

TIME WARNER INC.
1999 FINANCIALS

Keyword:

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**TIME WARNER INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

Description of Business

Time Warner Inc. ("Time Warner" or the "Company") is the world's leading media and entertainment company. Time Warner's principal business objective is to create and distribute branded information and entertainment copyrights throughout the world. Time Warner classifies its business interests into six fundamental areas: *Cable Networks*, consisting principally of interests in cable television programming; *Publishing*, consisting principally of interests in magazine publishing, book publishing and direct marketing; *Music*, consisting principally of interests in recorded music and music publishing; *Filmed Entertainment*, consisting principally of interests in filmed entertainment, television production and television broadcasting; *Cable*, consisting principally of interests in cable television systems; and *Digital Media*, consisting principally of interests in Internet-related and digital media businesses.

Strategic Overview

Time Warner had a strong financial performance in 1999, as measured by the operating performance of its businesses and the improved strength of its financial condition, as more fully described herein. This performance was driven primarily by solid business fundamentals at most of its businesses and a disciplined financial focus on cost management and controlled capital spending. This financial performance enabled Time Warner to use its increasing free cash flow and financial capacity to repurchase close to \$2 billion of common stock in 1999, while continuing to invest in the growth of its businesses.

Moreover, in early 2000, consistent with its ongoing strategy to focus on growth opportunities across its businesses, Time Warner announced two transactions of high strategic importance. These transactions consist of:

- A proposed merger with America Online, Inc. ("America Online"), the world's leader in interactive services, web brands, Internet technologies and electronic commerce services; and
- A proposed merger of the global operations of Time Warner's Music division and EMI Group plc ("EMI"), a leading recorded music company and music publisher.

Each of these transactions is discussed separately below.

America Online-Time Warner Merger

In January 2000, Time Warner and America Online announced that they had entered into an agreement to merge (the "Merger") by forming a new holding company named AOL Time Warner Inc. ("AOL Time Warner"). The Merger will create a leading, fully integrated media and communications company that will combine Time Warner's collection of media, entertainment and news brands and its technologically advanced cable infrastructure with America Online's extensive Internet franchises and technology. Management believes that the combined company will be well positioned to expand the use of the Internet in consumers' everyday lives and, accordingly, provide Time Warner's content businesses with increased access to consumers through a new and growing distribution medium. Management further believes that the Merger will result in significant new business and other value-creation opportunities, including additional opportunities for e-commerce, growth in subscribers for each company's products and services, and cost and operating efficiencies from cross-promotional and other opportunities.

As part of the Merger, each issued and outstanding share of each class of common stock of Time Warner will be converted into 1.5 shares of an identical series of common stock of AOL Time Warner. In addition, each issued and outstanding share of each class of preferred stock of Time Warner will be converted into one share of preferred stock of AOL Time Warner, which will have substantially identical terms except that such shares will be convertible into approximately 6.25 shares of AOL Time Warner common stock. Lastly, each issued and outstanding share of common stock of America Online will be converted into one share of common stock of AOL Time Warner.

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As a result of the Merger, the former shareholders of America Online will have an approximate 55% interest in AOL Time Warner and the former shareholders of Time Warner will have an approximate 45% interest in the combined entity, expressed on a fully diluted basis. The Merger is expected to be accounted for by AOL Time Warner as an acquisition of Time Warner under the purchase method of accounting for business combinations.

The Merger is expected to close in the fall of 2000 and is subject to customary closing conditions, including the approval of the shareholders of each of America Online and Time Warner and all necessary regulatory approvals. There can be no assurance that such approvals will be obtained.

Warner-EMI Music Merger

In January 2000, Time Warner and EMI announced they had entered into an agreement to combine their global music operations into two jointly owned ventures, to be referred to collectively as Warner EMI Music. Time Warner will control the joint ventures through majority board representation, among other factors, and is expected to account for the transaction under the purchase method of accounting.

The joint ventures will combine the domestic strength of Time Warner's Music division with the international strength of EMI's music operations. Management believes that this complementary strategic fit will better position the combined company to capitalize on incremental growth opportunities relating to online sales of music product, the digital distribution of music and the continuing globalization of the music industry. In addition, management believes that the combination will result in significant cost savings and operating efficiencies, including economies of scale in manufacturing and distribution, consolidation of duplicative functions and shared investment costs in new media and technology. Management expects these synergies to approximate \$400 million annually by the end of the third year following the closing of the transaction. In order to realize these synergies, management expects that the joint ventures will incur up to \$700 million of one-time costs.

As part of the transaction, each company will contribute its music operations to the joint ventures, subject to a comparable amount of debt. As of December 31, 1999, EMI had approximately \$1.5 billion of net debt. EMI shareholders also will receive an aggregate, special cash dividend of approximately \$1.3 billion. This dividend is expected to be financed through a combination of proceeds from debt incurred or assumed by the joint ventures and consideration to be paid by Time Warner directly to EMI for a new class of EMI equity securities. The new class of EMI equity securities to be held by Time Warner will convert automatically into an 8% common equity interest in EMI, on a fully diluted basis, if EMI's share price reaches £9 for a short period of time within the first three-and-a-half years after closing.

The transaction is expected to close by the end of 2000, subject to customary closing conditions, including regulatory approvals and the approval of EMI's shareholders. There can be no assurance that such approvals will be obtained.

Other Investments and Transactions

Investment in TWE

A majority of Time Warner's interests in filmed entertainment, television production, television broadcasting and cable television systems, and a portion of its interests in cable television programming and digital media, are held through Time Warner Entertainment Company, L.P. ("TWE"). Time Warner owns 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. The remaining 25.51% limited partnership interests in the Series A Capital and Residual Capital of TWE are held by a subsidiary of MediaOne Group, Inc. ("MediaOne").

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Since 1993, Time Warner historically had not consolidated TWE and certain related companies (the "Entertainment Group") for financial reporting purposes because MediaOne had rights that allowed it to participate in the management of TWE's businesses. However, in August 1999, TWE received a notice from MediaOne concerning the termination of its covenant not to compete with TWE. The termination of that covenant is necessary for MediaOne to complete its proposed merger with AT&T Corp. ("AT&T"). As a result of the termination notice and the operation of the TWE partnership agreement, MediaOne's rights to participate in the management of TWE's businesses terminated immediately and irrevocably. MediaOne retains only certain protective governance rights pertaining to certain limited matters affecting TWE as a whole. Because of this significant reduction in MediaOne's rights, Time Warner has consolidated the Entertainment Group, which substantially consists of TWE, in its 1999 financial statements, retroactive to the beginning of 1999.

Book-of-the-Month Club-Doubleday Merger

In the first quarter of 2000, Time Warner formed a jointly owned book club venture with Bertelsmann AG ("Bertelsmann"). The venture combined the domestic operations of Time Warner's Book-of-the-Month Club with the domestic book club operations of Doubleday Direct, Inc. ("Doubleday"), a leading consumer book club group owned by Bertelsmann. The venture does not include Time Warner's book club operations in the United Kingdom and Canada, which were sold directly to Bertelsmann. In connection with this transaction, Time Warner will deconsolidate its domestic book club operations in 2000 and account for its interest in the joint venture under the equity method of accounting.

The transaction combines two of the largest direct-marketing book club operators in the United States. Management believes that the combination will result in considerable cost savings and operating efficiencies, including cross-promotional opportunities, consolidation of duplicative functions and cost advantages through economies of scale. Moreover, management believes that the use of the joint venture's eight million-plus existing club members will foster the development of new incremental growth opportunities relating to online sales of books.

Columbia House-CDNOW Merger

In July 1999, Time Warner announced an agreement with Sony Corporation of America ("Sony") to merge their jointly owned music and video club operations of Columbia House Company Partnerships ("Columbia House") with CDnow, Inc. ("CDNOW"), a music and video e-commerce company. Since that time, the parties had been pursuing the receipt of regulatory approvals. While awaiting these approvals, the March 13th termination date in the merger agreement was reached, and the parties recently terminated the agreement. Accordingly, the merger will not occur.

In lieu of the merger, Time Warner and Sony each committed \$25.5 million of funding to CDNOW to help support the future growth of its business. Each company's funding will be in the form of a \$10.5 million equity investment and a \$15 million long-term convertible debt interest.

Time Warner will continue to evaluate strategic alternatives for Columbia House's operations. Those alternatives are focused primarily on ways to improve Columbia House's declining operating performance, including online initiatives, joint ventures and other strategic actions. In connection with some of these alternatives, Time Warner may be required to record a significant, noncash charge to reduce the carrying value of its interest in Columbia House.

Digital Media Investment Fund

In late 1999, Time Warner announced the formation of a \$500 million venture capital fund (the "Digital Media Fund") to identify and invest in new Internet-related and digital media businesses. The Digital Media

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Fund is comprised of \$250 million of cash and \$250 million of advertising and promotion across Time Warner's various content offerings. Digital Media Fund investments are expected to focus on non-controlling equity stakes in companies engaged in e-commerce, vertical and interactive content, technology, infrastructure and other digital media-related activities.

Use of EBITA

Time Warner evaluates operating performance based on several factors, including its primary financial measure of operating income before noncash amortization of intangible assets ("EBITA"). Consistent with management's financial focus on controlling capital spending, EBITA measures operating performance after charges for depreciation. In addition, EBITA eliminates the uneven effect across all business segments of considerable amounts of noncash amortization of intangible assets recognized in business combinations accounted for by the purchase method. These business combinations include the \$14 billion acquisition of Warner Communications Inc. in 1989, the \$6.2 billion acquisition of Turner Broadcasting System, Inc. ("TBS") in 1996 and the \$2.3 billion of cable acquisitions in 1996 and 1995, which created over \$25 billion of intangible assets that generally are being amortized over a twenty to forty year period. The exclusion of noncash amortization charges is also consistent with management's belief that Time Warner's intangible assets, such as cable television and sports franchises, music catalogues and copyrights, film and television libraries and the goodwill associated with its brands, generally are increasing in value and importance to Time Warner's business objective of creating, extending and distributing recognizable brands and copyrights throughout the world. As such, the following comparative discussion of the results of operations of Time Warner includes, among other factors, an analysis of changes in business segment EBITA. However, EBITA should be considered in addition to, not as a substitute for, operating income, net income and other measures of financial performance reported in accordance with generally accepted accounting principles.

Cost Savings

Since 1997, Time Warner has been engaged in a company-wide cost management program. The program's purpose is to control costs by identifying more efficient ways of conducting its businesses. During 1999, Time Warner realized approximately \$300 million of incremental cost savings, thereby increasing the aggregate cost reductions under this program to approximately \$900 million annually.

As part of these cost savings initiatives, Time Warner implemented some changes to its pension plans in 1999. As a result of these changes, and when taken together with other changes in actuarial assumptions that include a 100 basis point increase in pension discount rates, Time Warner expects to reduce its pension expense by approximately \$60 million in 2000.

Transactions Affecting Comparability of Results of Operations and Financial Condition

Consolidation of the Entertainment Group

As previously described, Time Warner's 1999 operating results and financial condition reflect the consolidation of the Entertainment Group, which substantially consists of TWE, retroactive to the beginning of 1999. Time Warner's 1998 and 1997 historical operating results and financial condition have not been changed, but are no longer comparable to 1999 because the Entertainment Group was reflected on an unconsolidated basis using the equity method of accounting. Accordingly, in order to enhance comparability and make an analysis of 1999 more meaningful, the following discussion of results of operations and changes in financial condition and liquidity is based upon pro forma financial information for 1998 as if the consolidation of the Entertainment Group had occurred at the beginning of that period.

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Other Significant Transactions and Nonrecurring Items

As more fully described herein, the comparability of Time Warner's operating results has been affected by certain other significant transactions and nonrecurring items in each period.

For 1999, the significant, nonrecurring items included (i) net pretax gains of approximately \$2.247 billion relating to the sale or exchange of cable television systems and investments, (ii) an approximate \$115 million pretax gain recognized in connection with the initial public offering of a 20% interest in Time Warner Telecom Inc. (the "Time Warner Telecom IPO"), an integrated communications provider that provides telephony services to businesses, (iii) an approximate \$215 million net pretax gain recognized in connection with the early termination and settlement of a long-term home video distribution agreement, (iv) an approximate \$97 million pretax gain recognized in connection with the sale of an interest in CanalSatellite, a satellite television platform servicing France and Monaco, (v) a one-time, noncash pretax charge of approximately \$106 million relating to Warner Bros.'s retail stores and (vi) an extraordinary loss of \$12 million relating to the retirement of debt.

For 1998, the significant, nonrecurring items included (i) net pretax gains of approximately \$108 million recognized by Time Warner and TWE relating to the sale or exchange of various cable television systems and investments, (ii) a pretax charge of approximately \$210 million principally to reduce TWE's carrying value of its investment in Primestar, Inc. ("Primestar") and (iii) an increase of \$234 million in Time Warner's 1998 preferred dividend requirements relating to the premium paid in connection with its redemption of Series M exchangeable preferred stock ("Series M Preferred Stock").

For 1997, the significant, nonrecurring items included (i) net pretax gains of approximately \$212 million recognized by Time Warner and TWE relating to the sale or exchange of various cable television systems, (ii) a pretax gain of approximately \$250 million relating to TWE's sale of its interest in E! Entertainment Television, Inc. ("E! Entertainment"), (iii) a pretax gain of \$200 million relating to Time Warner's disposal of its interest in Hasbro, Inc. ("Hasbro") and (iv) an extraordinary loss of \$55 million on the retirement of debt.

In order to meaningfully assess underlying operating trends, management believes that the results of operations for each period should be analyzed after excluding the effects of these significant nonrecurring items. As such, the following discussion and analysis focuses on amounts and trends adjusted to exclude the impact of these unusual items. However, unusual items may occur in any period. Accordingly, investors and other financial statement users individually should consider the types of events and transactions for which adjustments have been made.

In addition to the above significant and nonrecurring items, the comparability of Time Warner's Cable division results has been affected further by certain 1998 cable-related transactions, as described more fully in Note 2 to the accompanying consolidated financial statements. While these transactions had a significant effect on the comparability of the Cable division's EBITA and operating income, principally due to the deconsolidation of the related operations, they did not have a significant effect on the comparability of Time Warner's net income and per share results.

1998 Stock Split

Per common share and average common share amounts give effect to a two-for-one common stock split that occurred on December 15, 1998.

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RESULTS OF OPERATIONS

1999 vs. 1998

As a result of the consolidation of the Entertainment Group in 1999, and in accordance with Financial Accounting Standards Board Statement No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("FAS 131"), Time Warner restated its 1998 historical segment presentation to reflect the combination of Time Warner's and the Entertainment Group's business segments. EBITA and operating income are as follows:

	Years Ended December 31,			
	EBITA		Operating Income	
	1999	1998	1999	1998
	(millions)			
Cable Networks	\$1,397	\$1,160	\$1,192	\$ 960
Publishing	679	607	627	569
Music	452	493	179	213
Filmed Entertainment ^(a)	997	695	796	479
Broadcasting—The WB Network	(92)	(93)	(96)	(96)
Cable ^(b)	3,927	1,694	3,364	1,101
Digital Media	(17)	—	(17)	—
Intersegment elimination	(10)	(94)	(10)	(94)
Total	<u>\$7,333</u>	<u>\$4,462</u>	<u>\$6,035</u>	<u>\$3,132</u>
Entertainment Group EBITA and operating income reported on an unconsolidated basis ^(c)	—	(2,166)	—	(1,636)
Total reported consolidated EBITA and operating income	<u>\$7,333</u>	<u>\$2,296</u>	<u>\$6,035</u>	<u>\$1,496</u>

(a) 1999 results include a net pretax gain of approximately \$215 million recognized in connection with the early termination and settlement of a long-term, home video distribution agreement and a pretax gain of \$97 million relating to the sale of an interest in CanalSatellite, offset in part by a one-time, noncash pretax charge of \$106 million relating to Warner Bros.'s retail stores.

(b) The comparability of the Cable division's operating results has been affected by certain 1998 cable-related transactions in addition to net pretax gains related to the sale or exchange of certain cable television systems and investments of approximately \$2.247 billion in 1999 and \$108 million in 1998.

(c) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

Consolidated Results

Time Warner had revenues of \$27.333 billion, income of \$1.960 billion before an extraordinary loss on the retirement of debt and net income of \$1.948 billion in 1999, compared to revenues of \$26.244 billion on a pro forma basis (\$14.582 billion on a historical basis) and net income of \$168 million in 1998. After preferred dividend requirements, Time Warner had basic income per common share before the extraordinary item of \$1.51 in 1999, and \$1.50 after, compared to a net loss of \$.31 per common share in 1998. On a diluted basis, income per common share before the extraordinary item was \$1.43 in 1999, and \$1.42 after, compared to a net loss of \$.31 per common share in 1998.

As previously described, in addition to the consolidation of the Entertainment Group retroactive to the beginning of 1999, the comparability of Time Warner's operating results for 1999 and 1998 has been further affected by certain significant, nonrecurring items recognized in each period. These nonrecurring items consisted of approximately \$2.568 billion of net pretax gains in 1999, compared to \$102 million of net pretax losses in 1998. In addition, net income in 1999 included an extraordinary loss on the retirement of debt of \$12 million.

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Preferred dividend requirements in 1998 also included a \$234 million one-time increase relating to the premium paid in connection with Time Warner's redemption of its Series M Preferred Stock. The aggregate net effect of these items was an increase in basic net income per common share of \$1.11 in 1999, compared to a decrease of \$.25 per common share in 1998. On a diluted basis, the aggregate net effect of these items was an increase in basic net income per common share of \$1.03 in 1999, compared to a decrease of \$.25 per common share in 1998.

Time Warner's net income increased to \$1.948 billion in 1999, compared to \$168 million in 1998. However, excluding the significant effect of the nonrecurring items referred to earlier, net income increased by \$312 million to \$548 million in 1999 from \$236 million in 1998. As discussed more fully below, this improvement principally resulted from an overall increase in Time Warner's business segment operating income, offset in part by higher losses from certain investments accounted for under the equity method of accounting, higher interest expense principally in connection with borrowings used to redeem Time Warner's Series M Preferred Stock in December 1998 and higher income taxes due to the increase in Time Warner's income. Similarly, normalized basic and diluted net income per common share, excluding the effect of significant nonrecurring items, increased to \$.39, compared to a normalized net loss of \$.06 per common share in 1998. In addition to the factors discussed above, the improvement in 1999 normalized per share results reflects a \$254 million reduction in preferred dividend requirements principally relating to the redemption of Series M Preferred Stock in late 1998.

The relationship between income before income taxes and income tax expense of Time Warner is principally affected by the amortization of goodwill and certain other financial statement expenses that are not deductible for income tax purposes. Income tax expense of Time Warner includes all income taxes related to its allocable share of partnership income and its equity in the income tax expense of corporate subsidiaries of the Entertainment Group.

Business Segment Results

Cable Networks. Revenues increased to \$6.111 billion in 1999, compared to \$5.377 billion in 1998. EBITA increased to \$1.397 billion in 1999 from \$1.160 billion in 1998. Operating income increased to \$1.192 billion in 1999 from \$960 million in 1998. Revenues grew due to increases at the Turner cable networks group and HBO. For the Turner cable networks group, revenues benefited from increases in advertising and subscription revenues, offset in part by the absence of revenues from the Goodwill Games sponsored in the summer of 1998. The increase in advertising revenues was principally due to a strong overall advertising market for most of the group's networks, including CNN, TBS Superstation, TNT and Cartoon Network. The increase in subscription revenues was principally due to an increase in subscriptions and higher rates, primarily led by revenue increases at CNN, TBS Superstation, TNT and Turner Classic Movies. For HBO, revenues benefited primarily from an increase in subscriptions to 35.7 million from 34.6 million at the end of 1998.

Likewise, EBITA and operating income were higher due to increases at the Turner cable networks group and HBO. For the Turner cable networks group, the increase in EBITA and operating income was principally due to the revenue gains, offset in part by higher programming costs and start-up costs for two new entertainment networks. For HBO, the increase in EBITA and operating income was principally due to the revenue gains, increased cost savings, and higher income from Comedy Central, a 50%-owned equity investee.

Publishing. Revenues increased to \$4.663 billion in 1999, compared to \$4.496 billion in 1998. EBITA increased to \$679 million in 1999 from \$607 million in 1998. Operating income increased to \$627 million in 1999 from \$569 million in 1998. Revenues in 1999 were affected negatively by the deconsolidation of a direct-marketing operation, which is now being accounted for under the equity method of accounting. Notwithstanding this change, revenues increased primarily from significant, across-the-board growth in magazine advertising revenues, primarily led by *In Style*, *People*, *Fortune* and *Time*. Magazine circulation revenues also increased

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principally as a result of higher subscription and newsstand revenues, led by *Time* and *Teen People*, offset in part by higher commissions paid on subscriptions sold by third-party agencies. EBITA and operating income increased principally as a result of the revenue gains and increased cost savings. These increases were offset in part by start-up costs for new magazine launches and lower results from direct-marketing activities, including Book-of-the-Month Club and American Family Enterprises, a 50%-owned equity investee. In addition, EBITA and operating income for each period included some small one-time gains on the sale of assets that, in the aggregate, were comparable in amount and, therefore, did not have any significant effect on operating trends.

Music. Revenues decreased to \$3.834 billion in 1999, compared to \$4.025 billion in 1998. EBITA decreased to \$452 million in 1999 from \$493 million in 1998. Operating income decreased to \$179 million in 1999 from \$213 million in 1998. Revenues decreased primarily due to lower domestic and international recorded music sales, as well as declines in music publishing operations. The worldwide revenue decline principally related to less popular releases in comparison to the prior year, as well as industry-wide softness in various international markets, such as Brazil and Japan. EBITA and operating income decreased principally as a result of the decline in worldwide revenues and lower results from Columbia House, a 50%-owned equity investee, offset in part by increased cost savings, lower artist royalty costs and higher income from DVD manufacturing operations. Management expects that the revenue decline relating to lower worldwide sales levels will continue into the first quarter of 2000, which could continue to affect operating results negatively.

Filmed Entertainment. Revenues increased to \$8.075 billion in 1999, compared to \$7.978 billion in 1998. EBITA increased to \$997 million in 1999 from \$695 million in 1998. Operating income increased to \$796 million in 1999 from \$479 million in 1998. Revenues grew due to increases at Warner Bros., offset in part by revenue declines at the Turner filmed entertainment businesses, which include New Line Cinema, Castle Rock Entertainment and certain film and television libraries managed by Warner Bros. For Warner Bros., revenues benefited from increases in worldwide theatrical, home video and television distribution operations, offset in part by lower revenues from consumer products operations. The increase in worldwide home video revenues primarily resulted from increased sales of DVDs. For the Turner filmed entertainment businesses, revenues decreased principally as a result of the absence in 1999 of significant syndication revenues from the sale of second-cycle broadcasting rights for *Seinfeld* in 1998, and fewer theatrical releases in 1999.

