

Chapter 5

Using The Accounting Framework: America Online Inc.

AOL's 1996 & 1997 Balance Sheets

page 95

Total Assets 1996	\$ 959 million
Total Assets 1997	<u>\$ 847 million</u>
Change in Total Assets	\$(112 million)

What are the possible reasons for the change in total assets?

- Without examining the liability section of the balance sheet, one might have guessed they used assets to pay off some of their liabilities.
- Large operating loss
- Used cash to pay a dividend or repurchase stock

Potential Reasons For Decline in Total Assets

Total Liabilities 1996	\$446 million
Total Liabilities 1997	<u>\$719 million</u>
Change in Liabilities	\$273 million

Since liabilities increased by \$273, we can rule out that AOL used assets to pay off some of their liabilities.

Total Equity 1996	\$ 513 million
Total Equity 1997	<u>\$ 128 million</u>
Change in Equity	\$(385 million)

Since equity decreased, it is probably because AOL had a net operating loss for the period.

Explanation for Changes In Shareholders' Equity

Although retained earnings decreased by \$499 million, common stock and additional-paid-in capital increased by \$98 million. This is because AOL issued additional shares of stock.

What was the Net income for the period ? _____
Dividends paid to its investors ? _____

Analysis of the Income Statement

Total Revenue 1996	\$ 1,100 billion
Total Revenue 1997	<u>\$ 1,700 billion</u>
Change in Revenue	\$ 600 million

This indicates AOL generated a significant amount of new business during the year.

- » the income statement does not provide any detail as to whether the new revenue was generated through new subscribers or advertising revenue.
- » That is usually found in management's letter to the shareholders.

Analysis of the Income Statement Expenses

\$ million	
Cost of revenues	\$1,041
Marketing	\$ 409
General & administrative	\$ 194
Write-off of deferred subscriber acquisition cost	\$ 385

All of these expenses are normal expenses incurred by most businesses except for the write-off of deferred subscriber acquisition costs.

Subscriber Acquisition Costs - Footnotes 2 and 3

Explains that these cost are attributable to marketing programs that result in subscriber registrations which have a future benefit that exceeds the current year. Thus, these expenditures are recorded as an asset and amortized monthly over a period less than 24 months.

- » Due to change in business model, AOL changed to a flat-rate pricing and reduced reliance on online subscriber revenues.
- » This change in the future stream of revenue created uncertainty as to whether these expenditures created an asset (i.e., produced a future benefit)
- » After 10/1/96 these costs were expensed as incurred - no longer recorded as assets. Thus, the asset must be written off.

Information from the Cash Flow Statement

AOL's cash flow statement shows that:

- Cash flow from operations was a **positive** \$123 million.
- Cash flow from financing activities provided cash of \$79 million. Note this is consistent with our earlier analysis of stockholders' equity.
- Investing activities used cash of \$197 million. This is to be expected from a growing company.
- Overall increase in cash, \$6 million.

How could AOL's income statement show such a large loss, yet have a positive cash flow?

Articulation of Financial Statements Using AOL

	Accumulated Deficit (Retained Earnings)
Balance 6/30/96 From balance sheet	7,767
1997 loss from income statement	499,347
Balance 6/30/97 From balance sheet	507,114

How Does A Company Write Off An Asset ?

AOL must remove the asset from its books and debit the expense, deferred subscriber acquisition expense and credit the asset, deferred subscriber acquisition cost. Footnote 3 indicates that AOL wrote off \$385 million for the year.

Deferred subscriber acquisition expense	385	
Deferred subscriber acquisition cost		385

Explanation of Increase in Cash Flow

\$385, the write-off (expense) of the in deferred subscriber acquisition costs,
 \$59 of current subscriber acquisition costs
 \$22 noncash restructuring charges, and
 \$64 million of depreciation and amortization are all

non- cash expenses that are added back to net income.

The income statement reported \$530 million dollars in expenses that did not require the outlay of cash!

Deferred Subscriber Acquisition Costs

- » Beginning balance
- » The Statement of Cash Flows indicates that an additional \$130,229 cash was spent on these costs between 7/1/96 and 9/30/96
- » The Statement of Cash Flows indicates that amortization of these costs between 7/1/96 and 9/30/96 was \$56,189. AOL estimated that \$56,189 of the asset expired over this time period

1 Balance 6/30/96	314,181	
2 Deferred SA Costs Spent	130,229	
3 Amortization of SA Costs		\$59,189
4 Written off		385,221
Balance 6/30/97	_____	