
Other	6							6
Cash provided (used) by financing activities	5,836	4,857	(2,775)	(2,229)	(286)	(1,610)	433	4,226
INCREASE (DECREASE) IN CASH AND EQUIVALENTS								
	1,064	(26)		(537)	(70)	95	494	1,020
CASH AND EQUIVALENTS AT BEGINNING OF PERIOD								
	(10)	41		1,837	86	499	(1,734)	719
CASH AND EQUIVALENTS AT END OF PERIOD								
	\$ 1,054	\$ 15	\$	\$ 1,300	\$ 16	\$ 594	\$ (1,240)	\$ 1,739

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AOL TIME WARNER INC.
SUPPLEMENTARY INFORMATION
CONDENSED CONSOLIDATING FINANCIAL STATEMENTS (Continued)
(Unaudited)

Consolidating Statement of Cash Flows
For The Six Months Ended June 30, 2001
(Restated)

	AOL Time Warner	America Online	Time Warner	TW Companies	TBS	Subsidiaries	Non Guarantor Eliminations	AOL Time Warner Consolidated
	(millions)							
OPERATIONS								
Net income (loss)	\$ (2,106)	\$ 333	\$ (2,296)	\$ (1,772)	\$ (501)	\$ (1,806)	\$ 6,042	\$ (2,106)
Adjustments for noncash and nonoperating items:								
Depreciation and amortization	174	164	1		151	3,870		4,360
Amortization of film costs						1,066		1,066
Loss on write down of investments		624				50		674
Gain on sale of investments		(33)						(33)
Excess (deficiency) of distributions over equity in pretax income of consolidated subsidiaries	(2,633)	(4,456)	(3,331)	7,213	891		2,316	
Equity in losses of other investee companies after distributions		11		30		543		584
Changes in operating assets and liabilities, net of acquisitions	6,218	4,127	(658)	(5,848)	(546)	(3,046)	(2,800)	(2,553)
Adjustments for noncash and nonoperating items, and changes in operating assets and liabilities for discontinued operations						271		271
Cash provided (used) by operations	1,653	770	(6,284)	(377)	(5)	948	5,558	2,263
INVESTING ACTIVITIES								
Acquisition of Time Warner Inc. cash and equivalents			(1)	198	40	453		690
Other investments and acquisitions		(145)				(902)		(1,047)
Investments in available-for-sale securities		(171)						(171)
Advances to parents and consolidated subsidiaries				(1,689)		3,774	(2,085)	
Capital expenditures and product development costs from continuing operations		(297)			(28)	(1,290)		(1,615)
Capital expenditures from discontinued operations						(213)		(213)
Other investment proceeds		1,607				80		1,687
Cash provided (used) by investing activities		994	(1)	(1,491)	12	1,902	(2,085)	(669)
FINANCING ACTIVITIES								
Borrowings	3,967		1,380			3,914	(3,016)	6,245
Debt repayments			(1,380)	(337)		(6,320)	203	(7,834)
Change in due to/from parent	(4,597)	(4,245)	6,289	5,252	26	749	(3,474)	
Redemption of mandatorily redeemable preferred securities of subsidiary						(575)		(575)

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Proceeds from exercise of stock option and dividend reimbursement plans	727							727
Repurchases of common stock	(1,376)							(1,376)
Dividends paid and partnership distributions from discontinued operations						(49)		(49)
Dividends paid and partnership distributions from continuing operations			(4)					(4)
Other	19							19
Cash provided (used) by financing activities	(1,260)	(4,245)	6,285	4,915	26	(2,281)	(6,287)	(2,847)
INCREASE (DECREASE) IN CASH AND EQUIVALENTS AT BEGINNING OF PERIOD	393	(2,481)		3,047	33	569	(2,814)	(1,253)
		2,530				80		2,610
CASH AND EQUIVALENTS AT END OF PERIOD	\$ 393	\$ 49		\$ 3,047	\$ 33	\$ 649	\$ (2,814)	\$ 1,357

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this amendment to be signed on its behalf by the undersigned thereunto duly authorized.

AOL TIME WARNER INC.
(Registrant)

Date: January 28, 2003

By:

/s/ WAYNE H. PACE

Wayne H. Pace
Executive Vice President
and Chief Financial Officer

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CERTIFICATIONS

I, Richard D. Parsons, certify that:

1. I have reviewed this amendment to the quarterly report on Form 10-Q/A of AOL Time Warner Inc.;
2. Based on my knowledge, this quarterly report, as amended, does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report, as amended; and
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, as amended, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report, as amended.

Date: January 28, 2003

/s/ RICHARD D. PARSONS

Name: Richard D. Parsons
Title: Chief Executive Officer

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I, Wayne H. Pace, certify that:

1. I have reviewed this amendment to the quarterly report on Form 10-Q/A of AOL Time Warner Inc.;
2. Based on my knowledge, this quarterly report, as amended, does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report, as amended; and
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, as amended, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report, as amended.

Date: January 28, 2003

/s/ WAYNE H. PACE

Name: Wayne H. Pace
Title: Chief Financial Officer

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Exhibit Index

<u>Exhibit Number</u>	<u>Description</u>	<u>Sequential Page Number</u>
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.	