EBITA and operating income were higher due to increases at Warner Bros. and the Turner filmed entertainment businesses. For Warner Bros., the operating results in 1999 were affected by various significant, nonrecurring items, including an approximate \$215 million net pretax gain recognized in connection with the early termination and settlement of a long-term, home video distribution agreement, a pretax gain of \$97 million recognized in connection with the sale of an interest in CanalSatellite and a one-time, noncash pretax charge of \$106 million relating to Warner Bros.'s retail stores. Excluding the effect of these significant nonrecurring items, Warner Bros.'s EBITA and operating income increased principally as a result of improved results from worldwide theatrical, home video and domestic television syndication operations. These improvements were offset in part by lower results from consumer products operations and lower net gains on the sale of other assets. For the Turner filmed entertainment businesses, EBITA and operating income increased principally due to the absence of film write-offs relating to disappointing results for theatrical releases of Castle Rock Entertainment in 1998, offset in part by lower results from television distribution operations relating to the absence in 1999 of significant syndication sales of broadcasting rights for *Seinfeld* in 1998.

The decline in Warner Bros.'s consumer products operations relates, in part, to its retail stores. In the fourth quarter of 1999, Warner Bros. adopted a plan designed to improve the performance of its retail stores. The plan is expected to be executed largely over a three-year period and involves closing certain underperforming stores, transforming other stores into smaller and more efficient stores and exploiting potential e-commerce opportunities. As a result of this plan, Warner Bros. recorded a noncash, pretax charge of \$106 million to reduce the carrying value of certain fixed assets and leasehold improvements used in its retail stores. The charge

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represented the excess of the carrying value of those assets over the discounted future operating cash flows, adjusted to reflect a shorter recovery period due to planned store closures.

Broadcasting-The WB Network. Revenues increased to \$384 million in 1999, compared to \$260 million in 1998. EBITA improved to a loss of \$92 million in 1999 from a loss of \$93 million in 1998. Operating losses of \$96 million were the same in both 1999 and in 1998. Revenues increased principally as a result of one additional night of weekly prime-time programming in comparison to the prior year and advertising rate increases, offset in part by lower prime-time television ratings. Prime-time television ratings were, and are expected to continue to be, negatively affected by lower household delivery associated with the WGN Superstation discontinuing its carriage of The WB Network's programming beginning in the fall of 1999. The marginal EBITA loss improvement and flat operating losses principally resulted from the fact that significant revenue increases were offset by the combination of higher programming costs associated with the expanded programming schedule and higher start-up costs associated with The WB Network 100+ station group, a distribution alliance for The WB Network in smaller markets.

Cable. Revenues increased to \$5.374 billion in 1999, compared to \$5.342 billion in 1998. EBITA increased to \$3.927 billion in 1999 from \$1.694 billion in 1998. Operating income increased to \$3.364 billion in 1999 from \$1.101 billion in 1998. These operating results were affected by certain cable-related transactions that occurred in 1998 (the "1998 Cable Transactions") and by net pretax gains of \$2.247 billion recognized in 1999 and \$108 million in 1998 related to the sale or exchange of various cable television systems and investments. The 1998 Cable Transactions principally resulted in the deconsolidation of certain operations and are described more fully in Note 2 to the accompanying consolidated financial statements. Excluding the effect of the 1998 Cable Transactions, revenues increased due to growth in basic cable subscribers, increases in basic cable rates, increases in advertising and pay-per-view revenues and an increase in revenues from providing Road Runner-branded, high-speed online services. Similarly, excluding the effect of the 1998 Cable Transactions and the one-time gains, EBITA and operating income increased principally as a result of the revenue increases, offset in part by higher programming costs.

As of December 31, 1999 and 1998, there were 12.6 million subscribers under the management of Time Warner's Cable division.

Digital Media. Digital Media operating results reflect start-up costs associated with Time Warner's digital media businesses, including the November 1999 launch of Entertainment, Time Warner's entertainment Web destination. Digital Media had \$17 million of operating losses on \$1 million of revenues during 1999. Due to the start-up nature of these businesses, losses are expected to continue.

Interest and Other, Net. Interest and other, net, decreased to \$1.897 billion of expense in 1999, compared to \$2.050 billion of expense on a pro forma basis in 1998. Interest expense increased to \$1.519 billion in 1999, compared to \$1.451 billion on a pro forma basis in 1998. Interest expense increased principally because of higher interest costs incurred in connection with the \$2.1 billion of borrowings used to redeem the Company's Series M Preferred Stock in December 1998, offset in part by interest savings associated with the Company's 1998 debt reduction efforts. Other expense, net, decreased to \$378 million in 1999, compared to \$599 million on a pro forma basis in 1998. The decrease principally related to the recognition of an approximate \$115 million pretax gain in 1999 in connection with the Time Warner Telecom IPO and the absence of an approximate \$210 million pretax charge recorded in 1998 to reduce the carrying value of an interest in Primestar, offset in part by higher losses in 1999 from certain investments accounted for under the equity method of accounting.

Minority Interest. Minority interest expense increased to \$475 million in 1999, compared to \$338 million on a pro forma basis in 1998. Minority interest expense increased primarily due to the allocation of a portion of the higher net pretax gains in 1999 relating to the sale or exchange of various cable television systems and investments owned by the TWE-Advance/Newhouse Partnership ("TWE-A/N") to the minority owners of that partnership. Excluding the significant effect of the gains recognized in each period, minority interest expense

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decreased slightly in 1999 principally due to a higher allocation of losses to a minority partner in The WB Network.

1998 vs. 1997

As a result of the consolidation of the Entertainment Group in 1999, and in accordance with FAS 131, Time Warner restated its historical segment presentation to reflect the combination of Time Warner's and the Entertainment Group's business segments. EBITA and operating income are as follows:

	Years Ended December 31,			
	EBITA		Operating Income	
	1998	1997	1998	1997
	(millions)			
Cable Networks	\$1,160	\$ 964	\$ 960	\$ 765
Publishing	607	529	569	481
Music	493	467	213	166
Filmed Entertainment	695	604	479	389
Broadcasting-The WB Network	(93)	(88)	(96)	(88)
Cable ^(a)	1,694	1,611	1,101	1,011
Intersegment elimination	(94)	(54)	(94)	(54)
Total	<u>\$4,462</u>	<u>\$4,033</u>	<u>\$3,132</u>	<u>\$2,670</u>
Entertainment Group EBITA and operating income reported on an unconsolidated basis ^(b)	<u>(2,166)</u>	<u>(1,850)</u>	<u>(1,636)</u>	<u>(1,399)</u>
Total reported consolidated EBITA and operating income	<u>\$2,296</u>	<u>\$2,183</u>	<u>\$1,496</u>	<u>\$1,271</u>

(a) The comparability of the Cable division's operating results has been affected by certain 1998 cable-related transactions in addition to net pretax gains of approximately \$108 million in 1998 and \$212 million in 1997 related to the sale or exchange of certain cable television systems.

(b) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

Consolidated Results

Time Warner had revenues of \$14.582 billion and net income of \$168 million in 1998, compared to revenues of \$13.294 billion, income of \$301 million before an extraordinary loss on the retirement of debt and net income of \$246 million in 1997. Time Warner's equity in the pretax income of the Entertainment Group was \$356 million in 1998, compared to \$686 million in 1997. After preferred dividend requirements, Time Warner had basic and diluted loss per common share of \$.31 in 1998, compared to a loss of \$.01 per common share before the extraordinary item in 1997, and \$.06 per common share after.

As previously described, the comparability of Time Warner's and the Entertainment Group's operating results for 1998 and 1997 has been affected by certain significant, nonrecurring items recognized in each period. These nonrecurring items amounted to \$102 million of net pretax losses in 1998, compared to approximately \$660 million of net pretax gains in 1997. In addition, preferred dividend requirements for 1998 included a \$234 million one-time increase relating to the premium paid in connection with Time Warner's redemption of its Series M Preferred Stock. Lastly, 1997 included a \$55 million extraordinary loss on the retirement of debt. The aggregate net effect of these significant, nonrecurring items was a decrease in income per common share of \$.25 in 1998, compared to an increase in income per common share of \$.27 in 1997.

Time Warner's net income decreased to \$168 million in 1998, compared to net income of \$246 million in 1997. However, excluding the significant effect of the nonrecurring items referred to above, net income

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increased by \$300 million to \$236 million in 1998, compared to a net loss of \$64 million in 1997. As discussed more fully below, this improvement principally resulted from an overall increase in Time Warner's business segment operating income, an increase in income from its equity in the pretax income of the Entertainment Group and lower interest expense associated with Time Warner's debt reduction efforts and certain cable system transfers in 1998 (the "TWE-A/N Transfers"), offset in part by higher losses from certain investments accounted for under the equity method of accounting and lower gains on foreign exchange contracts. The TWE-A/N Transfers are described more fully in Note 2 to the accompanying financial statements. Similarly, normalized net loss per common share, excluding the effect of significant nonrecurring items, was \$.06 in 1998, compared to a normalized net loss per common share of \$.33 in 1997.

The Entertainment Group had revenues of \$12.256 billion and net income of \$331 million in 1998, compared to revenues of \$11.328 billion, income of \$642 million before an extraordinary loss on the retirement of debt and net income of \$619 million in 1997. Similarly, excluding the portion of the nonrecurring items referred to above that was recognized by the Entertainment Group, net income increased by \$229 million to \$465 million in 1998, compared to \$236 million in 1997. As discussed more fully below, this improvement principally resulted from an overall increase in the Entertainment Group's business segment operating income (including the positive effect of the TWE-A/N Transfers), offset in part by an increase in interest expense associated with the TWE-A/N Transfers and higher losses from certain investments accounted for under the equity method of accounting.

The relationship between income before income taxes and income tax expense of Time Warner is principally affected by the amortization of goodwill and certain other financial statement expenses that are not deductible for income tax purposes. Income tax expense of Time Warner includes all income taxes related to its allocable share of partnership income and its equity in the income tax expense of corporate subsidiaries of the Entertainment Group.

Business Segment Results

Cable Networks. Revenues increased to \$5.377 billion in 1998, compared to \$4.823 billion in 1997. EBITA increased to \$1.160 billion in 1998 from \$964 million in 1997. Operating income increased to \$960 million in 1998 from \$765 million in 1997. Revenues grew due to increases at the Turner cable networks group and HBO. For the Turner cable networks group, revenues benefited from an increase in subscription and advertising revenues. The increase in subscription revenues principally related to the conversion of TBS Superstation from an advertiser-supported broadcast superstation to a copyright-paid, cable television service, which allows TBS Superstation to charge cable operators for the right to carry its cable television programming. Subscription revenues also increased as a result of an increase in subscriptions, primarily at CNN, CNN International, TNT/Cartoon Europe and Turner Classic Movies, and higher rates. The increase in advertising revenues was principally due to a strong overall advertising market for most of the division's networks, including TNT, Cartoon Network, TNT/Cartoon Europe, CNN and CNN Headline News. For HBO, revenues benefited primarily from an increase in subscriptions to 34.6 million from 33.6 million at the end of 1997.

Likewise, EBITA and operating income were higher due to increases at the Turner cable networks group and HBO. For the Turner cable networks group, the increase in EBITA and operating income was principally due to the revenue gains and lower programming costs at TNT, offset in part by higher programming costs at CNN and losses associated with the Goodwill Games. For HBO, EBITA and operating income improved principally as a result of the revenue gains and, to a lesser extent, cost savings and higher income from Comedy Central.

Publishing. Revenues increased to \$4.496 billion in 1998, compared to \$4.290 billion in 1997. EBITA increased to \$607 million in 1998 from \$529 million in 1997. Operating income increased to \$569 million in 1998 from \$481 million in 1997. Revenues benefited primarily from significant increases in magazine

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advertising revenues, as well as increases in magazine circulation revenues. The increase in advertising revenues was principally due to a strong overall advertising market for most of the division's magazines, primarily led by *People*, *Time*, *Entertainment Weekly*, *Fortune* and *In Style*. The increase in circulation revenues was principally due to higher subscription and newsstand revenues, primarily led by the same magazines. EBITA and operating income increased principally as a result of the revenue gains, cost savings and one-time gains on the sale of certain assets, offset in part by lower results from direct-marketing operations.

Music. Revenues increased to \$4.025 billion in 1998, compared to \$3.691 billion in 1997. EBITA increased to \$493 million in 1998 from \$467 million in 1997. Operating income increased to \$213 million in 1998 from \$166 million in 1997. Revenues benefited from an increase in domestic and international recorded music sales principally relating to higher compact disc sales of a broad range of popular releases from new and established artists and movie soundtracks, as well as lower returns of product. EBITA and operating income increased principally as a result of the revenue gains and cost savings, offset in part by lower results from direct-marketing operations, higher artist costs and the absence of certain one-time gains recognized in 1997.

Filmed Entertainment. Revenues increased to \$7.978 billion in 1998, compared to \$7.003 billion in 1997. EBITA increased to \$695 million in 1998 from \$604 million in 1997. Operating income increased to \$479 million in 1998 from \$389 million in 1997. Revenues grew due to increases at Warner Bros. and the Turner filmed entertainment business. For Warner Bros., revenues benefited from a significant increase in licensing fees from television production and distribution operations, principally relating to the initial off-network domestic syndication availability of *Friends* and the initial off-network basic cable availability of *ER*, as well as an increase in revenues from consumer products licensing operations. For the Turner filmed entertainment businesses, revenues benefited from a significant increase in syndication sales resulting from the renewal by existing television station customers of second-cycle broadcasting rights for *Seinfeld*, as well as an increase in worldwide theatrical and home video revenues at New Line Cinema.

Likewise, EBITA and operating income increased due to increases at Warner Bros., offset in part by decreases at the Turner filmed entertainment businesses, principally as a result of film write-offs relating to disappointing results for theatrical releases of Castle Rock Entertainment in the first half of 1998. For Warner Bros., EBITA and operating income benefited principally from the revenue gains and cost savings, offset in part by lower international syndication sales of library product and lower results from theatrical releases. In addition, EBITA and operating income for each period included certain one-time gains on the sale of assets that were comparable in amount and therefore, did not have any significant effect on operating trends.

Broadcasting-The WB Network. Revenues increased to \$260 million in 1998, compared to \$136 million in 1997. EBITA decreased to a loss of \$93 million in 1998 from a loss of \$88 million in 1997. Operating losses increased to \$96 million in 1998 from \$88 million in 1997. Revenues increased as a result of higher advertising sales relating to improved television ratings and the addition of a fourth night of prime-time programming in January 1998 and a fifth night in September 1998. Despite the revenue increase, operating losses increased because of a lower allocation of losses to a minority partner in the network. However, excluding this minority interest effect, operating losses improved principally as a result of the revenue gains, which outweighed higher programming costs associated with the expanded programming schedule.

Cable. Revenues increased to \$5.342 billion in 1998, compared to \$5.240 billion in 1997. EBITA increased to \$1.694 billion in 1998 from \$1.611 billion in 1997. Operating income increased to \$1.101 billion in 1998 from \$1.011 billion in 1997. These operating results were affected by the 1998 Cable Transactions and by net pretax gains of \$108 million recognized in 1998 and \$212 million in 1997 related to the sale or exchange of various cable television systems and investments. Excluding the effect of the 1998 Cable Transactions, revenues increased principally as a result of an increase in basic cable subscribers, increases in regulated cable rates and an increase in advertising revenues. Similarly, excluding the effect of the 1998 Cable Transactions and the one-time gains, EBITA and operating income increased principally as a result of the revenue gains, offset in part by higher depreciation related to capital spending.

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Interest and Other, Net. The following is a discussion of interest and other, net, included in the consolidated results of Time Warner and the unconsolidated results of the Entertainment Group.

Interest and other, net, at Time Warner increased to \$1.128 billion of expense in 1998, compared to \$973 million of expense in 1997. Interest expense decreased to \$891 million in 1998, compared to \$1.049 billion in 1997, principally due to lower average debt levels associated with the Company's debt reduction efforts and the TWE-A/N Transfers. There was other expense, net, of \$237 million in 1998 compared to other income, net of \$76 million in 1997, primarily due to lower investment-related income, as well as lower gains on foreign exchange contracts and higher losses associated with the Company's asset securitization program. The significant decrease in investment-related income principally resulted from the absence of a \$200 million pretax gain recognized in 1997 in connection with the disposal of Time Warner's interest in Hasbro and higher losses in 1998 from certain investments accounted for under the equity method of accounting.

Interest and other, net, at the Entertainment Group increased to \$945 million of expense in 1998, compared to \$338 million of expense in 1997. Interest expense increased to \$566 million in 1998, compared to \$494 million in 1997, principally due to higher average debt levels associated with the TWE-A/N Transfers. There was other expense, net, of \$379 million in 1998, compared to other income, net, of \$156 million in 1997, primarily due to lower investment-related income, as well as higher losses associated with TWE's asset securitization program. The significant decrease in investment-related income principally resulted from the absence of an approximate \$250 million pretax gain recognized in 1997 in connection with the sale of an interest in E! Entertainment, the inclusion of an approximate \$210 million charge recorded in 1998 principally to reduce the carrying value of an interest in Primestar and higher losses in 1998 from certain investments accounted for under the equity method of accounting.

Minority Interest. Minority interest, recognized by the Entertainment Group on an unconsolidated basis, decreased to \$284 million in 1998, compared to \$324 million in 1997. Minority interest expense decreased primarily due to the allocation of a portion of the higher net pretax gains in 1997 relating to the sale or exchange of various cable television systems owned by TWE-A/N to the minority owners of that partnership. Excluding the effect of the gains recognized in each period, minority interest expense for 1998 and 1997 was comparable in amount and did not have any significant effect on operating trends.

FINANCIAL CONDITION AND LIQUIDITY

December 31, 1999

1999 Financial Condition

At December 31, 1999, Time Warner had \$18.1 billion of debt, \$1.3 billion of available cash and equivalents (net debt of \$16.8 billion), \$1.2 billion of borrowings against future stock option proceeds, \$575 million of mandatorily redeemable preferred securities of a subsidiary and \$9.7 billion of shareholders' equity, compared to \$17.5 billion of debt, \$529 million of available cash and equivalents (net debt of \$17.0 billion), \$895 million of borrowings against future stock option proceeds, \$792 million of mandatorily redeemable preferred securities of subsidiaries, and \$8.9 billion of shareholders' equity on a pro forma basis at December 31, 1998.

Debt Refinancings

In 1999, Time Warner Companies, Inc., a wholly owned subsidiary of Time Warner, redeemed all of its \$600 million principal amount of Floating Rate Reset Notes due July 29, 2009. The aggregate redemption cost of approximately \$620 million was funded with borrowings under Time Warner's bank credit agreement. In connection with this redemption, an extraordinary loss of \$12 million was recognized in the third quarter of 1999.

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Redemption of REIT Preferred Stock

In March 1999, a subsidiary of TWE (the "REIT") redeemed all of its shares of preferred stock ("REIT Preferred Stock") at an aggregate cost of \$217 million, which approximated net book value. The redemption was funded with borrowings under TWE's bank credit agreement.

Preferred Stock Conversions

During 1999 and January 2000, Time Warner issued approximately 71.4 million shares of common stock in connection with the conversion of approximately 17.2 million shares of convertible preferred stock. Because holders of preferred stock are entitled to cash dividends at a preferential rate prior to conversion, Time Warner's 1999 cash dividend requirements will be reduced in 2000 by approximately \$26 million. After giving effect to those conversions, there were approximately 5.4 million shares of preferred stock outstanding that are convertible into approximately 22.7 million shares of Time Warner common stock.

Common Stock Repurchase Program

In January 1999, Time Warner's Board of Directors authorized a new common stock repurchase program that allows the Company to repurchase, from time to time, up to \$5 billion of common stock. This program was expected to be completed over a three-year period. However, in connection with Time Warner's agreement to merge with America Online, Time Warner currently has suspended its stock repurchase program.

During 1999, Time Warner acquired 28.4 million shares of its common stock at an aggregate cost of \$1.896 billion. These repurchases increased the cumulative shares purchased under this and its previous common stock repurchase program begun in 1996 to approximately 123.5 million shares at an aggregate cost of \$4.936 billion, or approximately \$40 per share.

Cash Flows

During 1999, Time Warner's cash provided by operations amounted to \$3.953 billion and reflected \$7.333 billion of business segment EBITA, \$1.231 billion of noncash depreciation expense, \$213 million of proceeds from Time Warner's asset securitization program, less \$2.247 billion of net pretax gains on the sale or exchange of cable television systems and investments, \$1.406 billion of interest payments, \$377 million of income taxes, \$163 million of corporate expenses and \$631 million related to an increase in working capital requirements, other balance sheet accounts and noncash items. Cash provided by operations on a pro forma basis in 1998 of \$3.408 billion reflected \$4.462 billion of business segment EBITA, \$1.305 billion of noncash depreciation expense, \$183 million of proceeds from Time Warner's asset securitization program, less \$108 million of net pretax gains on the sale or exchange of cable television systems, \$1.343 billion of interest payments, \$300 million of income taxes, \$158 million of corporate expenses and \$633 million related to an increase in working capital requirements, other balance sheet accounts and noncash items.

Cash used by investing activities was \$1.930 billion in 1999, compared to \$908 million on a pro forma basis in 1998, principally as a result of higher capital expenditures, an increase in cash used for investment and acquisitions and a decrease in investment proceeds. Investment proceeds decreased largely relating to the 1998 sale of TWE's remaining interest in Six Flags Entertainment Corporation and the receipt of approximately \$650 million of proceeds in 1998 upon the formation of a cable joint venture in Texas, offset in part by the receipt of approximately \$280 million of net proceeds in 1999 in connection with an exchange of cable television systems. Capital expenditures increased to \$2.231 billion in 1999, compared to \$2.115 billion on a pro forma basis in 1998.

Cash used by financing activities was \$1.181 billion in 1999, compared to \$2.938 billion on a pro forma basis in 1998. The use of cash in 1999 principally resulted from the repurchase of approximately 28.4 million

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shares of Time Warner common stock at an aggregate cost of \$1.896 billion, the redemption of REIT Preferred Stock at an aggregate cost of \$217 million and the payment of \$289 million of dividends, offset in part by a \$583 million increase in net borrowings, \$421 million of proceeds received from the exercise of employee stock options and \$348 million of borrowings against future stock option proceeds. During 1998, Time Warner issued approximately \$2.1 billion of debt and used the proceeds therefrom to redeem its Series M Preferred Stock. Dividends paid in 1999 were \$235 million lower than in 1998, reflecting the effect of Time Warner's redemption of its Series M Preferred Stock in December 1998.

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

Management believes that Time Warner's operating cash flow, cash and equivalents and additional borrowing capacity are sufficient to fund its capital and liquidity needs for the foreseeable future without distributions and loans from TWE above those permitted by existing agreements.

