

Financial Accounting Tools That Will Be Used

Chapter 5

Using The Accounting Framework: America Online Inc.

- Content of the financial statements
- Relationships (Articulation) among the financial statements
- Information disclosed in footnotes to the financial statements
- Debits, credits and T-accounts



AOL's Revenue Sources

AOL's revenues generated by fees paid
by subscribers and advertising revenues

AOL's 1996 & 1997 Balance Sheets

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

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



Potential Reasons For A Decline 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 A Decline in Total Assets

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

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



Potential Reasons For A Decline in Total Assets

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.



Articulation of the Balance Sheet with the Income Statement

Recall that the net income for the period flows into the statement of retained earnings. Therefore, it should not be surprising to see that the loss on the income statement is \$499 million. This would also tell us that AOL did not pay any dividends 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. However, 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

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

All of these expenses are normal expenses incurred by most business expenses except for the write-off of deferred subscriber acquisition costs. Let's examine that expense.




Subscriber Acquisition Costs - Footnote #2

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



Subscriber Acquisition Costs - Footnote #3

- 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. 

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	385,221,000
Deferred subscriber acquisition cost	385,221,000



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?



Information from the Cash Flow Statement

- Operating cash flows, **positive** \$123 million
- Investing activities used cash of \$197 million - this is to be expected from a growing company
- Financing activities provided cash of \$79 million - from issuance of new stock
- Overall increase in cash, \$6 million.

How could a large loss have caused no cash flow problem?



Explanation of Increase in Cash Flow

The write-off (expense) of the \$385 million in deferred subscriber acquisition costs, current subscriber acquisition costs of \$59 million, \$22 noncash restructuring charges, and \$64 million of depreciation and amortization are all non-cash expenses that are added back to net income. It is a noncash expense. Therefore, the income statement reported \$530 million dollars in expenses that did not require the outlay of cash!



The Articulation of Financial Statements Using AOL

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



Analysis of Deferred Subscriber Acquisition Costs

Deferred Subscriber Acquisition Costs	
Balance 6/30/96 →	314,181

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.



Analysis of Deferred Subscriber Acquisition Costs

Deferred Subscriber Acquisition Costs	
314,181	
130,229	

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.



Analysis of Deferred Subscriber Acquisition Costs

Deferred Subscriber Acquisition Costs	
314,181	56,189
130,229	
Balance 9/30/96 →	385,221

It was this 385,221 that was "written off" as an expense on 10/1/96



Analysis of Deferred Subscriber Acquisition Costs

Deferred Subscriber Acquisition Costs	
314,181	56,189
130,229	
385,221	
	385,221 ← Write-off on 10/1/96

It was this 385,221 that was "written off" as an expense on 10/1/96



Analysis of Deferred Subscriber Acquisition Costs

Deferred Subscriber Acquisition Costs	
314,181	56,189
130,229	
385,221	
	385,221
Balance 6/30/97 →	0