Cable Capital Spending

Time Warner Cable has been engaged in a plan to upgrade the technological capability and reliability of its cable television systems and develop new services, which it believes will position the business for sustained, long-term growth. Capital spending by Time Warner Cable amounted to \$1.600 billion in 1999, compared to \$1.676 billion in 1998. Cable capital spending for 2000 is budgeted to be approximately \$2 billion, reflecting higher spending on variable capital to facilitate a more aggressive roll-out of Time Warner Cable's popular digital cable and Road Runner-branded high-speed online service. Capital spending by Time Warner Cable is expected to continue to be funded by cable operating cash flow. In exchange for certain flexibility in establishing cable rate pricing structures for regulated services and consistent with Time Warner Cable's long-term strategic plan, Time Warner Cable agreed with the Federal Communications Commission (the "FCC") in 1996 to invest a total of \$4 billion in capital costs in connection with the upgrade of its cable infrastructure. The agreement with the FCC covers all of the cable operations of Time Warner Cable, including the owned or managed cable television systems of TWE, TWE-A/N and Time Warner. As of December 31, 1999, Time Warner Cable had approximately \$250 million remaining under this commitment. Management expects to satisfy this commitment by December 31, 2000 when Time Warner Cable's technological upgrade of its cable television systems is scheduled to be completed.

Off-Balance Sheet Assets

As discussed below, Time Warner believes that the value of certain off-balance sheet assets should be considered, along with other factors discussed elsewhere herein, in evaluating the Company's financial condition and prospects for future results of operations, including its ability to fund its capital and liquidity needs.

Intangible Assets

As a creator and distributor of branded information and entertainment copyrights, Time Warner has a significant amount of internally generated intangible assets whose value is not fully reflected in the consolidated balance sheet. Such intangible assets extend across Time Warner's principal business interests, but are best exemplified by Time Warner's collection of copyrighted music product, its libraries of copyrighted film and television product and the creation or extension of brands. Generally accepted accounting principles do not recognize the value of such assets, except at the time they may be acquired in a business combination accounted for by the purchase method of accounting.

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Because Time Warner normally owns the copyrights to such creative material, it continually generates revenue through the sale of such products across different media and in new and existing markets. The value of film and television-related copyrighted product and trademarks is continually realized by the licensing of films and television series to secondary markets and the licensing of trademarks, such as the *Looney Tunes* characters and *Batman*, to the retail industry and other markets. In addition, technological advances, such as the introduction of the compact disc and home videocassette in the 1980's and the current exploitation of DVDs, have historically generated significant revenue opportunities through the repackaging and sale of such copyrighted products in the new technological format. Accordingly, such intangible assets have significant off-balance sheet asset value that is not fully reflected in the consolidated balance sheet of Time Warner.

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 Time Warner's filmed entertainment companies amounted to \$3.595 billion at December 31, 1999, compared to \$2.934 billion on a pro forma basis at December 31, 1998 (including amounts relating to the licensing of film product to Time Warner's cable television networks of \$1.176 billion at December 31, 1999 and \$995 million at December 31, 1998).

Because backlog generally relates to contracts for the licensing of theatrical and television product which have already been produced, the recognition of revenue for such completed product is principally only dependent upon the commencement of the availability period for telecast under the terms of the related licensing agreement. Cash licensing fees are collected periodically over the term of the related licensing agreements or on an accelerated basis using a \$500 million securitization facility. The portion of backlog for which cash has not already been received has significant off-balance sheet asset value as a source of future funding. As of December 31, 1999, including cash received under the securitization facility and other advanced payments, approximately \$700 million of cash licensing fees had been collected against the backlog. The backlog excludes advertising barter contracts, which are also expected to result in the future realization of revenues and cash through the sale of advertising spots received under such contracts.

Interest Rate and Foreign Currency Risk Management

Interest Rate Swap Contracts

Time Warner uses interest rate swap contracts to adjust the proportion of total debt that is subject to variable and fixed interest rates. At December 31, 1999, Time Warner had interest rate swap contracts to pay floating-rates of interest (average six-month LIBOR rate of 5.8%) and receive fixed-rates of interest (average rate of 5.5%) on \$400 million notional amount of indebtedness, which resulted in approximately 34% of Time Warner's underlying debt being subject to variable interest rates. At December 31, 1998, Time Warner had interest rate swap contracts on \$1.6 billion notional amount of indebtedness.

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Based on Time Warner's variable-rate obligations and related interest rate swap contracts outstanding at December 31, 1999, each 25 basis point increase or decrease in the level of interest rates would, respectively, increase or decrease Time Warner's annual interest expense and related cash payments by approximately \$19 million, including \$1 million related to interest rate swap contracts. Such potential increases or decreases are based on certain simplifying assumptions, including a constant level of variable-rate debt and related interest rate swap contracts during the period and, for all maturities, an immediate, across-the-board increase or decrease in the level of interest rates with no other subsequent changes for the remainder of the period.

Foreign Exchange Contracts

Time Warner uses foreign exchange contracts primarily to hedge the risk that unremitted or future royalties and license fees owed to Time Warner domestic companies for the sale or anticipated sale of U.S. copyrighted products abroad may be adversely affected by changes in foreign currency exchange rates. As part of its overall strategy to manage the level of exposure to the risk of foreign currency exchange rate fluctuations, Time Warner hedges a portion of its foreign currency exposures anticipated over the ensuing twelve month period. At December 31, 1999, Time Warner had effectively hedged approximately half of the estimated foreign currency exposures that principally relate to anticipated cash flows to be remitted to the U.S. over the ensuing twelve month period. To hedge this exposure, Time Warner used foreign exchange contracts that generally have maturities of three months or less, which generally will be rolled over to provide continuing coverage throughout the year. Time Warner often closes foreign exchange sale contracts by purchasing an offsetting purchase contract. At December 31, 1999, Time Warner had contracts for the sale of \$843 million and the purchase of \$468 million of foreign currencies at fixed rates, compared to contracts for the sale of \$755 million and the purchase of \$259 million of foreign currencies at December 31, 1998.

Based on the foreign exchange contracts outstanding at December 31, 1999, each 5% devaluation of the U.S. dollar as compared to the level of foreign exchange rates for currencies under contract at December 31, 1999 would result in approximately \$42 million of unrealized losses and \$23 million of unrealized gains on foreign exchange contracts involving foreign currency sales and purchases, respectively. Conversely, a 5% appreciation of the U.S. dollar would result in \$42 million of unrealized gains and \$23 million of unrealized losses, respectively. Consistent with the nature of the economic hedge provided by such foreign exchange contracts, such unrealized gains or losses largely would be offset by corresponding decreases or increases, respectively, in the dollar value of future foreign currency royalty and license fee payments that would be received in cash within the ensuing twelve month period from the sale of U.S. copyrighted products abroad.

Euro Conversion

Effective January 1, 1999, the "euro" was established as a single currency valid in more than two-thirds of the member countries of the European Union. These member countries have a three-year transitional period to physically convert their sovereign currencies to the euro. By July 1, 2002, all participating member countries must eliminate their currencies and replace their legal tender with euro-denominated bills and coins. Notwithstanding this transitional period, many commercial transactions are expected to become euro-denominated well before the July 2002 deadline. Accordingly, Time Warner continues to evaluate the short-term and long-term effects of the euro conversion on its European operations, principally publishing, music, cable networks and filmed entertainment.

Time Warner believes that the most significant short-term impact of the euro conversion is the need to modify its accounting and information systems to handle an increasing volume of transactions during the transitional period in both the euro and sovereign currencies of the participating member countries. Time Warner has identified its accounting and information systems in need of modification and an action plan has been formulated to address the nature and timing of remediation efforts. Remediation efforts have begun and the plan is expected to be substantially completed well before the end of the transitional period. This timetable will be

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adjusted, if necessary, to meet the anticipated needs of Time Warner's vendors and customers. Based on preliminary information, costs to modify its accounting and information systems have not been, and are not expected to be, material.

Time Warner believes that the most significant long-term business risk of the euro conversion may be increased pricing pressures for its products and services brought about by heightened consumer awareness of possible cross-border price differences. However, Time Warner believes that these business risks may be offset to some extent by lower material costs, other cost savings and marketing opportunities. Notwithstanding such risks, management does not believe that the euro conversion will have a material effect on Time Warner's financial position, results of operations or cash flows in future periods.

Year 2000 Technology Preparedness

Time Warner, like most large companies, depends on many different computer systems and other chip-based devices for the continuing conduct of its business. The Company took various precautions related to the fact that many older computer programs, computer hardware and chip-based devices might have failed to recognize dates beginning on January 1, 2000 as being valid dates, and as a result might have failed to operate or might have operated improperly as such dates were introduced.

During 1999, the Company completed its efforts to minimize the risk of disruption related to Year 2000 issues. This program was described in the Company reports filed with the Securities and Exchange Commission (the "SEC"). To date, the Company has experienced few problems related to Year 2000 compliance, and the problems that have been identified have been addressed. The Company is not aware of any remaining significant problems related to Year 2000 issues but is continuing to monitor the status of suppliers, vendors and other entities with which it does business.

Through the end of 1999, the Company, as a whole, incurred approximately \$150 million related to its Year 2000 remediation program, which started in 1996. These expenditures were funded from the Company's operating cash flow. The Company anticipates that its remediation program, and related expenditures, may continue into 2001 as temporary solutions to Year 2000 problems are replaced with upgraded equipment. Future expenditures are not expected to be significant.

Caution Concerning Forward-Looking Statements

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, together with management's public commentary related thereto, contains such "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, particularly statements anticipating future growth in revenues, EBITA and cash flow. Words such as "anticipate," "estimate," "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 management's present expectations of 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.

Time Warner operates in highly competitive, consumer driven and rapidly changing media and entertainment businesses that are dependent on government regulation and economic, political and social conditions in the countries in which they operate, consumer demand for their products and services, technological developments and (particularly in view of technological changes) protection of their intellectual property rights. Time Warner's actual results could differ materially from management's expectations because of changes in such factors. Some of the other factors that also could cause actual results to differ from those

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contained in the forward-looking statements include those identified in Time Warner's other filings with the SEC and:

- For 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" or common carrier requirements); increased difficulty in obtaining franchise renewals; the failure of new equipment (such as digital set-top boxes) or services (such as digital cable and high-speed on-line services or telephony over cable or video on demand) to function properly, to appeal to enough consumers or to be available at reasonable prices and to be delivered in a timely fashion; and greater than expected increases in programming or other costs.
- For Time Warner's cable programming and television 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 advertising to economic cyclicalities; 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 Time Warner's film and television businesses, their ability to continue to attract and select desirable talent and scripts at manageable costs; increases in production costs generally; 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; and the uncertain impact of technological developments such as DVD and the Internet.
- For Time Warner's music business, its ability to continue to attract and select desirable talent at manageable costs; the timely completion of albums by major artists; the popular demand for particular artists and albums; its ability to continue to enforce and capitalize on its intellectual property rights in digital environments; its ability to complete its proposed transaction with EMI and integrate the businesses successfully; and the overall strength of global music sales.
- For Time Warner's print media and publishing businesses, increases in paper, postal and distribution costs; the introduction and increased popularity of alternative technologies for the provision of news and information, such as the Internet; and fluctuations in advertiser and consumer spending.
- For Time Warner's digital media businesses, their ability to locate and invest in profitable businesses, to develop products and services that are attractive, accessible and commercially viable in terms of content, technology and cost; their ability to manage costs and generate revenues; aggressive competition from existing and developing technologies and products; the resolution of issues concerning commercial activities via the Internet, including security, reliability, cost, ease of use and access; and the possibility of increased government regulation of new media services.
- The risks related to the Company's merger with America Online, including the failure of the Time Warner or America Online shareholders to approve the Merger; the risk that the Time Warner and America Online businesses will not be integrated successfully; the costs related to the Merger; the inability to obtain, or meet conditions imposed for, governmental approvals for the Merger; and other factors generally affecting the businesses of the combined company.

In addition, Time Warner's overall financial strategy, including growth in operations, maintaining its financial ratios and strengthened balance sheet, could be adversely affected by increased interest rates, failure to meet earnings expectations, significant acquisitions or other transactions, consequences of the euro conversion and changes in Time Warner's plans, strategies and intentions.

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

1999
Historical^(a) **1998**
Pro Forma^(a) **1998**
Historical^(a)

ASSETS

Current assets

Cash and equivalents	\$ 1,284	\$ 529	\$ 442
Receivables, less allowances of \$1.682, \$1.513 and \$1.007 billion	4,931	4,640	2,885
Inventories	2,182	2,258	946
Prepaid expenses	1,464	1,342	1,176
Total current assets	9,861	8,769	5,449
Noncurrent inventories	4,201	4,219	1,900
Investments in and amounts due to and from Entertainment Group	—	—	4,980
Other investments	2,096	1,665	794
Property, plant and equipment	8,728	8,037	1,991
Music catalogues, contracts and copyrights	782	876	876
Cable television and sports franchises	8,472	6,943	2,868
Goodwill	15,458	15,830	11,919
Other assets	1,641	1,612	863
Total assets	\$51,239	\$47,951	\$31,640

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities

Accounts payable	\$ 1,923	\$ 1,966	\$ 996
Participations, royalties and programming costs payable	2,967	2,714	1,199
Debt due within one year	22	25	19
Other current liabilities	4,758	4,365	2,404
Total current liabilities	9,670	9,070	4,618
Long-term debt	18,083	17,503	10,925
Borrowings against future stock option proceeds	1,243	895	895
Deferred income taxes	4,234	3,491	3,491
Unearned portion of paid subscriptions	762	741	741
Other liabilities	3,773	3,580	1,543
Minority interests	3,186	3,027	—
Mandatorily redeemable preferred securities of subsidiaries holding solely notes and debentures of subsidiaries of the Company	575	792	575

Shareholders' equity

Preferred stock, \$.10 par value, 8.4, 22.6 and 22.6 million shares outstanding, \$.840, \$2.260 and \$2.260 billion liquidation preference	1	2	2
Series LMCN-V common stock, \$.01 par value, 114.1 million shares outstanding	1	1	1
Common stock, \$.01 par value, 1.173, 1.118 and 1.118 billion shares outstanding	12	11	11
Paid-in capital	12,998	13,134	13,134
Accumulated deficit	(3,299)	(4,296)	(4,296)
Total shareholders' equity	9,713	8,852	8,852
Total liabilities and shareholders' equity	\$51,239	\$47,951	\$31,640

(a) The 1999 financial statements reflect the consolidation of the Entertainment Group, which substantially consists of TWE, retroactive to the beginning of 1999. Time Warner's historical financial statements for 1998 have not been changed; however, in order to enhance comparability, pro forma financial statements for 1998 reflecting the consolidation of the Entertainment Group are presented supplementally (Note 1).

See accompanying notes.

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

	<u>1999</u>	<u>1998</u>	<u>1998</u>	<u>1997</u>
	<u>Historical^(a)</u>	<u>Pro Forma^(a)</u>	<u>Historical^(a)</u>	<u>Historical^(a)</u>
Revenues ^(h)	\$ 27,333	\$ 26,244	\$14,582	\$13,294
Cost of revenues ^{(b)(c)}	(14,940)	(14,820)	(7,502)	(6,723)
Selling, general and administrative ^{(b)(c)}	(7,513)	(7,070)	(4,802)	(4,400)
Amortization of goodwill and other intangible assets	(1,298)	(1,330)	(800)	(912)
Gain on sale or exchange of cable systems and investments ^(b)	2,247	108	18	12
Gain on early termination of video distribution agreement	215	—	—	—
Gain on sale of interest in CanalSatellite	97	—	—	—
Write-down of retail store assets	(106)	—	—	—
Business segment operating income	6,035	3,132	1,496	1,271
Equity in pretax income of Entertainment Group ^(b)	—	—	356	686
Interest and other, net ^{(b)(d)}	(1,897)	(2,050)	(1,128)	(973)
Corporate expenses ^(b)	(163)	(158)	(86)	(81)
Minority interest	(475)	(338)	(52)	(71)
Income before income taxes	3,500	586	586	832
Income taxes	(1,540)	(418)	(418)	(531)
Income before extraordinary item	1,960	168	168	301
Extraordinary loss on retirement of debt, net of \$9 and \$37 million income tax benefit in 1999 and 1997, respectively	(12)	—	—	(55)
Net income	1,948	168	168	246
Preferred dividend requirements ^(e)	(52)	(540)	(540)	(319)
Net income (loss) applicable to common shares	<u>\$ 1,896</u>	<u>\$ (372)</u>	<u>\$ (372)</u>	<u>\$ (73)</u>
Income (loss) per common share before extraordinary item:				
Basic	<u>\$ 1.51</u>	<u>\$ (.31)</u>	<u>\$ (.31)</u>	<u>\$ (.01)</u>
Diluted	<u>\$ 1.43</u>	<u>\$ (.31)</u>	<u>\$ (.31)</u>	<u>\$ (.01)</u>
Net income (loss) per common share:				
Basic	<u>\$ 1.50</u>	<u>\$ (.31)</u>	<u>\$ (.31)</u>	<u>\$ (.06)</u>
Diluted	<u>\$ 1.42</u>	<u>\$ (.31)</u>	<u>\$ (.31)</u>	<u>\$ (.06)</u>
Average common shares:				
Basic	<u>1,267.0</u>	<u>1,194.7</u>	<u>1,194.7</u>	<u>1,135.4</u>
Diluted	<u>1,398.3</u>	<u>1,194.7</u>	<u>1,194.7</u>	<u>1,135.4</u>

(a) The 1999 financial statements reflect the consolidation of the Entertainment Group, which substantially consists of TWE, retroactive to the beginning of 1999. Time Warner's historical financial statements for prior periods have not been changed; however, in order to enhance comparability, pro forma financial statements for 1998 reflecting the consolidation of the Entertainment Group are presented supplementally (Note 1).

(b) Includes the following income (expenses) resulting from transactions with related companies and, on a historical basis for 1998 and 1997, the Entertainment Group:

Revenues	\$ 506	\$ 511	\$ 487	\$ 384
Cost of revenues	(207)	(154)	(318)	(245)
Selling, general and administrative	(29)	(23)	(40)	(53)
Gain (loss) on sale or exchange of cable systems and investments	427	(4)	(4)	—
Equity in pretax income of Entertainment Group	—	—	105	5
Interest and other, net	12	1	(9)	(36)
Corporate expenses	—	—	72	72

(c) Includes depreciation expense of:

	<u>\$ 1,231</u>	<u>\$ 1,305</u>	<u>\$ 378</u>	<u>\$ 382</u>
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(d) Includes an approximate \$115 million pretax gain recognized in the second quarter of 1999 in connection with the initial public offering of a 20% interest in Time Warner Telecom Inc.

(e) Preferred dividend requirements for 1998 include a one-time effect of \$234 million relating to the premium paid in connection with the redemption of the Company's 10¼% Series M exchangeable preferred stock ("Series M Preferred Stock"). See Note 11.

See accompanying notes.

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

	<u>1999</u> <u>Historical^(a)</u>	<u>1998</u> <u>Pro Forma^(a)</u>	<u>1998</u> <u>Historical^(a)</u>	<u>1997</u> <u>Historical^(a)</u>
OPERATIONS				
Net income	\$ 1,948	\$ 168	\$ 168	\$ 246
Adjustments for noncash and nonoperating items:				
Extraordinary loss on retirement of debt	12	—	—	55
Depreciation and amortization	2,529	2,635	1,178	1,294
Amortization of film costs	2,294	2,478	542	379
Noncash interest expense	4	30	30	98
Gain on sale or exchange of cable systems and investments	(2,247)	(108)	(18)	(12)
Excess (deficiency) of distributions over equity in pretax income of Entertainment Group	—	—	342	(207)
Equity in losses of other investee companies after distributions	344	267	147	36
Changes in operating assets and liabilities:				
Receivables	(349)	(940)	(597)	(167)
Inventories	(2,321)	(2,962)	(854)	(463)
Accounts payable and other liabilities	1,690	1,500	810	501
Other balance sheet changes	49	340	97	(352)
Cash provided by operations	<u>3,953</u>	<u>3,408</u>	<u>1,845</u>	<u>1,408</u>
INVESTING ACTIVITIES				
Consolidation of the Entertainment Group's cash and equivalents	87	—	—	—
Investments and acquisitions	(870)	(548)	(159)	(113)
Capital expenditures	(2,231)	(2,115)	(512)	(574)
Investment proceeds	1,084	1,755	569	187
Proceeds received from distribution of TWE Senior Capital	—	—	455	455
Cash provided (used) by investing activities	<u>(1,930)</u>	<u>(908)</u>	<u>353</u>	<u>(45)</u>
FINANCING ACTIVITIES				
Borrowings	4,332	5,257	3,743	5,413
Debt repayments	(3,749)	(4,215)	(2,317)	(6,394)
Borrowings against future stock option proceeds	348	1,015	1,015	230
Repayments of borrowings against future stock option proceeds	—	(653)	(653)	(185)
Redemption of mandatorily redeemable preferred securities of subsidiary	(217)	—	—	—
Repurchases of Time Warner common stock	(1,896)	(2,240)	(2,240)	(344)
Redemption of Series M Preferred Stock	—	(2,093)	(2,093)	—
Dividends paid	(289)	(524)	(524)	(338)
Proceeds received from stock option and dividend reinvestment plans ..	421	740	740	454
Other	(131)	(225)	(72)	(68)
Cash used by financing activities	<u>(1,181)</u>	<u>(2,938)</u>	<u>(2,401)</u>	<u>(1,232)</u>
INCREASE (DECREASE) IN CASH AND EQUIVALENTS	842	(438)	(203)	131
CASH AND EQUIVALENTS AT BEGINNING OF PERIOD	442	967	645	514
CASH AND EQUIVALENTS AT END OF PERIOD	<u>\$ 1,284</u>	<u>\$ 529</u>	<u>\$ 442</u>	<u>\$ 645</u>

(a) The 1999 financial statements reflect the consolidation of the Entertainment Group, which substantially consists of TWE, retroactive to the beginning of 1999. Time Warner's historical financial statements for prior periods have not been changed; however, in order to enhance comparability, pro forma financial statements for 1998 reflecting the consolidation of the Entertainment Group are presented supplementally (Note 1).

See accompanying notes.

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

	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Paid-In Capital</u>	<u>Accumulated Deficit</u>	<u>Total</u>
BALANCE AT DECEMBER 31, 1996	\$ 4	\$11	\$12,245	\$(2,758)	\$9,502
Net income				246	246
Foreign currency translation adjustments				(76)	(76)
Unrealized losses on securities, net of \$89 million tax benefit ^(a)				(128)	(128)
Comprehensive income				42	42
Common stock dividends				(204)	(204)
Preferred stock dividends				(319)	(319)
Issuance of common stock in connection with the TBS acquisition			67		67
Repurchases of Time Warner common stock			(344)		(344)
Shares issued pursuant to stock option, dividend reinvestment and benefit plans			711	(98)	613
Other	—	—	(4)	3	(1)
BALANCE AT DECEMBER 31, 1997	4	11	12,675	(3,334)	9,356
Net income				168	168
Foreign currency translation adjustments				4	4
Realized and unrealized losses on derivative financial instruments, net of \$13 million tax benefit				(20)	(20)
Cumulative effect of change in accounting for derivative financial instruments, net of \$3 million tax benefit				(18)	(18)
Comprehensive income				134	134
Common stock dividends				(216)	(216)
Preferred stock dividends				(540)	(540)
Issuance of common stock in connection with the conversion of zero- coupon convertible notes due 2013			1,150		1,150
Issuance of common stock in connection with the conversion of convertible preferred stock	(2)	1	151	(150)	—
Repurchases of Time Warner common stock		(1)	(2,239)		(2,240)
Shares issued pursuant to stock option, dividend reinvestment and benefit plans	—	1	1,397	(190)	1,208
BALANCE AT DECEMBER 31, 1998	2	12	13,134	(4,296)	8,852
Net income				1,948	1,948
Foreign currency translation adjustments				(63)	(63)
Unrealized gains on securities, net of \$147 million tax provision				221	221
Realized and unrealized gains on derivative financial instruments, net of \$6 million tax provision				9	9
Comprehensive income				2,115	2,115
Common stock dividends				(228)	(228)
Preferred stock dividends				(52)	(52)
Issuance of common stock in connection with the conversion of convertible preferred stock	(1)	1	23	(23)	—
Repurchases of Time Warner common stock			(1,896)		(1,896)
Shares issued pursuant to stock option, dividend reinvestment and benefit plans	—	—	1,737	(815)	922
BALANCE AT DECEMBER 31, 1999	<u>\$ 1</u>	<u>\$13</u>	<u>\$12,998</u>	<u>\$(3,299)</u>	<u>\$9,713</u>

(a) Includes a \$13 million reduction (net of a \$9 million tax effect) related to realized gains on the sale of securities in 1997.

See accompanying notes.

TIME WARNER INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Time Warner Inc. ("Time Warner" or the "Company") is the world's leading media and entertainment company. Time Warner's principal business objective is to create and distribute branded information and entertainment copyrights throughout the world. Time Warner classifies its business interests into six fundamental areas: *Cable Networks*, consisting principally of interests in cable television programming; *Publishing*, consisting principally of interests in magazine publishing, book publishing and direct marketing; *Music*, consisting principally of interests in recorded music and music publishing; *Filmed Entertainment*, consisting principally of interests in filmed entertainment, television production and television broadcasting; *Cable*, consisting principally of interests in cable television systems; and *Digital Media*, consisting principally of interests in Internet-related and digital media businesses.

Each of the business interests within Cable Networks, Publishing, Music, Filmed Entertainment, Cable and Digital Media 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 cable television networks, such as HBO, Cinemax, CNN, TNT and TBS Superstation, (2) magazine franchises, such as *Time*, *People* and *Sports Illustrated* and direct marketing brands such as Time Life Inc. and Book-of-the-Month Club, (3) 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, (4) 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*, (5) The WB Network, a national broadcasting network launched in 1995 as an extension of the Warner Bros. brand and as an additional distribution outlet for the Company's collection of children's cartoons and television programming, (6) Time Warner Cable, currently the largest operator of cable television systems in the U.S. and (7) Internet websites, such as CNN.com and Entertaindom.com.

Financial information for Time Warner's various business segments is presented herein as an indication of financial performance (Note 16). Except for start-up losses incurred in connection with The WB Network and Digital Media, Time Warner's principal business segments generate significant operating income and cash flow from operations. The cash flow from operations generated by such business segments is considerably greater than their operating income due to significant amounts of noncash amortization of intangible assets recognized in various acquisitions accounted for by the purchase method of accounting. Noncash amortization of intangible assets recorded by Time Warner's business segments amounted to \$1.298 billion in 1999, \$800 million in 1998 (\$1.330 billion on a pro forma basis) and \$912 million in 1997.

Basis of Presentation

Consolidation of TWE

A majority of Time Warner's interests in filmed entertainment, television production, television broadcasting and cable television systems, and a portion of its interests in cable television programming and digital media are held through Time Warner Entertainment Company, L.P. ("TWE"). Time Warner owns 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 are held by a subsidiary of MediaOne Group, Inc. ("MediaOne").

Since 1993, Time Warner historically had not consolidated TWE and certain related companies (the "Entertainment Group") for financial reporting purposes because MediaOne had rights that allowed it to

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

participate in the management of TWE's businesses. However, in August 1999, TWE received a notice from MediaOne concerning the termination of its covenant not to compete with TWE. The termination of that covenant is necessary for MediaOne to complete its proposed merger with AT&T Corp. ("AT&T"). As a result of the termination notice and the operation of the TWE partnership agreement, MediaOne's rights to participate in the management of TWE's businesses terminated immediately and irrevocably. MediaOne retains only certain protective governance rights pertaining to certain limited matters affecting TWE as a whole.

Because of this significant reduction in MediaOne's rights, Time Warner's 1999 financial statements reflect the consolidation of the Entertainment Group, which substantially consists of TWE, retroactive to the beginning of 1999. Time Warner's historical financial statements for prior periods have not been changed, but are no longer comparable to 1999 because the Entertainment Group was reflected on an unconsolidated basis using the equity method of accounting. Accordingly, in order to enhance comparability, pro forma financial statements for 1998 reflecting the consolidation of the Entertainment Group are presented supplementally.

1998 Stock Split

Common stock, paid-in-capital, stock options, per common share and average common share amounts give effect to a two-for-one common stock split that occurred on December 15, 1998.

Reclassifications

Certain reclassifications have been made to the prior years' financial statements to conform to the 1999 presentation.

Basis of Consolidation and Accounting for Investments

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

Investments in companies in which Time Warner has significant influence, but less than a controlling voting interest, are accounted for using the equity method. Under the equity method, only Time Warner's investment in and amounts due to and from the equity investee are included in the consolidated balance sheet; only Time Warner's share of the investee's earnings is included in the consolidated operating results; and only the dividends, cash distributions, loans or other cash received from the investee, less any additional cash investments, loan repayments or other cash paid to the investee, are included in the consolidated cash flows.

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

The effect of any changes in Time Warner's ownership interests resulting from the issuance of equity capital by consolidated subsidiaries or equity investees to unaffiliated parties is included in income.

Foreign Currency Translation

The financial position and operating results of substantially all foreign operations are consolidated using the local currency as the functional currency. Local currency assets and liabilities are translated at the rates of

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

exchange on the balance sheet date, and local currency revenues and expenses are translated at average rates of exchange during the period. Resulting translation gains or losses, which have not been material, are included as a component of accumulated other comprehensive income (loss) in accumulated deficit.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and footnotes thereto. Actual results could differ from those estimates.

Significant estimates inherent in the preparation of the accompanying consolidated financial statements include management's forecast of anticipated revenues and cash flows from investments and the sale of future and existing music and publishing-related products, as well as from the distribution of theatrical and television product, in order to evaluate the ultimate recoverability of accounts receivable, film inventory, artist and author advances and investments, recorded as assets in the consolidated balance sheet. Accounts receivable and sales of product in the music and publishing industries, as well as sales of home video product in the filmed entertainment industry, are subject to customers' rights to return unsold items. Management periodically reviews such estimates and it is reasonably possible that management's assessment of recoverability of accounts receivable, individual films and television product, individual artist and author advances, and investments may change based on actual results and other factors.

Revenues and Costs

Publishing and Music

The unearned portion of paid magazine subscriptions is deferred until magazines are delivered to subscribers. Upon each delivery, a proportionate share of the gross subscription price is included in revenues. Magazine advertising revenues are recognized when the advertisements are published.

In accordance with industry practice, certain products (such as magazines, books, home videocassettes, compact discs, DVDs and cassettes) are sold to customers with the right to return unsold items. Revenues from such sales are recognized when the products are shipped based on gross sales less a provision for future returns.

Inventories of magazines, books, cassettes and compact discs are stated at the lower of cost or estimated realizable value. Cost is determined using first-in, first-out; last-in, first-out; and average cost methods. Returned goods included in inventory are valued at estimated realizable value, but not in excess of cost.

Cable and Cable Networks

A significant portion of cable system and cable network programming revenues are derived from subscriber fees and advertising. Subscriber fees are recorded as revenue in the period the service is provided and advertising revenues are recognized in the period that the advertisements are exhibited. The costs of rights to exhibit feature films and other programming on the cable networks during one or more availability periods ("programming costs") generally are recorded when the programming is initially available for exhibition, and are allocated to the appropriate availability periods and amortized as the programming is exhibited.

Digital Media

Digital media revenues primarily are derived from advertising and e-commerce activities. Advertising revenues are recognized in the period that the advertisements are exhibited. Revenues from e-commerce activities are recognized when the products are sold.

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

Filmed Entertainment

Feature films are produced or acquired for initial exhibition in theaters followed by distribution in the home video, pay cable, basic cable, broadcast network and syndicated television markets. Generally, distribution to the theatrical, home video and pay cable markets (the primary markets) is completed principally within eighteen months of initial release. Thereafter, feature films are distributed to the basic cable, broadcast network and syndicated television markets (the secondary markets). Theatrical revenues are recognized as the films are exhibited. Home video revenues, less a provision for returns, are recognized when the home videos are sold. Revenues from the distribution of theatrical product to cable, broadcast network and syndicated television markets are recognized when the films are available to telecast.

Television films and series are initially produced for the networks or first-run television syndication (the primary markets) and may be subsequently licensed to foreign or domestic cable and syndicated television markets (the secondary markets). Revenues from the distribution of television product are recognized when the films or series are available to telecast, except for barter agreements where the recognition of revenue is deferred until the related advertisements are exhibited.

License agreements for the telecast of theatrical and television product in the cable, broadcast network and syndicated television markets are routinely entered into well in advance of their available date for telecast, which is generally determined by the telecast privileges granted under previous license agreements. Accordingly, there are significant contractual rights to receive cash and barter under these licensing agreements. For cash contracts, the related revenues will not be recognized until such product is available for telecast under the contractual terms of the related license agreement. For barter contracts, the related revenues will not be recognized until the product is available for telecast and the advertising spots received under such contracts are either used or sold to third parties. All of these contractual rights for which revenue is not yet recognizable is referred to as "backlog."

Inventories of theatrical and television product are stated at the lower of unamortized cost or net realizable value. Cost principally consists of direct production costs and production overhead. A portion of the cost to acquire TBS in 1996 was allocated to its theatrical and television product, including an allocation to purchased program rights (such as the animation library of Hanna-Barbera Inc. and the former film and television libraries of Metro-Goldwyn-Mayer, Inc. and RKO Pictures, Inc.) and product that had been exhibited at least once in all markets ("Library"). Library product is amortized on a straight-line basis over twenty years. Individual films and series are amortized, and the related participations and residuals are accrued, based on the proportion that current revenues from the film or series bear to an estimate of total revenues anticipated from all markets. These estimates are revised periodically and losses, if any, are provided in full. Current film inventories generally include the unamortized cost of completed feature films allocated to the primary markets, television films and series in production pursuant to a contract of sale, film rights acquired for the home video market and advances pursuant to agreements to distribute third-party films in the primary markets. Noncurrent film inventories generally include the unamortized cost of completed theatrical and television films allocated to the secondary markets, theatrical films in production and the Library.

Proposed Changes to Film Accounting Standards

In October 1998, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants ("AcSEC") issued an exposure draft of a proposed Statement of Position, "Accounting by Producers and Distributors of Films" (the "SOP"). The proposed rules would establish new accounting standards for producers and distributors of films, including changes in revenue recognition and accounting for advertising, development and overhead costs.

AcSEC currently is in the process of finalizing these proposed rules. Based on AcSEC's conclusions reached as of the end of 1999, the SOP would require that advertising costs for theatrical and television product

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

be expensed as incurred. This compares to Time Warner's existing policy of capitalizing and then expensing advertising costs for theatrical product over the related revenue streams. In addition, the SOP would require development costs for abandoned projects and certain indirect overhead costs to be charged directly to expense, instead of those costs being capitalized to film costs, which currently is required under the existing accounting model. The SOP would also require all film costs to be classified in the balance sheet as a noncurrent asset. The proposed SOP's provisions in other areas, such as revenue recognition, generally are consistent with Time Warner's existing accounting policies.

At the time that Time Warner adopts the final provisions of the SOP, it expects to record a one-time, noncash, after-tax charge of approximately \$400 to \$425 million primarily to reduce the carrying value of its film inventory. This charge will be reflected as a cumulative effect of a change in accounting principle.

The provisions of the SOP are still being deliberated by AcSEC and could change prior to the issuance of a final standard, which is expected to occur by the end of the second quarter of 2000. The SOP is expected to be effective for calendar-year companies on January 1, 2001, with early application encouraged. Time Warner expects to adopt the provisions of the SOP upon issuance.

Revenue Classification Changes

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" ("SAB 101"), which will be effective for Time Warner in the second quarter of 2000. SAB 101 clarifies certain existing accounting principles for the recognition and classification of revenues in financial statements. While Time Warner's existing revenue recognition policies are consistent with the provisions of SAB 101, the new rules are expected to result in some changes as to how the filmed entertainment industry classifies its revenues, particularly relating to distribution arrangements for third-party and co-financed joint venture product. As a result, Time Warner is in the process of evaluating the overall impact of SAB 101 on its consolidated financial statements. It is expected that both annual revenues and costs in Time Warner's filmed entertainment businesses will be reduced by an equal amount of approximately \$1.5 to \$2 billion as a result of these classification changes. However, other aspects of SAB 101 are not expected to have a significant effect on Time Warner's consolidated financial statements.

Advertising

Through 1999, in accordance with Financial Accounting Standards Board ("FASB") Statement No. 53, "Financial Reporting by Producers and Distributors of Motion Picture Films," advertising costs for theatrical and television product have been capitalized and amortized over the related revenue streams in each market that such costs are intended to benefit, which generally does not exceed three months. Other advertising costs are expensed upon the first exhibition of the advertisement, except for certain direct-response advertising, for which the costs are capitalized and amortized over the expected period of future benefits. Direct-response advertising principally consists of product promotional mailings, broadcast advertising, catalogs and other promotional costs incurred in the Company's direct-marketing businesses. Deferred advertising costs generally are amortized over periods of up to three years subsequent to the promotional event using straight-line or accelerated methods, with a significant portion of such costs amortized in twelve months or less. Deferred advertising costs for Time Warner amounted to \$250 million at the end of 1999 and \$282 million at the end of 1998 (\$282 million on a pro forma basis), respectively. Advertising expense, excluding theatrical and television product, amounted to \$1.511 billion in 1999, \$1.154 billion in 1998 (\$1.438 billion on a pro forma basis) and \$1.080 billion in 1997.

Cash and Equivalents

Cash equivalents consist of commercial paper and other investments that are readily convertible into cash and have original maturities of three months or less.

TIME WARNER INC.
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Financial Instruments

Effective July 1, 1998, Time Warner adopted FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133"). FAS 133 requires that all derivative financial instruments that qualify for hedge accounting, such as interest rate swap contracts and foreign exchange contracts, be recognized in the financial statements and measured at fair value regardless of the purpose or intent for holding them. Changes in the fair value of derivative financial instruments are either recognized periodically in income or shareholders' equity (as a component of comprehensive income), depending on whether the derivative is being used to hedge changes in fair value or cash flows. The adoption of FAS 133 did not have a material effect on Time Warner's primary financial statements, but did reduce comprehensive income in 1998 by \$18 million in the accompanying consolidated statement of shareholders' equity.

The carrying value of Time Warner's financial instruments approximates fair value, except for differences with respect to long-term, fixed-rate debt (Note 7) and certain differences relating to cost method investments and other financial instruments that are not significant. The fair value of financial instruments is generally determined by reference to market values resulting from trading on a national securities exchange or in an over-the-counter market. In cases where quoted market prices are not available, fair value is based on estimates using present value or other valuation techniques.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Additions to cable property, plant and equipment generally include material, labor, overhead and interest. Depreciation is provided generally on the straight-line method over useful lives ranging up to thirty years for buildings and improvements and up to sixteen years for furniture, fixtures, cable television and other equipment. Property, plant and equipment consists of:

	December 31,		
	1999 Historical	1998 Pro Forma (millions)	1998 Historical
Land and buildings.....	\$ 1,606	\$ 1,764	\$ 963
Cable television equipment	8,671	7,648	1,035
Furniture, fixtures and other equipment	4,048	3,714	1,400
	14,325	13,126	3,398
Less accumulated depreciation	(5,597)	(5,089)	(1,407)
Total	\$ 8,728	\$ 8,037	\$ 1,991

Intangible Assets

As a creator and distributor of branded information and entertainment copyrights, Time Warner has a significant and growing number of intangible assets, including goodwill, cable television and sports franchises, film and television libraries, music catalogues, contracts and copyrights, and other copyrighted products and trademarks. In accordance with generally accepted accounting principles, Time Warner does not recognize the fair value of internally generated intangible assets. Costs incurred to create and produce copyrighted product, such as feature films, television series and compact discs, generally are either expensed as incurred, or capitalized as tangible assets as in the case of cash advances and inventoriable product costs. However, accounting recognition is not given to any increasing asset value that may be associated with the collection of the underlying copyrighted material. Additionally, costs incurred to create or extend brands, such as magazine titles and new television networks, generally result in losses over an extended development period and are recognized as a reduction of income as incurred, while any corresponding brand value created is not recognized

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

as an intangible asset in the consolidated balance sheet. On the other hand, intangible assets acquired in business combinations accounted for by the purchase method of accounting are capitalized and amortized over their expected useful life as a noncash charge against future results of operations. Accordingly, the intangible assets reported in the consolidated balance sheet do not reflect the fair value of Time Warner's internally generated intangible assets, but rather are limited to intangible assets resulting from certain acquisitions in which the cost of the acquired companies exceeded the fair value of their tangible assets at the time of acquisition.

Time Warner amortizes goodwill and sports franchises over periods up to forty years using the straight-line method. Cable television franchises, film and television libraries, music catalogues, contracts and copyrights, and other intangible assets are amortized over periods up to twenty years using the straight-line method. Amortization of intangible assets amounted to \$1.298 billion in 1999, \$800 million in 1998 (\$1.330 billion on a pro forma basis) and \$912 million in 1997. Accumulated amortization of intangible assets at December 31, 1999 and 1998 amounted to \$8.3 billion and \$3.9 billion (\$7.4 billion on a pro forma basis), respectively.

Time Warner periodically reviews the carrying value of acquired intangible assets for each acquired entity to determine whether an impairment may exist. Time Warner considers relevant cash flow and profitability information, including estimated future operating results, trends and other available information, in assessing whether the carrying value of intangible assets can be recovered. If it is determined that the carrying value of intangible assets will not be recovered from the undiscounted future cash flows of the acquired business, the carrying value of such intangible assets would be considered impaired and reduced by a charge to operations in the amount of the impairment. An impairment charge is measured as any deficiency in the amount of estimated undiscounted future cash flows of the acquired business available to recover the carrying value related to the intangible assets.

Income Taxes

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

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

Stock Options

In accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), compensation cost for stock options is recognized in income based on the excess, if any, of the quoted market price of the stock at the grant date of the award or other measurement date over the amount an employee must pay to acquire the stock. Generally, the exercise price for stock options granted to employees equals or exceeds the fair market value of Time Warner common stock at the date of grant, thereby resulting in no recognition of compensation expense by Time Warner.

Income (Loss) Per Common Share

Basic income (loss) per common share is computed by dividing the net income (loss) applicable to common shares after preferred dividend requirements by the weighted average of common shares outstanding during the period. Weighted-average common shares include shares of Time Warner's common stock and Series LMCN-V common stock. Diluted income (loss) per common share adjusts basic income (loss) per common

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

share for the effects of convertible securities, stock options and other potentially dilutive financial instruments, only in the periods in which such effect is dilutive.

Comprehensive Income

In accordance with FASB Statement No. 130, "Reporting Comprehensive Income," Time Warner reports comprehensive income and its components in financial statements. Comprehensive income consists of net income and other gains and losses affecting shareholders' equity that, under generally accepted accounting principles, are excluded from net income. For Time Warner, such items consist primarily of unrealized gains and losses on marketable equity investments, gains and losses on certain derivative financial instruments and foreign currency translation gains and losses.

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

	<u>Foreign Currency Translation Losses</u>	<u>Unrealized Gains on Securities</u>	<u>Derivative Financial Instrument Gains (Losses)</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>
	(millions)			
Balance at December 31, 1998	\$ (83)	\$ 5	\$(38)	\$(116)
1999 activity	<u>(63)</u>	<u>221</u>	<u>9</u>	<u>167</u>
Balance at December 31, 1999	<u>\$(146)</u>	<u>\$226</u>	<u>\$(29)</u>	<u>\$ 51</u>

2. CABLE TRANSACTIONS

Time Warner, TWE and the TWE-Advance/Newhouse Partnership ("TWE-A/N") completed a series of significant transactions in 1999 and 1998. These transactions, which related to the cable television business and related ancillary businesses, enhanced Time Warner Cable's geographic clustering of cable television properties or reduced existing debt and/or Time Warner Cable's share of future funding requirements for such businesses. These transactions are discussed more fully below.

Gain on Sale or Exchange of Cable Television Systems and Investments

During the past three years, largely in an effort to enhance their geographic clustering of cable television properties, Time Warner and TWE sold or exchanged various cable television systems and investments. The 1999 transactions included a number of transactions generally involving large exchanges of cable television systems. In these transactions, Time Warner Cable exchanged cable television systems serving approximately (i) 575,000 subscribers for other cable television systems of comparable size owned by TCI Communications, Inc. ("TCI"), a subsidiary of AT&T (the "TCI Cable Trades") and (ii) 314,000 subscribers for other cable television systems of comparable size owned by MediaOne. In addition, in 1999, Time Warner Cable obtained sole control of certain partnerships previously held with Fanch Communications, retaining cable television systems serving approximately 158,000 subscribers and approximately \$280 million of net cash proceeds, in exchange for its interests in other cable television systems formerly owned by such partnerships. The systems acquired by Time Warner Cable were accounted for under the purchase method of accounting for business combinations. As such, the net assets received were recorded at fair value based on the negotiated terms of the transactions. In connection with these and other transactions, the operating results of Time Warner include net pretax gains of \$2.247 billion in 1999, \$108 million in 1998 and \$212 million in 1997.

Because a substantial portion of these pretax gains was recognized by TWE, and TWE was reported on an unconsolidated basis for all periods prior to 1999, these gains were either classified in Time Warner's operating

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income or Time Warner's equity in the pretax income of the Entertainment Group in the accompanying consolidated statement of operations. In particular, Time Warner's operating income includes pretax gains of \$2.247 billion in 1999, \$18 million in 1998 (\$108 million on a pro forma basis) and \$12 million in 1997. In 1998 and 1997, Time Warner's equity in the pretax income of the Entertainment Group included pretax gains of \$90 million and \$200 million, respectively.

Time Warner Telecom

Time Warner Telecom Inc. ("Time Warner Telecom"), an integrated communications provider that provides a wide range of telephony and data services to businesses, was formed in July 1998 when Time Warner, TWE and TWE-A/N completed a reorganization of their business telephony operations (the "Time Warner Telecom Reorganization"). As part of that reorganization, (i) the business telephony operations conducted by Time Warner, TWE and TWE-A/N were each contributed to Time Warner Telecom and (ii) TWE's and TWE-A/N's interests in Time Warner Telecom were distributed to their partners, Time Warner, MediaOne and the Advance/Newhouse Partnership ("Advance/Newhouse"), a limited partner in TWE-A/N. No gain or loss was recognized on the transaction. Time Warner's initial interest in Time Warner Telecom was recorded based on the historical cost basis of the contributed net assets.

In May 1999, Time Warner Telecom completed an initial public offering of 20% of its common stock (the "Time Warner Telecom IPO"). Time Warner Telecom issued approximately 21 million shares of common stock at a price of \$14 per share and raised net proceeds of approximately \$270 million. Approximately \$180 million of these proceeds were used to pay obligations owed to Time Warner and TWE. In turn, Time Warner and TWE used those proceeds principally to reduce bank debt. In connection with the Time Warner Telecom IPO and certain related transactions, Time Warner's ownership interest in Time Warner Telecom was diluted from 62% to 48%. As a result, Time Warner recognized a gain of approximately \$115 million before providing for deferred taxes. This gain has been included in interest and other, net, in Time Warner's 1999 consolidated statement of operations.

As of December 31, 1999, Time Warner Telecom is owned 48% by Time Warner, 15% by MediaOne, 15% by Advance/Newhouse and 22% by other third parties. Time Warner's interest in Time Warner Telecom is being accounted for under the equity method of accounting.

Primestar

In April 1998, TWE and Advance/Newhouse transferred the direct broadcast satellite operations conducted by TWE and TWE-A/N (the "DBS Operations") and the 31% partnership interest in Primestar Partners, L.P. held by TWE-A/N ("Primestar Partners" and collectively, the "Primestar Assets") to Primestar, Inc. ("Primestar"), a separate holding company. As a result of that transfer and similar transfers by the other previously existing partners of Primestar Partners, Primestar Partners became an indirect wholly owned subsidiary of Primestar. In exchange for contributing its interests in the Primestar Assets, TWE received approximately 48 million shares of Primestar common stock (representing an approximate 24% equity interest) and realized approximately \$240 million of debt reduction. As a result of this transaction, effective as of April 1, 1998, TWE deconsolidated the DBS Operations and the 24% equity interest in Primestar received in the transaction is being accounted for under the equity method of accounting. This transaction is referred to as the "Primestar Roll-up Transaction."

In the fourth quarter of 1998, TWE recorded a charge of approximately \$210 million principally to reduce the carrying value of its interest in Primestar. This charge reflected a significant decline in the fair value of Primestar during that quarter. The decline in Primestar's value was confirmed by the sale of its operations and assets to DirecTV, a competitor of Primestar owned by Hughes Electronics Corp., which occurred during the first half of 1999.

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As a result of the sale to DirecTV, Primestar began to wind down its operations during 1999. Time Warner recognized its share of Primestar's 1999 losses under the equity method of accounting. Such losses are included in interest and other, net in Time Warner's 1999 consolidated statement of operations. As of December 31, 1999, Primestar has substantially completed the wind down of its operations. As such, future wind-down losses are not expected to be material to Time Warner's operating results.

On a historical basis, the 1998 charge has been included in Time Warner's equity in the pretax income of the Entertainment Group and, on a pro forma basis for 1998, in Time Warner's interest and other, net in the accompanying consolidated statement of operations.

TCI Cable Transactions

During 1999 and 1998, Time Warner, TWE, TWE-A/N and TCI completed a number of significant cable-related transactions. These transactions consisted of (i) the formation in December 1998 of a cable television joint venture in Texas (the "Texas Cable Joint Venture") that is managed by Time Warner Cable, (ii) the expansion in August 1998 of an existing joint venture in Kansas City, which is managed by Time Warner Cable, through the contribution by TCI of a contiguous cable television system serving approximately 95,000 subscribers, subject to approximately \$200 million of debt and (iii) the TCI Cable Trades in 1999, as previously discussed above. The Kansas City joint venture is being accounted for under the equity method of accounting.

The Texas Cable Joint Venture is a 50-50 cable television joint venture between TWE-A/N and TCI. TWE-A/N contributed cable television systems serving approximately 545,000 subscribers, subject to approximately \$650 million of debt. TCI contributed cable television systems serving approximately 565,000 subscribers, subject to approximately \$650 million of debt. TWE-A/N did not recognize a gain or loss on the transaction and the initial investment in the Texas Cable Joint Venture was recorded based on the historical cost basis of the contributed net assets. The Texas Cable Joint Venture is being accounted for under the equity method of accounting.

As a result of the formation of the Texas Cable Joint Venture, the combined debt of Time Warner and TWE was reduced by approximately \$650 million. Also, as a result of the Texas and Kansas City transactions, Time Warner and TWE benefited from the geographic clustering of cable television systems and the number of subscribers under the management of Time Warner Cable was increased by approximately 660,000 subscribers.

Road Runner Joint Venture

In June 1998, Time Warner, TWE, TWE-A/N, MediaOne, Microsoft Corp. ("Microsoft") and Compaq Computer Corp. ("Compaq") formed a joint venture to operate and expand Time Warner Cable's and MediaOne's existing high-speed online businesses (the "Road Runner Joint Venture"). In exchange for contributing these operations, Time Warner received a common equity interest in the Road Runner Joint Venture of 10.7%, TWE received a 25% interest, TWE-A/N received a 32.9% interest and MediaOne received a 31.4% interest. In exchange for Microsoft and Compaq contributing \$425 million of cash to the Road Runner Joint Venture, Microsoft and Compaq each received a preferred equity interest therein that is convertible into a 10% common equity interest (the "Preferred Equity Interests"). Accordingly, on a fully diluted basis, the Road Runner Joint Venture is owned 8.6% by Time Warner, 20% by TWE, 26.3% by TWE-A/N, 25.1% by MediaOne, 10% by Microsoft and 10% by Compaq. No gain or loss was recognized on the transaction. As such, each of Time Warner's, TWE's and TWE-A/N's initial interest in the Road Runner Joint Venture was recorded based on the historical cost basis of the contributed net assets. In addition, each of Time Warner's, TWE's and TWE-A/N's interest in the Road Runner Joint Venture is being accounted for under the equity method of accounting because of certain approval rights held by MediaOne.

If the Road Runner Joint Venture does not successfully complete a public offering of its common stock by December 31, 2001, Microsoft and Compaq may put their Preferred Equity Interests back to the venture at an

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independently determined fair value, plus any accrued and unpaid dividends at a rate of 6% per annum. Microsoft and Compaq also have the right to put their Preferred Equity Interests back to the venture upon the occurrence of certain early termination events, as set forth in the partnership agreement. If these termination rights are triggered and exercised, the put price paid to Microsoft and Compaq will equal the amount of their original investment plus a cumulative annual preferred return of 15%.

The aggregate \$425 million of capital contributed by Microsoft and Compaq is being used by the Road Runner Joint Venture to continue to expand the roll out of high-speed online services. Time Warner Cable has entered into an affiliation agreement with the Road Runner Joint Venture, pursuant to which Time Warner Cable provides Road Runner's high-speed online services to customers in its cable franchise areas through its technologically advanced, high-capacity cable architecture. In exchange, Time Warner Cable initially retains 70% of the subscription revenues and 30% of the national advertising and transactional revenues generated from the delivery of these online services to its cable subscribers. Time Warner Cable's share of these subscription revenues will change periodically to 75% by 2006.

TWE-A/N Transfers

As of December 31, 1999, TWE-A/N owned cable television systems (or interests therein) serving approximately 6.7 million subscribers, of which 5.5 million subscribers were served by consolidated, wholly owned cable television systems and 1.2 million subscribers were served by unconsolidated, partially owned cable television systems. TWE-A/N had approximately \$1.4 billion of debt at December 31, 1999.

TWE-A/N is owned approximately 64.8% by TWE, the managing partner, 33.3% by Advance/Newhouse and 1.9% indirectly by Time Warner. On a historical basis for 1999 and on a pro forma basis for 1998, the financial position and operating results of TWE-A/N have been consolidated by Time Warner and the partnership interest owned by Advance/Newhouse is reflected in Time Warner's consolidated financial statements as minority interest. On a historical basis for all periods prior to 1999, the financial position and operating results of TWE-A/N have been consolidated by TWE and reflected by Time Warner under the equity method of accounting. In accordance with the partnership agreement, Advance/Newhouse can require TWE to purchase its equity interest for fair market value at specified intervals following the death of both of its principal shareholders. In addition, TWE or Advance/Newhouse can initiate a restructuring of the partnership, in which Advance/Newhouse would withdraw from the partnership and receive one-third of the partnership's net assets.

In early 1998, Time Warner (through a wholly owned subsidiary) contributed cable television systems (or interests therein) serving approximately 650,000 subscribers to TWE-A/N, subject to approximately \$1 billion of debt, in exchange for common and preferred partnership interests in TWE-A/N, and completed certain transactions relating to Paragon Communications ("Paragon" and collectively, the "TWE-A/N Transfers"). The cable television systems transferred to TWE-A/N were formerly owned by TWI Cable Inc. ("TWI Cable"), a wholly owned subsidiary of Time Warner, and Paragon. Prior to this transaction, the economic ownership of Paragon was held 50% by subsidiaries of Time Warner, 25% beneficially by TWE and 25% beneficially by TWE-A/N. The debt assumed by TWE-A/N has been guaranteed by TWI Cable and certain of its subsidiaries, including Paragon. The TWE-A/N Transfers were accounted for effective as of January 1, 1998. Time Warner and TWE-A/N accounted for this transaction at fair value. However, because the fair value of the consideration received approximated Time Warner's carrying value of the net assets transferred, Time Warner did not recognize a gain or loss on the transaction.

Paragon was a partnership formerly owning cable television systems serving approximately 1 million subscribers. As part of the TWE-A/N Transfers, TWE and TWE-A/N exchanged substantially all of their aggregate 50% beneficial interests in Paragon for an equivalent share of Paragon's cable television systems (or interests therein) serving approximately 500,000 subscribers, resulting in wholly owned subsidiaries of Time Warner owning 100% of the restructured Paragon entity, with less than 1% beneficially held for TWE.

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Accordingly, effective as of January 1, 1998, Time Warner has consolidated Paragon, which it formerly accounted for under the equity method of accounting. Because this transaction represented an exchange of TWE's and TWE-A/N's beneficial interests in Paragon for an equivalent amount of its cable television systems, it did not have a significant economic impact on Time Warner, TWE or TWE-A/N.

On a pro forma basis, giving effect to the TWE-A/N Transfers as if they had occurred at the beginning of 1997, Time Warner would have reported for the year ended December 31, 1997, revenues of \$13.233 billion, depreciation expense of \$375 million, operating income before noncash amortization of intangible assets of \$2.068 billion, operating income of \$1.219 billion, equity in the pretax income of the Entertainment Group of \$679 million, income before extraordinary item of \$307 million (\$.01 loss per common share) and net income of \$252 million (\$.06 loss per common share).

3. FILMED ENTERTAINMENT TRANSACTIONS

1999 Gain on Termination of Video Distribution Agreement

In March 1999, Warner Bros. and Metro-Goldwyn-Mayer, Inc. ("MGM") terminated a long-term distribution agreement under which Warner Bros. had exclusive worldwide distribution rights for MGM/United Artists home video product. In connection with the early termination and settlement of this distribution agreement, Warner Bros. recognized a net pretax gain of approximately \$215 million, which has been included in operating income in the accompanying consolidated statement of operations.

1999 Gain on Sale of Interest in CanalSatellite

In December 1999, Warner Bros. sold its 10% interest in CanalSatellite, a satellite television distribution service in France and Monaco, to Canal+, a large French media and entertainment company. In connection with the sale, Warner Bros. recognized a pretax gain of \$97 million, which has been included in operating income in the accompanying consolidated statement of operations.

1999 Warner Bros. Retail Stores Write-Down

In the fourth quarter of 1999, Warner Bros. recorded a one-time, noncash pretax charge of \$106 million to reduce the carrying value of certain fixed assets and leasehold improvements used in its retail stores. This charge resulted from a plan adopted in December 1999 that is designed to improve the performance of Warner Bros.'s retail store operations. The plan is expected to be executed largely over a three-year period and involves closing certain underperforming stores, transforming other stores into smaller and more efficient stores, and exploiting potential e-commerce opportunities.

The charge represents the excess of the carrying value of the assets used in Warner Bros.'s retail stores over the discounted future operating cash flows, adjusted to reflect a shorter recovery period due to planned store closures. The charge has been included in operating income in the accompanying consolidated statement of operations.

1998 Sale of Six Flags

In April 1998, TWE sold its remaining 49% interest in Six Flags Entertainment Corporation ("Six Flags") to Premier Parks Inc. ("Premier"), a regional theme park operator, for approximately \$475 million of cash. TWE used the net, after-tax proceeds from this transaction to reduce debt by approximately \$300 million. As part of the transaction, TWE will continue to license its animated cartoon and comic book characters to Six Flags's theme parks and will similarly license such rights to Premier's theme parks in the United States and Canada under a long-term agreement covering an aggregate of twenty-five existing and all future locations. As of

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December 31, 1999, approximately \$330 million of the original \$400 million gain on the sale of TWE's interest had been deferred, principally as a result of uncertainties surrounding its realization. Those uncertainties relate to ongoing litigation as described in Note 17 and TWE's continuing guarantees of Premier's long-term obligations to make minimum payments to the limited partners of the Six Flags Over Texas and Six Flags Over Georgia theme parks. If current trends continue, Time Warner expects the deferred gain to be recognized over the next several years, subject to the resolution of the Six Flags litigation. That is, the deferred gain will not fall below the estimated exposure relating to the Six Flags litigation. In addition, upon closing of the America Online-Time Warner merger, any portion of the deferred gain not attributable to the Six Flags litigation is likely to be eliminated in purchase accounting.

4. INVESTMENT IN ENTERTAINMENT GROUP

Partnership Structure

Time Warner's investment in the Entertainment Group consists substantially of its investment in TWE, as well as certain related companies. TWE is a Delaware limited partnership that was capitalized in 1992 to own and operate substantially all of the Filmed Entertainment-Warner Bros., Cable Networks-HBO and Cable businesses previously owned by subsidiaries of Time Warner. Time Warner, through its wholly owned subsidiaries, collectively owns general and limited partnership interests in TWE consisting of 74.49% of the Series A Capital and Residual Capital and 100% of the Series B Capital. The remaining 25.51% limited partnership interests in the Series A Capital and Residual Capital of TWE are held by MediaOne. Certain Time Warner subsidiaries are the general partners of TWE ("Time Warner General Partners").

Partnership Capital and Allocation of Income

Each partner's interest in TWE generally consists of the undistributed priority capital and residual equity amounts that were initially assigned to that partner or its predecessor based on the estimated fair value of the net assets each contributed to TWE ("Undistributed Contributed Capital"), plus, with respect to the priority capital interests only, any undistributed priority capital return. The priority capital return consists of net partnership income allocated to date in accordance with the provisions of the TWE partnership agreement and the right to be allocated additional partnership income which, together, provides for the various priority capital rates of return as specified in the following table. The sum of Undistributed Contributed Capital and the undistributed priority capital return is referred to herein as "Cumulative Priority Capital". Cumulative Priority Capital is not necessarily indicative of the fair value of the underlying priority capital interests principally due to above-market rates of return on certain priority capital interests as compared to securities of comparable credit risk and maturity, such as the 13.25% rate of return on the Series B Capital interest owned 100% by the Time Warner General Partners. Furthermore, the ultimate realization of Cumulative Priority Capital could be affected by the fair value of TWE, which is subject to fluctuation.

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A summary of the priority of Undistributed Contributed Capital, Time Warner's ownership of Undistributed Contributed Capital and Cumulative Priority Capital at December 31, 1999 and priority capital rates of return thereon is as set forth below:

<u>Priority of Undistributed Contributed Capital</u>	<u>Undistributed Contributed Capital^(a)</u>	<u>Cumulative Priority Capital</u>	<u>Priority Capital Rates of Return^(b)</u>	<u>% Owned by Time Warner</u>
	(billions)			
Series A Capital	\$5.6	\$14.5	13.00%	74.49%
Series B Capital	2.9 ^(d)	7.7	13.25%	100.00%
Residual Capital	3.3 ^(d)	3.3 ^(c)	— ^(c)	74.49%

(a) Excludes partnership income or loss allocated thereto.

(b) To the extent income allocations are concurrently distributed, the priority capital rates of return on the Series A Capital and Series B Capital are 11% and 11.25%, respectively.

(c) Residual Capital is not entitled to stated priority rates of return and, as such, its Cumulative Priority Capital is equal to its Undistributed Contributed Capital. However, in the case of certain events such as the liquidation or dissolution of TWE, Residual Capital is entitled to any excess of the then fair value of the net assets of TWE over the aggregate amount of Cumulative Priority Capital and special tax allocations.

(d) The Undistributed Contributed Capital relating to the Series B Capital has priority over the priority returns on the Series A Capital. The Undistributed Contributed Capital relating to the Residual Capital has priority over the priority returns on the Series B Capital and the Series A Capital.

Because Undistributed Contributed Capital generally is based on the fair value of the net assets that each partner initially contributed to the partnership, the aggregate of such amounts is significantly higher than TWE's partners' capital as reflected in its consolidated financial statements, which is based on the historical cost of the contributed net assets. For purposes of allocating partnership income or loss to the partners, partnership income or loss is based on the fair value of the net assets contributed to the partnership and results in significantly less partnership income, or results in partnership losses, in contrast to the net income reported by TWE for financial statement purposes, which also is based on the historical cost of contributed net assets.

Under the TWE partnership agreement, partnership income, to the extent earned, is first allocated to the partners' capital accounts so that the economic burden of the income tax consequences of partnership operations is borne as though the partnership were taxed as a corporation ("special tax allocations"). After any special tax allocations, partnership income is allocated to the Series A Capital and Series B Capital, in order of priority, at rates of 13.00% and 13.25% per annum, respectively, and finally to the Residual Capital. Partnership losses generally are allocated first to eliminate prior allocations of partnership income to, and then to reduce the Undistributed Contributed Capital of, the Residual Capital, Series B Capital and Series A Capital, in that order, and then to reduce any special tax allocations. To the extent partnership income is insufficient to satisfy all special allocations in a particular accounting period, the right to receive additional partnership income necessary to provide for the various priority capital rates of return is carried forward until satisfied out of future partnership income, including any partnership income that may result from any liquidation, sale or dissolution of TWE. TWE reported net income of \$2.759 billion, \$326 million and \$614 million in 1999, 1998 and 1997, respectively, no portion of which was allocated to the limited partners.

The Series B Capital owned by the Time Warner General Partners may be increased if certain operating performance targets are achieved over a ten-year period ending on December 31, 2001, although it does not appear likely at this time that such targets will be achieved. In addition, MediaOne has an option to obtain up to an additional 6.33% of Series A Capital and Residual Capital interests. The determination of the amount of additional interests that MediaOne is eligible to acquire is 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. The option is exercisable at any time through May 2005. The option exercise price is dependent upon the year of exercise and

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ranges from an exercise price of approximately \$1.3 billion in 2000 to \$1.8 billion in 2005. Either MediaOne or TWE may elect that the exercise price be paid with partnership interests rather than cash.

Summarized Financial Information of the Entertainment Group

As previously described in Note 1, Time Warner's historical financial statements for 1999 and pro forma financial statements for 1998 reflect the consolidation of the Entertainment Group, effective as of the beginning of each year. However, in order to facilitate an analysis of Time Warner's results of operations and financial condition for all historical periods in which the Entertainment Group was not consolidated, set forth below is summarized financial information of the Entertainment Group. The summarized financial information reflects the TWE-A/N Transfers effective as of January 1, 1998, the Primestar Roll-up Transaction effective as of April 1, 1998, the formation of the Road Runner Joint Venture effective as of June 30, 1998, the Time Warner Telecom Reorganization effective as of July 1, 1998 and the formation of the Texas Cable Joint Venture effective as of December 31, 1998.

	Years Ended December 31,		
	1999	1998	1997
Operating Statement Information		(millions)	
Revenues	\$13,164	\$12,256	\$11,328
Depreciation and amortization	(1,364)	(1,436)	(1,386)
Business segment operating income ^(a)	4,227	1,724	1,461
Interest and other, net ^(b)	(818)	(945)	(338)
Minority interest	(427)	(284)	(324)
Income before income taxes	2,909	423	727
Income before extraordinary item	2,759	331	642
Net income	2,759	331	619

(a) Includes a net pretax gain of approximately \$215 million in 1999 in connection with the early termination and settlement of a long-term, home video distribution agreement, a pretax gain of approximately \$97 million in 1999 relating to the sale of an interest in CanalSatellite, a one-time, noncash pretax charge of approximately \$106 million in 1999 relating to certain Warner Bros.'s retail stores and net pretax gains of approximately \$2.119 billion in 1999, \$90 million in 1998 and \$200 million in 1997 related to the sale or exchange of certain cable television systems and investments.

(b) 1998 includes a pretax charge of approximately \$210 million principally to reduce the carrying value of an interest in Primestar. 1997 includes a pretax gain of approximately \$250 million related to the sale of an interest in E! Entertainment Television, Inc.

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	<u>Years Ended December 31,</u>		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
Cash Flow Information	(millions)		
Cash provided by operations	\$2,713	\$2,288	\$1,799
Capital expenditures	(1,475)	(1,603)	(1,565)
Investments and acquisitions	(478)	(388)	(172)
Investment proceeds	948	1,246	520
Collection of loan to Time Warner	400	—	—
Borrowings	2,658	1,514	3,400
Debt repayments	(2,764)	(1,898)	(3,085)
Issuance of preferred stock of subsidiary	—	—	243
Redemption of preferred stock of subsidiary	(217)	—	—
Capital distributions	(1,200)	(1,153)	(934)
Other financing activities, net	(155)	(241)	(100)
Increase (decrease) in cash and equivalents	430	(235)	106
	<u>December 31,</u>		
	<u>1999</u>	<u>1998</u>	
	(millions)		
Balance Sheet Information			
Cash and equivalents	\$ 517	\$ 87	
Total current assets	5,311	4,187	
Total assets	24,843	22,241	
Total current liabilities	5,723	4,940	
Long-term debt	6,655	6,578	
Minority interests	1,815	1,522	
Preferred stock of subsidiary	—	217	
Time Warner General Partners' Senior Capital	—	603	
Partners' capital	7,149	5,210	

Capital Distributions

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

Through July 1999, the Time Warner General Partners held senior priority capital interests ("Senior Capital") in TWE. At that time, the Time Warner General Partners received a \$627 million distribution from TWE in full redemption of the remaining portion of their Senior Capital interests plus related priority capital return. This distribution increased the cumulative cash distributions received from TWE relating to the Time Warner General Partners' Senior Capital interests to \$2.1 billion. A portion of the proceeds received from the July 1999 distribution was used to repay all \$400 million of outstanding borrowings under Time Warner's credit agreement with TWE.

At December 31, 1999 and 1998, the Time Warner General Partners had recorded \$1.292 billion and \$1.130 billion, respectively, of stock option related distributions due from TWE, based on closing prices of Time Warner common stock of \$72.31 and \$62.06, respectively. Time Warner is paid when the options are exercised. The Time Warner General Partners also receive tax-related distributions from TWE on a current basis. During 1999, the Time Warner General Partners received distributions from TWE in the amount of \$1.2 billion, consisting of \$627 million of Senior Capital distributions (representing the return of \$454 million of contributed capital and the distribution of \$173 million of priority capital return), \$347 million of tax-related distributions and \$226 million of stock option related distributions. During 1998, the Time Warner General Partners received

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distributions from TWE in the amount of \$1.153 billion, consisting of \$579 million of Senior Capital distributions (representing the return of \$455 million of contributed capital and the distribution of \$124 million of priority capital return), \$314 million of tax-related distributions and \$260 million of stock option related distributions. During 1997, the Time Warner General Partners received distributions from TWE in the amount of \$934 million, consisting of \$535 million of Senior Capital distributions (representing the return of \$455 million of contributed capital and the distribution of \$80 million of priority capital return), \$324 million of tax-related distributions and \$75 million of stock option related distributions. In addition to the tax, stock option and Time Warner General Partners' Senior Capital distributions, TWE may make other capital distributions to its partners that are also subject to certain limitations contained in the TWE partnership and credit agreements.

In addition, in connection with the Time Warner Telecom Reorganization in 1998, TWE made a \$191 million noncash distribution to its partners, of which certain wholly owned subsidiaries of Time Warner received an interest in Time Warner Telecom recorded at \$143 million based on TWE's historical cost of the net assets (Note 2).

5. OTHER INVESTMENTS

Time Warner's other investments consist of:

	December 31,		
	1999 Historical	1998 Pro Forma	1998 Historical
	(millions)		
Equity-method investments	\$1,012	\$1,042	\$483
Cost-method investments	73	177	12
Fair-value investments ^(a)	1,011	446	299
Total	\$2,096	\$1,665	\$794

(a) Principally includes investments in Internet-related and digital media businesses and investments relating to Time Warner's deferred compensation plans.

The following discussion presents information on Time Warner's equity investees and separately highlights some of the more significant and strategic investments held by Time Warner.

Equity-Method Investments

At December 31, 1999, companies accounted for using the equity method include: Time Warner Telecom (48% owned), the Road Runner Joint Venture (55% owned on a fully diluted basis), certain cable television system joint ventures (generally 50% owned), Courtroom Television Network (50% owned), the Columbia House Company partnerships (50% owned), other music joint ventures (generally 50% owned), American Family Enterprises (50% owned), Comedy Partners, L.P. (50% owned) and Primestar (24% owned). A summary of combined financial information as reported by the equity investees of Time Warner is set forth below:

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	Years Ended December 31,			
	1999 Historical	1998 Pro Forma	1998 Historical	1997 Historical
	(millions)			
Revenues.....	\$3,064	\$3,604	\$1,275	\$1,336
Depreciation and amortization	(418)	(749)	(43)	(13)
Operating income (loss)	64	(266)	(1)	80
Net loss	(346)	(461)	(109)	(36)
Current assets	1,570	1,848	1,183	792
Total assets	5,214	7,293	2,065	1,132
Current liabilities	1,294	1,215	587	418
Long-term debt	3,367	4,724	1,807	1,303
Total liabilities	4,807	6,163	2,464	1,791
Total shareholders' (deficit) or partners' capital	407	1,130	(399)	(659)

Time Warner Telecom

As discussed more fully under Note 2, Time Warner has a 48% interest in Time Warner Telecom. Time Warner Telecom is an integrated communications provider that provides a wide range of telephony and data services to businesses in a number of metropolitan areas across the United States. As of December 31, 1999, based on Time Warner's ownership of 50.4 million shares of Class B common stock and the \$49.9375 market price of Time Warner Telecom's publicly traded Class A common stock, the market value of Time Warner's interest in Time Warner Telecom was \$2.5 billion.

Road Runner Joint Venture

As discussed more fully under Note 2, Time Warner, TWE and TWE-A/N have a collective 55% interest in the Road Runner Joint Venture on a fully diluted basis. The Road Runner Joint Venture operates a high-speed online service that connects customers to the Internet at speeds significantly faster than telephone dial-up services. As of December 31, 1999, the Road Runner Joint Venture had approximately 550,000 subscribers in 37 markets that pass more than 13 million homes.

Cable Television System Joint Ventures

Time Warner Cable has an approximate 50% weighted-average interest in a number of unconsolidated cable television systems that served an aggregate 1.7 million subscribers as of December 31, 1999. For 1999, these cable television systems reported combined operating income of \$231 million and combined depreciation and amortization of \$267 million. In addition, at the end of 1999, these cable television systems had debt of approximately \$1.9 billion.

Other Investments

Time Warner has a number of other fair value method investments, including interests in Internet-related and digital media businesses. These interests generally consist of common equity and common equity equivalents. As of December 31, 1999, Internet-related and digital media investments included 2,252,252 of common share equivalents in OpenTV Corp., a designer and marketer of digital interactive television software and components; 349,612 of common share equivalents in Intervu Inc., a service provider for Internet audio and video delivery solutions; 2,486,742 of common share equivalents in Healtheon/WebMD Corp., an end-to-end Internet healthcare company connecting physicians and consumers to the entire healthcare industry; 5,170,509 of common share equivalents in Fortune City, an international online community; and 2,627,080 of common share

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equivalents in Hoover's Inc., an Internet provider of news, financial and other information on various companies and industries.

Time Warner's ownership and voting interests in these companies are generally less than 20%, which is not large enough to exert significant influence. As such, these publicly traded investments are accounted for at market value. As of December 31, 1999, the aggregate market value of these publicly traded investments approximated \$450 million, resulting in unrealized pretax gains of approximately \$350 million included as a component of other comprehensive income in shareholders' equity.

6. INVENTORIES

Inventories consist of:

	December 31, 1999		December 31, 1998		December 31, 1998	
	Historical		Pro Forma		Historical	
	Current	Noncurrent	Current	Noncurrent	Current	Noncurrent
	(millions)					
Film costs:						
Released, less amortization	\$ 777	\$ 966	\$ 665	\$1,052	\$ 51	\$ 308
Completed and not released	73	17	199	76	20	—
In process and other	8	864	25	811	2	240
Library, less amortization	—	1,554	—	1,668	—	1,007
Programming costs, less amortization	820	800	883	612	457	345
Magazines, books, recorded music and other merchandise	504	—	486	—	416	—
Total	<u>\$2,182</u>	<u>\$4,201</u>	<u>\$2,258</u>	<u>\$4,219</u>	<u>\$946</u>	<u>\$1,900</u>

Excluding the Library, the unamortized cost of completed films at December 31, 1999 amounted to \$1.8 billion, over 90% of which is expected to be amortized within three years after release.

7. LONG-TERM DEBT

Long-term debt consists of:

	Weighted Average Interest Rate at December 31, 1999	Maturities	December 31,		
			1999 Historical	1998 Pro Forma	1998 Historical
			(millions)		
Bank credit agreement borrowings	6.85%	2002	\$ 4,846	\$ 3,945	\$ 1,234
Commercial paper	6.46%	2000	360	62	—
Fixed-rate senior notes and debentures	8.03%	2000-2036	12,277	12,296	8,491
Variable-rate senior notes	5.93%	2031	600	1,200	1,200
Total			<u>\$18,083</u>	<u>\$17,503</u>	<u>\$10,925</u>

Bank Credit Agreement

Time Warner has a revolving credit facility (the "Bank Credit Agreement") that permits borrowings in an aggregate amount of up to \$7.5 billion, with no scheduled reduction in credit availability prior to maturity in

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November 2002. The borrowers under the Bank Credit Agreement are Time Warner and a number of its consolidated subsidiaries, consisting of Time Warner Companies, Inc. (“TW Companies”), Turner Broadcasting System, Inc. (“TBS”), TWI Cable, TWE and TWE-A/N. Borrowings under the Bank Credit Agreement are limited to (i) \$6 billion in the aggregate for Time Warner, TW Companies, TBS and TWI Cable, (ii) \$7.5 billion in the case of TWE and (iii) \$2 billion in the case of TWE-A/N, subject in each case to an aggregate borrowing limit of \$7.5 billion and certain other limitations and adjustments. Such borrowings bear interest at specific rates for each of the borrowers (generally equal to LIBOR plus a margin of 35 basis points) and each borrower is required to pay a commitment fee of .125% per annum on the unused portion of its commitment, which margin and fee vary based on the credit rating or financial leverage of the applicable borrower. Borrowings may be used for general business purposes and unused credit is available to support commercial paper borrowings. The Bank Credit Agreement contains certain covenants generally for each borrower relating to, among other things, additional indebtedness; liens on assets; cash flow coverage and leverage ratios; and dividends, distributions and other restricted cash payments or transfers of assets from the borrowers to their respective shareholders, partners or affiliates.

Variable-Rate Senior Notes

In 1999, TW Companies redeemed all of its \$600 million principal amount of Floating Rate Reset Notes due July 29, 2009. The aggregate redemption cost of approximately \$620 million was funded with borrowings under the Bank Credit Agreement.

The only variable-rate senior notes outstanding at the end of 1999 were \$600 million principal amount of Floating Rate Reset Notes due December 30, 2031 that are redeemable at the election of the holders on December 30, 2001 (the “Five-Year Floating Rate Notes”). The Five-Year Floating Rate Notes bear interest at a floating rate equal to LIBOR less 25 basis points until December 30, 2001, at which time, if not redeemed, the interest rate will be reset at a fixed rate equal to 6.59% plus a margin based upon the credit risk of TW Companies at such time.

Zero-Coupon Convertible Notes

During 1998, approximately \$1.15 billion accreted amount of zero-coupon convertible notes due 2013 (the “Zero-Coupon Convertible Notes”) were converted into an aggregate 37.4 million shares of Time Warner common stock. To partially offset the dilution resulting from this conversion, Time Warner incurred a corresponding \$1.15 billion of debt and used the proceeds therefrom to repurchase common stock.

Interest Expense and Maturities

Time Warner periodically refinances its debt in an effort to lower its overall cost of borrowings and to stagger debt maturities. In connection with such refinancings, Time Warner recognized an extraordinary loss on the retirement of debt of \$12 million in 1999 and \$55 million in 1997.

At December 31, 1999, Time Warner had interest rate swap contracts to pay floating-rates of interest and receive fixed-rates of interest on \$400 million notional amount of indebtedness, which resulted in approximately 34% of Time Warner’s underlying debt being subject to variable interest rates (Note 15).

Interest expense amounted to \$1.519 billion in 1999, \$891 million in 1998 (\$1.451 billion on a pro forma basis) and \$1.049 billion in 1997. The weighted average interest rate on Time Warner’s total debt, including TWE’s debt and the effect of interest rate swap contracts, was 7.6% and 7.3% at December 31, 1999 and 1998, respectively.

Annual repayments of long-term debt for the five years subsequent to December 31, 1999 consist of \$500 million due in 2000, \$5.8 billion due in 2002, \$48 million due in 2003 and \$523 million due in 2004. Such

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repayments exclude the aggregate redemption price of \$600 million in 2001 relating to the Five-Year Floating Rate Notes, the year in which the holders thereof may first exercise their redemption options. Time Warner has the intent and ability under the Bank Credit Agreement to continue to refinance its borrowings on a long-term basis.

Fair Value of Debt

Based on the level of interest rates prevailing at December 31, 1999, the fair value of Time Warner's fixed rate debt approximated its carrying value. Based on the level of interest rates prevailing at December 31, 1998, the fair value of Time Warner's fixed-rate debt exceeded its carrying value by \$1.098 billion (\$1.862 billion on a pro forma basis). Unrealized gains or losses on debt do not result in the realization or expenditure of cash and generally are not recognized for financial reporting purposes unless the debt is retired prior to its maturity.

8. BORROWINGS AGAINST FUTURE STOCK OPTION PROCEEDS

In connection with Time Warner's common stock repurchase program (Note 12), Time Warner has a \$1.3 billion revolving credit facility that provides for borrowings against future stock option proceeds (the "Stock Option Proceeds Credit Facility"). Borrowings under the Stock Option Proceeds Credit Facility are principally used to fund stock repurchases. At December 31, 1999 and 1998, Time Warner had outstanding borrowings against future stock option proceeds of \$1.243 billion and \$895 million, respectively.

As of December 31, 1999, the Stock Option Proceeds Credit Facility provided for borrowings of up to \$1.3 billion, of which up to \$125 million was reserved solely for the payment of interest and fees thereunder. Borrowings under the Stock Option Proceeds Credit Facility generally bear interest at LIBOR plus a margin equal to 75 basis points and are principally expected to be repaid from the cash proceeds received from the exercise of designated employee stock options. The receipt of such stock option proceeds in excess of \$1.3 billion through March 2000, and thereafter in full on a cumulative basis, must be used to permanently reduce the borrowing availability under the facility. At December 31, 1999, based on a closing market price of Time Warner common stock of \$72.31, the aggregate value of potential proceeds to Time Warner from the exercise of outstanding vested, "in the money" stock options covered under the facility was approximately \$1.8 billion, representing a 1.4 to 1 coverage ratio over the related \$1.3 billion borrowing availability. To the extent that such stock option proceeds are not sufficient to satisfy Time Warner's obligations under the Stock Option Proceeds Credit Facility, Time Warner is generally required to repay such borrowings using proceeds from the sale of shares of its common stock held in escrow under the Stock Option Proceeds Credit Facility or, at Time Warner's election, using available cash on hand. Time Warner had placed 76 million shares in escrow at December 31, 1999, which shares are not considered to be issued and outstanding capital stock of the Company. Time Warner may be required, from time to time, to have up to 210 million shares held in escrow.

Because borrowings under the Stock Option Proceeds Credit Facility are expected to be principally repaid by Time Warner from the cash proceeds related to the exercise of employee stock options, Time Warner's principal credit rating agencies have concluded that such borrowings and related financing costs are credit neutral and are excludable from debt and interest expense for purposes of evaluating the Company's leverage and coverage ratios.

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9. INCOME TAXES

Domestic and foreign pretax income are as follows:

	Years Ended December 31,		
	1999	1998	1997
	(millions)		
Domestic	\$3,184	\$486	\$728
Foreign	316	100	104
Total	<u>\$3,500</u>	<u>\$586</u>	<u>\$832</u>

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

	Years Ended December 31,		
	1999	1998	1997
	(millions)		
Federal:			
Current ^(a)	\$ 470	\$ 436	\$191
Deferred	556	(259)	49
Foreign:			
Current ^(b)	240	260	205
Deferred	9	(49)	(3)
State and Local:			
Current ^(a)	179	166	88
Deferred	86	(136)	1
Total	<u>\$1,540</u>	<u>\$ 418</u>	<u>\$531</u>

(a) Includes utilization of tax carryforwards of \$198 million in 1999, \$126 million in 1998 and \$109 million in 1997. Excludes federal and state and local tax benefits of \$486 million in 1999, \$478 million in 1998 and \$165 million in 1997 resulting from the exercise of stock options and vesting of restricted stock awards, which were credited directly to paid-in-capital. Excludes current tax benefits of \$9 million in 1999 and \$37 million in 1997 resulting from the retirement of debt, which reduced the extraordinary losses in such years.

(b) Includes foreign withholding taxes of \$120 million in 1999, \$113 million in 1998 and \$114 million in 1997.

The differences between income taxes expected at the U.S. federal statutory income tax rate of 35% and income taxes provided are as set forth below. The relationship between income before income taxes and income tax expense is most affected by the amortization of goodwill and certain other financial statement expenses that are not deductible for income tax purposes.

	Years Ended December 31,		
	1999	1998	1997
	(millions)		
Taxes on income at U.S. federal statutory rate	\$1,225	\$205	\$291
State and local taxes, net of federal tax benefits	172	20	58
Nondeductible goodwill amortization	173	170	170
Other nondeductible expenses	9	13	11
Foreign income taxed at different rates, net of U.S. foreign tax credits	(37)	—	9
Other	(2)	10	(8)
Total	<u>\$1,540</u>	<u>\$418</u>	<u>\$531</u>

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Significant components of Time Warner's net deferred tax liabilities are as follows:

	December 31,	
	1999	1998
	(millions)	
Assets acquired in business combinations	\$2,635	\$3,158
Depreciation and amortization	2,240	1,112
Unrealized appreciation of certain marketable securities	155	4
Other	<u>422</u>	<u>452</u>
Deferred tax liabilities	<u>5,452</u>	<u>4,726</u>
Tax carryforwards	231	304
Accrued liabilities	572	513
Receivable allowances and return reserves	223	217
Other	<u>192</u>	<u>201</u>
Deferred tax assets	<u>1,218</u>	<u>1,235</u>
Net deferred tax liabilities	<u>\$4,234</u>	<u>\$3,491</u>

U.S. income and foreign withholding taxes have not been recorded on permanently reinvested earnings of foreign subsidiaries aggregating approximately \$1.1 billion at December 31, 1999. Determination of the amount of unrecognized deferred U.S. income tax liability with respect to such earnings is not practicable. If such earnings are repatriated, additional U.S. income and foreign withholding taxes are substantially expected to be offset by the accompanying foreign tax credits.

U.S. federal tax carryforwards at December 31, 1999 consisted of \$93 million of net operating losses, \$123 million of investment tax credits and \$76 million of alternative minimum tax credits. The utilization of certain carryforwards is subject to limitations under U.S. federal income tax laws. Except for the alternative minimum tax credits which do not expire, the other U.S. federal tax carryforwards expire in varying amounts as follows for income tax reporting purposes:

	Carryforwards	
	Net Operating Losses	Investment Tax Credits
	(millions)	
2000	\$ 1	\$ 25
2001	1	36
2002	—	32
2003	—	13
Thereafter up to 2012	<u>91</u>	<u>17</u>
	<u>\$93</u>	<u>\$123</u>

10. MANDATORILY REDEEMABLE PREFERRED SECURITIES

Redemption of REIT Preferred Stock

In 1997, a newly formed, substantially owned subsidiary of TWE (the "REIT") issued 250,000 shares of preferred stock ("REIT Preferred Stock"). The REIT was intended to qualify as a real estate investment trust under the Internal Revenue Code of 1986, as amended.

In March 1999, the REIT redeemed all of its shares of REIT Preferred Stock at an aggregate cost of \$217 million, which approximated net book value. The redemption was funded with borrowings under TWE's bank credit agreement.

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Redemption of Hasbro-Related Preferred Trust Securities

In 1995, Time Warner, through TW Companies, issued approximately 12.1 million Company-obligated mandatorily redeemable preferred securities of a wholly owned subsidiary (“PERCS”) for aggregate gross proceeds of \$374 million. The PERCS were mandatorily redeemable in December 1997 for an amount per PERCS equal to the lesser of \$54.41, and the market value of 1.5 shares of common stock of Hasbro, Inc. (“Hasbro”) on December 17, 1997, payable in cash or, at Time Warner’s option, Hasbro common stock. Pursuant to these terms, Time Warner redeemed the PERCS in December 1997 for all of its 18.1 million shares of Hasbro common stock. In connection with this redemption and the related disposal of its interest in Hasbro, Time Warner recognized a \$200 million pretax gain in 1997, which has been classified in interest and other, net, in the accompanying consolidated statement of operations.

Preferred Trust Securities

In 1995, Time Warner, 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 is the obligor on the Preferred Trust Securities are \$592 million principal amount of 8 $\frac{1}{2}$ % subordinated debentures of TW Companies due December 31, 2025. Cumulative cash distributions are payable on the Preferred Trust Securities at an annual rate of 8 $\frac{1}{2}$ %. The Preferred Trust Securities are mandatorily redeemable for cash on December 31, 2025, and TW Companies has the right to redeem the Preferred Trust Securities, in whole or in part, on or after December 31, 2000, or in other certain circumstances. If TW Companies elects to redeem these securities, the redemption amount would be in each case at an amount per Preferred Trust Security equal to \$25 per security, plus accrued and unpaid distributions thereon.

Time Warner has certain obligations relating to the Preferred Trust Securities which amount to a full and unconditional guaranty (on a subordinated basis) of its subsidiary’s obligations with respect thereto.

11. REDEMPTION OF SERIES M PREFERRED STOCK

In December 1998, Time Warner redeemed all of its outstanding shares of 10 $\frac{1}{4}$ % Series M Preferred Stock. The aggregate redemption cost of approximately \$2.1 billion was funded with proceeds from the issuance of lower-cost debt. As a result of this redemption, preferred dividend requirements in Time Warner’s 1998 consolidated statement of operations include a one-time effect of \$234 million relating to the redemption premium paid in connection therewith.

Because the weighted-average interest rate of the debt is approximately 400 basis points lower than the dividend rate of the Series M Preferred Stock and the interest on the debt is tax deductible (whereas dividends are not), Time Warner has realized over \$100 million of annual cash savings as a result of this redemption.

12. SHAREHOLDERS’ EQUITY

At December 31, 1999, shareholders’ equity of Time Warner included 8.4 million shares of convertible preferred stock, 114.1 million shares of Series LMCN-V common stock and 1.173 billion shares of common stock (net of 22.1 million shares of common stock in treasury). Time Warner currently is authorized to issue up to 250 million shares of preferred stock, up to 5 billion shares of common stock and up to 600 million shares of additional classes of common stock, including Series LMCN-V common stock. Shares of Series LMCN-V common stock have substantially identical rights as shares of Time Warner’s common stock, except shares of Series LMCN-V common stock have limited voting rights and are non-redeemable.

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Convertible Preferred Stock

Over the past two years, Time Warner issued approximately 112.6 million shares of common stock in connection with the conversion of 27 million shares of convertible preferred stock. After those conversions, and the conversion in January 2000 of substantially all outstanding shares of Series F preferred stock into 12.3 million shares of common stock, Time Warner has approximately 5.4 million shares of convertible preferred stock outstanding. Such shares are convertible into approximately 22.7 million shares of Time Warner common stock.

The principal terms of each outstanding series of convertible preferred stock (collectively, the “Convertible Preferred Stock”) are similar in nature, unless otherwise noted below. Each share of Convertible Preferred Stock: (1) is entitled to a liquidation preference of \$100 per share, (2) is immediately convertible into 4.16528 shares of Time Warner common stock at a conversion price of \$24 per share (based on its liquidation value) and (3) entitles the holder thereof to vote with the common stockholders on all matters on which the common stockholders are entitled to vote, and each share of such Convertible Preferred Stock is entitled to four votes on any such matter.

Holders of Series E preferred stock and Series J preferred stock will receive a \$3.75 annual dividend per share through January 4, 2001 and May 2, 2000, respectively. Thereafter, holders of Series E preferred stock and Series J preferred stock will receive dividends equal to the dividends paid on shares of Time Warner common stock multiplied by the number of shares into which their shares of preferred stock are convertible (the “Common Equivalent Dividend Rate”). Holders of Series F preferred stock and Series I preferred stock will continue to receive dividends based on the Common Equivalent Dividend Rate.

Time Warner has the right at any time to redeem for cash or exchange for Time Warner common stock, shares of Series I preferred stock at their liquidation value or stated conversion price. Time Warner also has the right at any time to exchange for Time Warner common stock, shares of Series F preferred stock and to redeem such shares for cash at any time on or after January 4, 2001. These rights also are exercisable at any time on or after May 2, 2000 for shares of Series J preferred stock and January 4, 2001 for shares of Series E preferred stock.

Common Stock Repurchase Program

In January 1999, Time Warner’s Board of Directors authorized a new common stock repurchase program that allows the Company to repurchase, from time to time, up to \$5 billion of common stock. This program was expected to be completed over a three-year period. However, in connection with Time Warner’s agreement to merge with America Online, Time Warner currently has suspended its stock repurchase program.

During 1999, Time Warner acquired 28.4 million shares of its common stock at an aggregate cost of \$1.896 billion. These repurchases increased the cumulative shares purchased under this and its previous common stock repurchase program begun in 1996 to approximately 123.5 million shares at an aggregate cost of \$4.936 billion, or approximately \$40 per share.

1998 Stock Split

In December 1998, a two-for-one common stock split was effectuated by the payment of a 100% stock dividend in the amount of 558.2 million shares of common stock (the “1998 Stock Split”). The 1998 Stock Split did not affect the number of shares of Series LMCN-V common stock outstanding in 1998. In May 1999, Time Warner amended the terms of its Series LMCN-V common stock, which effectively resulted in a two-for-one stock split and the issuance of approximately 57 million shares of Series LMCN-V common stock (the “LMCN-V Stock Split”). As a result, each share of Series LMCN-V common stock now is equivalent effectively to one share of common stock instead of two. Because the equivalent number of shares of common

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stock did not change, the LMCN-V Stock Split did not have any effect on Time Warner's consolidated financial statements.

Dilutive Securities and Holders of Record

At December 31, 1999, Time Warner had convertible securities and outstanding stock options that were convertible or exercisable into approximately 158.6 million shares of common stock (as adjusted for the January 2000 conversion of Series F preferred stock). Similarly, those securities were convertible or exercisable into approximately 242.2 million shares of common stock at December 31, 1998 and 363.6 million shares at December 31, 1997. In addition, Time Warner has placed a number of shares of common stock in escrow under its Stock Option Proceeds Credit Facility (see Note 8).

At February 29, 2000, there were approximately 25,000 holders of record of Time Warner common stock. This total does not include the large number of investors who hold such shares through banks, brokers or other fiduciaries.

Shareholder Rights Plan

Pursuant to Time Warner's shareholder rights plan, as amended, each share of Time Warner common stock has attached to it one right, which becomes exercisable in certain events involving the acquisition of 15% or more of the then outstanding common stock of Time Warner on a fully diluted basis. Upon the occurrence of such an event, each right entitles its holder to purchase for \$75 the economic equivalent of common stock of Time Warner, or in certain circumstances, of the acquiror, worth twice as much. In connection with the plan, 8 million shares of preferred stock were reserved. The rights expire on January 20, 2004.

In connection with Time Warner's agreement to merge with America Online, Inc. ('America Online') entered into in January 2000, Time Warner amended the rights plan to provide that the consummation of the merger and the other transactions contemplated by the merger agreement with America Online would not trigger the exercise of rights under the rights plan. See Note 20 for a summary of the terms of the America Online-Time Warner merger.

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Income (Loss) Per Common Share Before Extraordinary Item

Set forth below is a reconciliation of basic and diluted income (loss) per common share before extraordinary item for each period.

	Years Ended December 31,			
	1999 <u>Historical</u>	1998 <u>Pro Forma^(a)</u>	1998 <u>Historical^(a)</u>	1997 <u>Historical^(a)</u>
	(millions, except per share amounts)			
Income (loss) applicable to common shares before extraordinary item—basic	\$1,908	\$ (372)	\$ (372)	\$ (18)
Interest savings, net of tax ^(b)	43	—	—	—
Preferred dividends	<u>52</u>	—	—	—
Income (loss) applicable to common shares before extraordinary item—diluted	<u>\$2,003</u>	<u>\$ (372)</u>	<u>\$ (372)</u>	<u>\$ (18)</u>
Average number of common shares outstanding—basic	1,267.0	1,194.7	1,194.7	1,135.4
Dilutive effect of stock options	72.6	—	—	—
Dilutive effect of convertible preferred shares	<u>58.7</u>	—	—	—
Average number of common shares outstanding—diluted	<u>1,398.3</u>	<u>1,194.7</u>	<u>1,194.7</u>	<u>1,135.4</u>
Income (loss) per common share before extraordinary item:				
Basic	<u>\$ 1.51</u>	<u>\$ (.31)</u>	<u>\$ (.31)</u>	<u>\$ (.01)</u>
Diluted	<u>\$ 1.43</u>	<u>\$ (.31)</u>	<u>\$ (.31)</u>	<u>\$ (.01)</u>

(a) 1998 and 1997 basic and diluted loss per common share before extraordinary item are the same because the effect of Time Warner's stock options and convertible preferred stock was antidilutive.

(b) Reflects the required use of a portion of the proceeds from the future exercise of employee stock options to repay all outstanding borrowings under Time Warner's stock option proceeds credit facility.

13. STOCK-BASED COMPENSATION PLANS

Stock Option Plans

Time Warner has various stock option plans under which Time Warner may grant options to purchase Time Warner common stock to employees of Time Warner and TWE. Such options have been granted to employees of Time Warner and TWE with exercise prices equal to, or in excess of, fair market value at the date of grant. Accordingly, in accordance with APB 25 and related interpretations, compensation cost generally is not recognized for its stock option plans. Generally, the options become exercisable over a three-year vesting period and expire ten years from the date of grant. Had compensation cost for Time Warner's stock option plans been determined based on the fair value method set forth in FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("FAS 123"), Time Warner's net income and basic and diluted net income (loss) per common share would have been changed to the pro forma amounts indicated below:

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	Years Ended December 31,		
	1999	1998	1997
	(millions, except per share amounts)		
Net income:			
As reported.....	\$1,948	\$ 168	\$ 246
Pro forma.....	<u>\$1,852</u>	<u>\$ 106</u>	<u>\$ 200</u>
Net income (loss) per basic common share:			
As reported.....	\$ 1.50	\$(.31)	\$(.06)
Pro forma.....	<u>\$ 1.42</u>	<u>\$(.36)</u>	<u>\$(.10)</u>
Net income (loss) per diluted common share:			
As reported.....	\$ 1.42	\$(.31)	\$(.06)
Pro forma.....	<u>\$ 1.36</u>	<u>\$(.36)</u>	<u>\$(.10)</u>

For purposes of applying FAS 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1999, 1998 and 1997: dividend yields of 0.3%, 0.5% and 1%, respectively; expected volatility of 23.4%, 21.6% and 21.9%, respectively; risk-free interest rates of 5.3%, 5.5% and 6.4%, respectively; and expected lives of 5 years in all periods. The weighted average fair value of an option granted during the year was \$21.18 (\$12.50, net of taxes), \$11.13 (\$6.57, net of taxes) and \$6.58 (\$3.88, net of taxes) for the years ended December 31, 1999, 1998 and 1997, respectively. In each period, Time Warner granted options to certain executives at exercise prices exceeding the market price of Time Warner common stock on the date of grant. These above-market options had a weighted average exercise price and fair value of \$95.10 and \$19.49 (\$11.50, net of taxes), respectively, in 1999; \$49.54 and \$9.45 (\$5.58, net of taxes), respectively, in 1998; and \$32.45 and \$6.29 (\$3.71, net of taxes), respectively, in 1997.

A summary of stock option activity under all plans is as follows:

	Thousands of Shares	Weighted-Average Exercise Price
Balance at January 1, 1997.....	195,734	\$15.98
Granted.....	16,544	22.41
Exercised.....	(32,632)	13.66
Cancelled.....	(942)	18.89
Balance at December 31, 1997.....	178,704	\$16.99
Granted.....	18,100	37.71
Exercised.....	(48,323)	15.01
Cancelled.....	(417)	28.01
Balance at December 31, 1998.....	148,064	\$20.14
Granted.....	12,954	68.50
Exercised.....	(24,257)	16.49
Cancelled.....	(893)	46.17
Balance at December 31, 1999.....	<u>135,868</u>	\$25.23

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	December 31,		
	1999	1998	1997
	(thousands)		
Exercisable	106,728	112,471	145,616
Available for future grants	21,635	11,207	12,771

The following table summarizes information about stock options outstanding at December 31, 1999:

<u>Range of Exercise Prices</u>	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/99	Weighted- Average Remaining Contractual Life	Weighted- Average Exercise Price	Number Exercisable at 12/31/99	Weighted- Average Exercise Price
	(thousands)			(thousands)	
Under \$10	6,104	0.6 years	\$ 9.08	6,104	\$ 9.08
\$10.00 to \$15.00	18,760	2.6 years	\$12.11	18,760	\$12.11
\$15.01 to \$20.00	46,331	3.9 years	\$18.28	44,974	\$18.27
\$20.01 to \$30.00	33,265	5.4 years	\$22.06	29,547	\$21.94
\$30.01 to \$45.00	15,874	7.9 years	\$35.08	6,403	\$34.68
\$45.01 to \$65.00	5,070	8.5 years	\$54.35	928	\$48.67
\$65.01 to \$103.74	10,464	9.0 years	\$69.96	12	\$69.16
Total	135,868	5.0 years	\$25.23	106,728	\$18.93

For options exercised by employees of TWE, Time Warner is reimbursed by TWE for the amount by which the market value of Time Warner common stock on the exercise date exceeds the exercise price, or the greater of the exercise price or \$13.88 for options granted prior to the TWE capitalization on June 30, 1992. There were 44.8 million options held by employees of TWE at December 31, 1999, 34.7 million of which were exercisable.

Restricted Stock Plans

Time Warner also has various restricted stock plans for employees and non-employee directors of the Board. Under these plans, shares of common stock are granted which do not vest until the end of a restriction period, generally between three to five years. In accordance with APB 25 and related interpretations, Time Warner recognizes compensation cost for restricted stock awards ratably over the vesting period based on the fair market value of the shares on the date of grant.

At December 31, 1999, Time Warner had approximately 190,000 shares of restricted stock outstanding. During 1999, Time Warner issued 99,400 shares of restricted stock at a weighted-average fair value of \$64.24. Grants of restricted stock in prior years were not significant. In addition, compensation cost recognized in connection with restricted stock grants was not material in any period.

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

In connection with Time Warner's agreement to merge with America Online entered into in January 2000, all Time Warner stock options and restricted stock outstanding at that time became fully vested, pursuant to the terms of Time Warner's stock option and restricted stock plans. See Note 20 for a summary of the terms of the America Online-Time Warner merger.

14. BENEFIT PLANS

Time Warner and its subsidiaries have defined benefit pension plans covering most domestic employees. Pension benefits are based on formulas that reflect the employees' years of service and compensation levels

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during their employment period. Time Warner's common stock represents approximately 13% and 12% of plan assets at December 31, 1999 and 1998, respectively. A summary of activity for Time Warner's defined benefit pension plans is as follows:

	Years Ended December 31,			
	<u>1999</u> <u>Historical</u>	<u>1998</u> <u>Pro Forma</u>	<u>1998</u> <u>Historical</u>	<u>1997</u> <u>Historical</u>
	(millions)			
Components of Pension Expense				
Service cost	\$ 107	\$ 95	\$ 53	\$ 45
Interest cost	118	110	74	68
Expected return on plan assets	(132)	(108)	(73)	(62)
Net amortization and deferral	<u>(3)</u>	<u>2</u>	<u>2</u>	<u>1</u>
Total	<u>\$ 90</u>	<u>\$ 99</u>	<u>\$ 56</u>	<u>\$ 52</u>
	December 31,			
	<u>1999</u> <u>Historical</u>	<u>1998</u> <u>Pro Forma</u>	<u>1998</u> <u>Historical</u>	
	(millions)			
Change in Projected Benefit Obligation				
Projected benefit obligation at beginning of year	\$1,749	\$1,451	\$ 990	
Service cost	107	95	53	
Interest cost	118	110	74	
Actuarial (gain) loss ^(a)	(427)	159	98	
Benefits paid	<u>(70)</u>	<u>(66)</u>	<u>(52)</u>	
Projected benefit obligation at end of year	<u>1,477</u>	<u>1,749</u>	<u>1,163</u>	
Change in Plan Assets				
Fair value of plan assets at beginning of year	1,480	1,203	839	
Actual return on plan assets	266	303	191	
Employer contribution	21	34	16	
Benefits paid	<u>(64)</u>	<u>(60)</u>	<u>(46)</u>	
Fair value of plan assets at end of year	<u>1,703</u>	<u>1,480</u>	<u>1,000</u>	
Overfunded (unfunded) projected benefit obligation	226	(269)	(163)	
Additional minimum liability ^(b)	(40)	(37)	(33)	
Unrecognized actuarial gain ^(a)	(589)	(26)	(16)	
Unrecognized prior service cost	<u>26</u>	<u>21</u>	<u>16</u>	
Accrued pension expense	<u>\$ (377)</u>	<u>\$ (311)</u>	<u>\$ (196)</u>	

(a) Reflects certain changes in actuarial assumptions made during 1999, including a shortening of the expected service period and an increase in the discount rate.

(b) The additional minimum liability is offset fully by a corresponding intangible asset recognized in the consolidated balance sheet.

	December 31,		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
Weighted-Average Pension Assumptions			
Discount rate	7.75%	6.75%	7.25%
Expected return on plan assets	9%	9%	9%
Rate of compensation increase	6%	6%	6%

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Included above are projected benefit obligations and accumulated benefit obligations for unfunded defined benefit pension plans of \$174 million and \$145 million as of December 31, 1999, respectively; and \$118 million and \$97 million as of December 31, 1998, respectively (\$157 million and \$124 million on a pro forma basis).

Employees of Time Warner's operations in foreign countries participate to varying degrees in local pension plans, which in the aggregate are not significant.

Time Warner also has certain defined contribution plans, including savings and profit sharing plans, as to which the expense amounted to \$100 million in 1999, \$84 million in 1998 (\$119 million on a pro forma basis) and \$83 million in 1997. Contributions to the savings plans are based upon a percentage of the employees' elected contributions. Contributions to the profit sharing plans generally are determined by management and approved by the boards of directors of the participating companies.

15. DERIVATIVE FINANCIAL INSTRUMENTS

Time Warner uses derivative financial instruments principally to manage the risk that changes in interest rates will affect either the fair value of its debt obligations or the amount of its future interest payments and, with regard to foreign currency exchange rates, to manage the risk that changes in exchange rates will affect the amount of unremitted or future royalties and license fees to be received from the sale of U.S. copyrighted products abroad. The following is a summary of Time Warner's risk management strategies and the effect of these strategies on Time Warner's consolidated financial statements.

Interest Rate Risk Management

Interest Rate Swap Contracts

Interest rate swap contracts are used to adjust the proportion of total debt that is subject to variable and fixed interest rates. Under an interest rate swap contract, Time Warner either agrees to pay an amount equal to a specified variable-rate of interest times a notional principal amount, and to receive in return an amount equal to a specified fixed-rate of interest times the same notional principal amount or, vice versa, to receive a variable-rate amount and to pay a fixed-rate amount. The notional amounts of the contract are not exchanged. No other cash payments are made unless the contract is terminated prior to maturity, in which case the amount paid or received in settlement is established by agreement at the time of termination, and usually represents the net present value, at current rates of interest, of the remaining obligations to exchange payments under the terms of the contract. Interest rate swap contracts are entered into with a number of major financial institutions in order to minimize counterparty credit risk.

Time Warner accounts for its interest rate swap contracts differently based on whether it has agreed to pay an amount based on a variable-rate or fixed-rate of interest. For interest rate swap contracts under which Time Warner agrees to pay variable-rates of interest, these contracts are considered to be a hedge against changes in the fair value of Time Warner's fixed-rate debt obligations. Accordingly, the interest rate swap contracts are reflected at fair value in Time Warner's consolidated balance sheet and the related portion of fixed-rate debt being hedged is reflected at an amount equal to the sum of its carrying value plus an adjustment representing the change in fair value of the debt obligations attributable to the interest rate risk being hedged. In addition, changes during any accounting period in the fair value of these interest rate swap contracts, as well as offsetting changes in the adjusted carrying value of the related portion of fixed-rate debt being hedged, are recognized as adjustments to interest expense in Time Warner's consolidated statement of operations. The net effect of this accounting on Time Warner's operating results is that interest expense on the portion of fixed-rate debt being hedged is generally recorded based on variable interest rates.

For interest rate swap contracts under which Time Warner agrees to pay fixed-rates of interest, these contracts are considered to be a hedge against changes in the amount of future cash flows associated with Time

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Warner's interest payments of Time Warner's variable-rate debt obligations. Accordingly, the interest rate swap contracts are reflected at fair value in Time Warner's consolidated balance sheet and the related gains or losses on these contracts are deferred in shareholders' equity (as a component of comprehensive income). These deferred gains and losses are then amortized as an adjustment to interest expense over the same period in which the related interest payments being hedged are recognized in income. However, to the extent that any of these contracts are not considered to be perfectly effective in offsetting the change in the value of the interest payments being hedged, any changes in fair value relating to the ineffective portion of these contracts are immediately recognized in income. The net effect of this accounting on Time Warner's operating results is that interest expense on the portion of variable-rate debt being hedged is generally recorded based on fixed interest rates.

At December 31, 1999, Time Warner had interest rate swap contracts to pay variable-rates of interest (average six-month LIBOR rate of 5.8%) and receive fixed-rates of interest (average rate of 5.5%) on \$400 million notional amount of indebtedness. This resulted in approximately 34% of Time Warner's underlying debt being subject to variable interest rates. The \$400 million notional amount of outstanding contracts will mature during 2000. At December 31, 1998, Time Warner had interest rate swap contracts on \$1.6 billion notional amount of indebtedness. The net gain or loss on the ineffective portion of these interest rate swap contracts was not material in any period.

Interest Rate Lock Agreements

In the past, Time Warner infrequently used interest rate lock agreements to hedge the risk that the cost of a future issuance of fixed-rate debt may be adversely affected by changes in interest rates. Under an interest rate lock agreement, Time Warner agrees to pay or receive an amount equal to the difference between the net present value of the cash flows for a notional principal amount of indebtedness based on the existing yield of a U.S. treasury bond at the date when the agreement is established and at the date when the agreement is settled, typically when Time Warner issues new debt. The notional amounts of the agreement are not exchanged. Interest rate lock agreements are entered into with a number of major financial institutions in order to minimize counterparty credit risk.

Interest rate lock agreements are reflected at fair value in Time Warner's consolidated balance sheet and the related gains or losses on these agreements are deferred in shareholders' equity (as a component of comprehensive income). These deferred gains and losses are then amortized as an adjustment to interest expense over the same period in which the related interest costs on the new debt issuances are recognized in income.

At December 31, 1998, Time Warner had outstanding interest rate lock agreements for an aggregate \$650 million notional principal amount of indebtedness, which were settled in January 1999. Since that time, Time Warner has not entered into any interest rate lock agreements to hedge the cost of future issuances of fixed-rate debt. At December 31, 1999, Time Warner had deferred approximately \$30 million of net losses on interest rate lock agreements, of which less than \$1 million is expected to be recognized in income over the next twelve months.

Foreign Currency Risk Management

Foreign exchange contracts are used primarily by Time Warner to hedge the risk that unremitted or future royalties and license fees owed to Time Warner domestic companies for the sale or anticipated sale of U.S. copyrighted products abroad may be adversely affected by changes in foreign currency exchange rates. As part of its overall strategy to manage the level of exposure to the risk of foreign currency exchange rate fluctuations, Time Warner hedges a portion of its foreign currency exposures anticipated over the ensuing twelve-month period. At December 31, 1999, Time Warner had effectively hedged approximately half of the estimated foreign currency exposures that principally relate to anticipated cash flows to be remitted to the U.S. over the ensuing

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twelve-month period. To hedge this exposure, Time Warner used foreign exchange contracts that generally have maturities of three months or less, which generally will be rolled over to provide continuing coverage throughout the year. Time Warner often closes foreign exchange sale contracts by purchasing an offsetting purchase contract. Foreign exchange contracts are placed with a number of major financial institutions in order to minimize credit risk.

Time Warner records these foreign exchange contracts at fair value in its consolidated balance sheet and the related gains or losses on these contracts are deferred in shareholders' equity (as a component of comprehensive income). These deferred gains and losses are recognized in income in the period in which the related royalties and license fees being hedged are received and recognized in income. However, to the extent that any of these contracts are not considered to be perfectly effective in offsetting the change in the value of the royalties and license fees being hedged, any changes in fair value relating to the ineffective portion of these contracts are immediately recognized in income. Gains and losses on foreign exchange contracts generally are included as a component of interest and other, net, in Time Warner's consolidated statement of operations.

At December 31, 1999, Time Warner had contracts for the sale of \$843 million and the purchase of \$468 million of foreign currencies at fixed rates. Contracts in a net sale position primarily consisted of Japanese yen (62% of net contract value), European currency (46%), Canadian dollars (15%) and English pounds (2%), offset in part by contracts in a net purchase position, primarily consisting of New Zealand dollars (34%).

Time Warner had contracts for the sale of \$755 million and the purchase of \$259 million of foreign currencies at December 31, 1998. Time Warner had deferred approximately \$1 million of net gains on foreign exchange contracts at December 31, 1999, which is substantially expected to be recognized in income over the next twelve months. Time Warner recognized \$8 million in losses in 1999, \$8 million in losses in 1998 (\$10 million on a pro forma basis) and \$27 million in gains in 1997, on foreign exchange contracts. These amounts were or are expected to be largely offset by corresponding decreases and increases, respectively, in the dollar value of foreign currency royalties and license fee payments that have been or are anticipated to be received in cash from the sale of U.S. copyrighted products abroad.

16. SEGMENT INFORMATION

Time Warner classifies its business interests into six fundamental areas: *Cable Networks*, consisting principally of interests in cable television programming; *Publishing*, consisting principally of interests in magazine publishing, book publishing and direct marketing; *Music*, consisting principally of interests in recorded music and music publishing; *Filmed Entertainment*, consisting principally of interests in filmed entertainment, television production and television broadcasting; *Cable*, consisting principally of interests in cable television systems; and *Digital Media*, consisting principally of interests in Internet-related and digital media businesses. Time Warner's Digital Media segment commenced operations in 1999.

Information as to the operations of Time Warner in different business segments is set forth below based on the nature of the products and services offered. Time Warner evaluates performance based on several factors, of which the primary financial measure is business segment operating income before noncash amortization of intangible assets ("EBITA"). As a result of the consolidation of the Entertainment Group in 1999, Time Warner's and the Entertainment Group's business segments have been combined. Accordingly, segment information for 1998 and 1997 has been restated in order to conform to the new presentation. The accounting policies of the business segments are the same as those described in the summary of significant accounting policies (Note 1). Intersegment sales are accounted for at fair value as if the sales were to third parties.

The operating results of Time Warner's Cable segment reflect (i) the TWE-A/N Transfers effective as of January 1, 1998, (ii) the Primestar Roll-up Transaction, effective as of April 1, 1998, (iii) the formation of the Road Runner Joint Venture, effective as of June 30, 1998, (iv) the Time Warner Telecom Reorganization,

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effective as of July 1, 1998 and (v) the formation of the Texas Cable Joint Venture, effective as of December 31, 1998.

	<u>Years Ended December 31,</u>		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
	(millions)		
Revenues			
Cable Networks	\$ 6,111	\$ 5,377	\$ 4,823
Publishing	4,663	4,496	4,290
Music	3,834	4,025	3,691
Filmed Entertainment	8,075	7,978	7,003
Broadcasting-The WB Network	384	260	136
Cable	5,374	5,342	5,240
Digital Media	1	—	—
Intersegment elimination	<u>(1,109)</u>	<u>(1,234)</u>	<u>(812)</u>
Total business segment revenues	\$27,333	\$26,244	\$24,371
Entertainment Group revenues reported on an unconsolidated basis ^(a)	<u>—</u>	<u>(11,662)</u>	<u>(11,077)</u>
Total consolidated revenues	<u>\$27,333</u>	<u>\$14,582</u>	<u>\$13,294</u>

(a) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

	<u>Years Ended December 31,</u>		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
	(millions)		
EBITA^(a)			
Cable Networks	\$1,397	\$1,160	\$ 964
Publishing	679	607	529
Music	452	493	467
Filmed Entertainment ^(b)	997	695	604
Broadcasting-The WB Network	(92)	(93)	(88)
Cable ^(c)	3,927	1,694	1,611
Digital Media	(17)	—	—
Intersegment elimination	<u>(10)</u>	<u>(94)</u>	<u>(54)</u>
Total business segment EBITA	\$7,333	\$4,462	\$4,033
Entertainment Group EBITA reported on an unconsolidated basis ^(d) ...	<u>—</u>	<u>(2,166)</u>	<u>(1,850)</u>
Total consolidated EBITA	<u>\$7,333</u>	<u>\$2,296</u>	<u>\$2,183</u>

(a) EBITA represents business segment operating income before noncash amortization of intangible assets. After deducting amortization of intangible assets, Time Warner's business segment operating income was \$6.035 billion in 1999, \$1.496 billion in 1998 and \$1.271 billion in 1997.

(b) 1999 results include a net pretax gain of \$215 million recognized in connection with the early termination and settlement of a long-term, home video distribution agreement and a pretax gain of \$97 million relating to the sale of an interest in CanalSatellite, offset in part by a one-time, noncash pretax charge of \$106 million relating to Warner Bros.'s retail stores.

(c) Includes net pretax gains relating to the sale or exchange of certain cable television systems and investments of approximately \$2.247 billion in 1999, \$108 million in 1998 and \$212 million in 1997.

(d) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

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

	<u>Years Ended December 31,</u>		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
	(millions)		
Depreciation of Property, Plant and Equipment			
Cable Networks	\$ 132	\$ 116	\$ 109
Publishing	81	80	79
Music	74	72	83
Filmed Entertainment	156	172	204
Broadcasting-The WB Network	1	1	1
Cable	786	864	862
Digital Media	<u>1</u>	<u>—</u>	<u>—</u>
Total business segment depreciation	\$1,231	\$1,305	\$1,338
Entertainment Group depreciation reported on an unconsolidated basis ^(a)	<u>—</u>	<u>(927)</u>	<u>(956)</u>
Total consolidated depreciation	<u>\$1,231</u>	<u>\$ 378</u>	<u>\$ 382</u>

(a) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

	<u>Years Ended December 31,</u>		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
	(millions)		
Amortization of Intangible Assets^(a)			
Cable Networks	\$ 205	\$ 200	\$ 199
Publishing	52	38	48
Music	273	280	301
Filmed Entertainment	201	216	215
Broadcasting-The WB Network	4	3	—
Cable	563	593	600
Digital Media	<u>—</u>	<u>—</u>	<u>—</u>
Total business segment amortization	\$1,298	\$1,330	\$1,363
Entertainment Group amortization reported on an unconsolidated basis ^(b)	<u>—</u>	<u>(530)</u>	<u>(451)</u>
Total consolidated amortization	<u>\$1,298</u>	<u>\$ 800</u>	<u>\$ 912</u>

(a) Includes amortization relating to all business combinations accounted for by the purchase method, including the \$14 billion acquisition of Warner Communications Inc. in 1989, the \$6.2 billion acquisition of TBS in 1996 and the \$2.3 billion of cable acquisitions in 1996 and 1995.

(b) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

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

Information as to the assets and capital expenditures is as follows:

	December 31,		
	1999	1998	1997
	(millions)		
Assets			
Cable Networks	\$ 9,940	\$ 9,499	\$ 9,441
Publishing	2,870	2,726	2,490
Music	7,483	7,354	6,797
Filmed Entertainment	10,393	10,841	10,658
Broadcasting-The WB Network	284	244	113
Cable	18,380	16,094	17,766
Digital Media	28	—	—
Corporate ^(a)	1,861	1,193	1,334
Total business segment assets	\$51,239	\$47,951	\$48,599
Entertainment Group assets reported on an unconsolidated basis ^(b)	—	(16,311)	(14,436)
Total consolidated assets	<u>\$51,239</u>	<u>\$31,640</u>	<u>\$34,163</u>

(a) Consists principally of cash, cash equivalents and other investments.

(b) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

	Years Ended December 31,		
	1999	1998	1997
	(millions)		
Capital Expenditures			
Cable Networks	\$ 229	\$ 143	\$ 132
Publishing	106	58	77
Music	134	92	87
Filmed Entertainment	136	125	147
Broadcasting-The WB Network	2	1	1
Cable	1,600	1,676	1,683
Digital Media	2	—	—
Corporate	22	20	12
Total business segment capital expenditures	\$2,231	\$ 2,115	\$ 2,139
Entertainment Group capital expenditures reported on an unconsolidated basis ^(a)	—	(1,603)	(1,565)
Total consolidated capital expenditures	<u>\$2,231</u>	<u>\$ 512</u>	<u>\$ 574</u>

(a) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

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

Information as to operations in different geographical areas is as follows:

	Years Ended December 31,		
	1999	1998	1997
	(millions)		
Revenues^(a)			
United States	\$21,654	\$ 20,803	\$ 19,004
United Kingdom	1,000	1,001	937
Germany	724	695	704
Japan	629	567	589
Canada	420	429	399
France	418	390	347
Other international	<u>2,488</u>	<u>2,359</u>	<u>2,391</u>
Total revenues by geographic area	\$27,333	\$ 26,244	\$ 24,371
Entertainment Group revenues reported on an unconsolidated basis ^(b)	—	(11,662)	(11,077)
Total	<u>\$27,333</u>	<u>\$ 14,582</u>	<u>\$ 13,294</u>

(a) Revenues are attributed to countries based on location of customer.

(b) Represents amounts previously reported for the Entertainment Group, adjusted by intercompany eliminations and other consolidating adjustments necessary for Time Warner to reflect the Entertainment Group on a consolidated basis.

Because a substantial portion of international revenues is derived from the sale of U.S. copyrighted products abroad, assets located outside the United States are not material.

17. COMMITMENTS AND CONTINGENCIES

Time Warner's total rent expense amounted to \$521 million in 1999, \$286 million in 1998 (\$504 million on a pro forma basis) and \$237 million in 1997. The minimum rental commitments under noncancellable long-term operating leases are: 2000-\$450 million; 2001-\$442 million; 2002-\$416 million; 2003-\$385 million; 2004-\$362 million; and after 2004-\$2.809 billion.

Time Warner's minimum commitments and guarantees under certain programming, licensing, artists, athletes, franchise and other agreements aggregated approximately \$14.5 billion at December 31, 1999, which are payable principally over a ten-year period.

Time Warner is subject to a class action lawsuit alleging collusive pricing practices by the major record companies in their capacity as distributors of compact discs to CD wholesalers and retailers. The trial presently is scheduled for the fall of 2000. Although management believes the case is without merit, an adverse jury verdict could result in a material loss to Time Warner. Due to the lack of specificity to plaintiffs' claims, a range of loss is not determinable at this time.

TWE also is subject to certain litigation relating to Six Flags. In December 1998, a jury returned an adverse verdict in the Six Flags matter in the amount of \$454 million. TWE and its former 51% partner in Six Flags are financially responsible for this judgment. Management believes that there were numerous legal errors in the case and has appealed the verdict. In management's opinion and considering the gain deferred on the sale of Six Flags described in Note 3 to cover this potential exposure, the resolution of this matter is not expected to have a material effect on Time Warner's financial statements.

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

Time Warner is subject to numerous other legal proceedings. In management's opinion and considering established reserves, the resolution of these matters will not have a material effect, individually and in the aggregate, on Time Warner's financial statements.

18. RELATED PARTY TRANSACTIONS

In the normal course of conducting their businesses, Time Warner and its subsidiaries and affiliates have had various transactions with TWE and other Entertainment Group companies, generally on terms resulting from a negotiation between the affected units that in management's view results in reasonable allocations. For all periods prior to the consolidation of the Entertainment Group in 1999, these transactions were included in Time Warner's operating results and reported as related party transactions. However, on a historical basis for 1999 and on a pro forma basis for 1998, these transactions have been eliminated in Time Warner's consolidated financial statements. Nevertheless, in order to facilitate an understanding of the effects of these transactions on Time Warner's historical financial statements for 1998 and 1997, a summary of significant transactions between Time Warner and TWE is provided below.

TWE's employees participate in various Time Warner medical, stock option and other benefit plans for which Time Warner charges TWE its allocable share of plan expenses, including administrative costs.

Time Warner's Cable Networks-TBS division has license agreements with TWE, pursuant to which the cable networks have acquired broadcast rights to certain film and television product. In addition, Time Warner's Music division provides home videocassette distribution services to certain TWE operations, and certain TWE units place advertising in magazines published by Time Warner's Publishing division.

Time Warner's Filmed Entertainment-TBS division has various service agreements with TWE's Filmed Entertainment-Warner Bros. division, pursuant to which TWE's Filmed Entertainment-Warner Bros. division provides certain management and distribution services for Time Warner's theatrical, television and animated product, as well as certain services for administrative and technical support.

Time Warner's cable businesses have management services agreements with TWE, pursuant to which TWE manages, or provides services to, the cable television systems owned by Time Warner. Such cable television systems also pay TWE for the right to carry cable television programming provided by TWE's cable networks. Similarly, Time Warner receives fees from TWE's cable television systems for the right to carry cable television programming provided by Time Warner's cable networks.

Time Warner's and TWE's cable businesses have sold or exchanged various cable television systems to MediaOne in an effort to strengthen their geographic clustering of cable television properties. See Note 2 for further information.

Time Warner had a credit agreement with TWE that allowed it to borrow up to \$400 million from TWE. Time Warner paid interest to TWE on outstanding borrowings at a rate equal to LIBOR plus 1% per annum. In 1999, Time Warner repaid all outstanding borrowings under this credit agreement.

Time Warner provides TWE with certain corporate support services, including accounting, tax, legal and administration, for which it received a fee in the amount of \$73 million in 1999 and \$72 million in both 1998 and 1997.

TWE was required to pay a \$130 million advisory fee to MediaOne over a five-year period that ended September 15, 1998 for MediaOne's expertise in telecommunications, telephony and information technology, and its participation in the management and technological upgrade of TWE's cable systems.

In addition to transactions with TWE and other Entertainment Group companies, Time Warner has had transactions with the Columbia House Company partnerships, Comedy Partners, L.P., Time Warner Telecom, the

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

Road Runner Joint Venture and other equity investees of Time Warner and the Entertainment Group, generally with respect to sales of products and services in the ordinary course of business.

19. ADDITIONAL FINANCIAL INFORMATION

Cash Flows

As of December 31, 1999, Time Warner had certain asset securitization facilities, which provide for the accelerated receipt of up to approximately \$1 billion of cash on available receivables. In connection with each of these securitization facilities, Time Warner sells, on a revolving and nonrecourse basis, certain of its accounts receivables ("Pooled Receivables") to a wholly owned, special purpose entity which, in turn, sells a percentage ownership interest in the Pooled Receivables to a third-party, commercial paper conduit sponsored by a financial institution. These securitization transactions have been accounted for as a sale in accordance with FASB Statement No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." Accordingly, accounts receivable sold under this securitization program have been reflected as a reduction in receivables in the accompanying consolidated balance sheet. Net proceeds received under this securitization program were \$228 million in 1999, \$17 million in 1998 and \$108 million in 1997.

Time Warner, through TWE, also has an asset securitization facility, which effectively provides for the accelerated receipt of up to \$500 million of cash through the year 2000 on available licensing contracts. Assets securitized under this facility consist of cash contracts for the licensing of theatrical and television product for broadcast network and syndicated television exhibition, under which revenues have not been recognized because such product is not available for telecast until a later date ("Backlog Contracts"). In connection with this securitization facility, Time Warner sells, on a revolving and nonrecourse basis, certain of its Backlog Contracts ("Pooled Backlog Contracts") to a wholly owned, special purpose entity which, in turn, sells a percentage ownership interest in the Pooled Backlog Contracts to a third-party, commercial paper conduit sponsored by a financial institution.

Because the Backlog Contracts securitized under this facility consist of cash contracts for the licensing of theatrical and television product that have already been produced, the recognition of revenue for such completed product is only dependent upon the commencement of the availability period for telecast under the terms of the licensing agreements. Accordingly, the proceeds received under the program are classified as deferred revenues in long-term liabilities in the accompanying consolidated balance sheet. In 1999, approximately \$15 million of proceeds were repaid under this securitization program. This compares to net proceeds received of approximately \$166 million in 1998 on a pro forma basis.

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

	Year Ended December 31,			
	1999 Historical	1998 Pro Forma	1998 Historical	1997 Historical
	(millions)			
Cash payments made for interest	\$1,406	\$1,343	\$812	\$929
Cash payments made for income taxes	424	356	261	305
Tax-related distributions received from TWE	—	—	314	324
Income tax refunds received	47	56	52	52

Noncash investing activities in 1999 included the exchange of certain cable television systems (Note 2). Noncash investing activities in 1998 included the exchange of certain cable television systems, the Time Warner Telecom Reorganization, the formation of the Road Runner Joint Venture and the TWE-A/N Transfers (Note 2). Noncash financing activities in 1999 included the conversion of 14.2 million shares of convertible preferred stock into approximately 59.1 million shares of common stock. Noncash financing activities in 1998 included the conversion of \$1.15 billion of Zero-Coupon Convertible Notes into 37.4 million shares of common stock

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

(Note 7) and the conversion of 12.8 million shares of convertible preferred stock into approximately 53.5 million shares of common stock (Note 12). Noncash financing activities in 1997 included the redemption of the PERCS in exchange for Time Warner's interest in Hasbro (Note 10) and the payment of \$185 million of noncash dividends on the Series M Preferred Stock.

Interest and Other, Net

Interest and other, net, consists of:

	Years Ended December 31,			
	1999 Historical	1998 Pro Forma	1998 Historical	1997 Historical
	(millions)			
Interest expense	\$(1,519)	\$(1,451)	\$ (891)	\$(1,049)
Gain on Time Warner Telecom IPO	115	—	—	—
Gain on sale of investment in Hasbro	—	—	—	200
Write-down of investment in Primestar	—	(210)	—	—
Other investment-related activity, principally net losses of corporate-related equity investees	(250)	(208)	(91)	(76)
Corporate finance-related activity, principally losses on asset securitization programs	(145)	(101)	(76)	(16)
Miscellaneous	(98)	(80)	(70)	(32)
Total interest and other, net	<u>\$(1,897)</u>	<u>\$(2,050)</u>	<u>\$(1,128)</u>	<u>\$ (973)</u>

Other Current Liabilities

Other current liabilities consist of:

	December 31,		
	1999 Historical	1998 Pro Forma	1998 Historical
	(millions)		
Accrued expenses	\$3,030	\$2,924	\$1,542
Accrued compensation	1,026	835	538
Accrued income taxes	105	125	93
Deferred revenues	597	481	231
Total	<u>\$4,758</u>	<u>\$4,365</u>	<u>\$2,404</u>

20. SUBSEQUENT EVENTS (unaudited)

America Online-Time Warner Merger

In January 2000, Time Warner and America Online announced that they had entered into an agreement to merge (the "Merger") by forming a new holding company named AOL Time Warner Inc. ("AOL Time Warner"). As part of the Merger, each issued and outstanding share of each class of common stock of Time Warner will be converted into 1.5 shares of an identical series of common stock of AOL Time Warner. In addition, each issued and outstanding share of each class of preferred stock of Time Warner will be converted into one share of preferred stock of AOL Time Warner, which will have substantially identical terms except that such shares will be convertible into approximately 6.25 shares of AOL Time Warner common stock. Lastly, each issued and outstanding share of common stock of America Online will be converted into one share of common stock of AOL Time Warner.

As a result of the Merger, the former shareholders of America Online will have an approximate 55% interest in AOL Time Warner and the former shareholders of Time Warner will have an approximate 45% interest in the combined entity, expressed on a fully diluted basis. The Merger is expected to be accounted for by

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

AOL Time Warner as an acquisition of Time Warner under the purchase method of accounting for business combinations.

The Merger is expected to close in the fall of 2000 and is subject to customary closing conditions, including the approval of the shareholders of each of America Online and Time Warner and all necessary regulatory approvals. There can be no assurance that such approvals will be obtained.

Warner-EMI Music Merger

In January 2000, Time Warner and EMI Group plc ("EMI") announced they had entered into an agreement to combine their global music operations into two jointly owned ventures, to be referred to collectively as Warner EMI Music. Time Warner will control the joint ventures through majority board representation, among other factors, and will account for the transaction under the purchase method of accounting.

As part of the transaction, each company will contribute its music operations to the joint ventures, subject to a comparable amount of debt. As of December 31, 1999, EMI had approximately \$1.5 billion of net debt. EMI shareholders also will receive an aggregate special cash dividend of approximately \$1.3 billion. This dividend is expected to be financed through a combination of proceeds from debt incurred or assumed by the joint ventures and consideration to be paid by Time Warner directly to EMI for a new class of EMI equity securities. The new class of EMI equity securities to be held by Time Warner will convert automatically into an 8% common equity interest in EMI, on a fully diluted basis, if EMI's share price reaches £9 for a short period of time within the first three-and-a-half years after closing.

The transaction is expected to close by the end of 2000, subject to customary closing conditions, including regulatory approvals and the approval of EMI's shareholders. There can be no assurance that such approvals will be obtained.

REPORT OF MANAGEMENT

The accompanying consolidated financial statements have been prepared by management in conformity with generally accepted accounting principles, and necessarily include some amounts that are based on management's best estimates and judgments.

Time Warner maintains a system of internal accounting controls designed to provide management with reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly. The concept of reasonable assurance is based on the recognition that the cost of a system of internal control should not exceed the benefits derived and that the evaluation of those factors requires estimates and judgments by management. Further, because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Nevertheless, management believes that a high level of internal control is maintained by Time Warner through the selection and training of qualified personnel, the establishment and communication of accounting and business policies, and its internal audit program.

The Audit Committee of the Board of Directors, composed solely of directors who are not employees of Time Warner, meets periodically with management and with Time Warner's internal auditors and independent auditors to review matters relating to the quality of financial reporting and internal accounting control, and the nature, extent and results of their audits. Time Warner's internal auditors and independent auditors have free access to the Audit Committee.

Joseph A. Ripp
*Executive Vice President and
Chief Financial Officer*

James W. Barge
*Vice President and
Controller*

REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Shareholders Time Warner Inc.

We have audited the accompanying consolidated balance sheet of Time Warner Inc. ("Time Warner") as of December 31, 1999 and 1998, and the related consolidated statements of operations, cash flows and shareholders' equity for each of the three years in the period ended December 31, 1999. These financial statements are the responsibility of Time Warner's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Time Warner at December 31, 1999 and 1998, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

New York, New York
February 2, 2000

TIME WARNER INC.
SELECTED FINANCIAL INFORMATION

The selected financial information for each of the five years in the period ended December 31, 1999 set forth below has been derived from and should be read in conjunction with the financial statements and other financial information presented elsewhere herein. Capitalized terms are as defined and described in such consolidated financial statements, or elsewhere herein. Certain reclassifications have been made to conform to the 1999 presentation.

The selected historical financial information for 1999 reflects the consolidation of the Entertainment Group, which substantially consists of TWE, retroactive to the beginning of 1999. The selected historical financial information for all prior periods has not been changed. However, in order to enhance comparability, pro forma financial statements for 1998 reflecting the consolidation of the Entertainment Group are presented supplementally.

The selected historical financial information for 1998 reflects (i) the TWE-A/N Transfers and (ii) the redemption of Time Warner's Series M Preferred Stock at an aggregate cost of approximately \$2.1 billion using proceeds from the issuance of lower-cost debt.

The selected historical financial information for 1996 reflects (i) the use of approximately \$1.55 billion of net proceeds from the issuance of Series M Preferred Stock to reduce outstanding indebtedness and (ii) the acquisitions of TBS and Cablevision Industries Corporation and related companies, resulting in (a) the issuance of an aggregate 6.3 million shares of Time Warner preferred stock having a total liquidation preference of \$633 million and 365.4 million shares of Time Warner common stock and (b) the assumption or incurrence of approximately \$4.8 billion of indebtedness.

The selected historical financial information for 1995 reflects (i) the acquisitions of KBLCOM Incorporated and Summit Communications Group, Inc. and (ii) the exchange by Toshiba Corporation and ITOCHU Corporation of their direct and indirect interests in TWE, resulting in (a) the issuance of an aggregate 29.3 million shares of Time Warner preferred stock having a total liquidation preference of \$2.926 billion and 5.2 million shares of Time Warner common stock and (b) the assumption or incurrence of approximately \$1.3 billion of indebtedness.

Per common share amounts and average common shares have been restated to give effect to the two-for-one common stock split that occurred on December 15, 1998.

TIME WARNER INC.
SELECTED FINANCIAL INFORMATION — (Continued)

Selected Operating Statement Information	Years Ended December 31,					
	1999	1998	1998	1997	1996	1995
	Historical	Pro Forma	Historical	Historical	Historical	Historical
	(millions, except per share amounts)					
Revenues	\$27,333	\$26,244	\$14,582	\$13,294	\$10,064	\$8,067
Depreciation and amortization	(2,529)	(2,635)	(1,178)	(1,294)	(988)	(559)
Business segment operating income ^{(a)(b)(c)}	6,035	3,132	1,496	1,271	966	697
Equity in pretax income of Entertainment Group ^(d)	—	—	356	686	290	256
Interest and other, net ^{(e)(f)}	(1,897)	(2,050)	(1,128)	(973)	(1,102)	(866)
Income (loss) before extraordinary item	1,960	168	168	301	(156)	(124)
Net income (loss) ^(g)	1,948	168	168	246	(191)	(166)
Net income (loss) applicable to common shares (after preferred dividends) ^{(g)(h)}	1,896	(372)	(372)	(73)	(448)	(218)
Per share of common stock: ^(h)						
Basic net income (loss)	\$ 1.50	\$ (0.31)	\$ (0.31)	\$ (0.06)	\$ (0.52)	\$ (0.28)
Diluted net income (loss)	\$ 1.42	\$ (0.31)	\$ (0.31)	\$ (0.06)	\$ (0.52)	\$ (0.28)
Dividends	\$ 0.18	\$ 0.18	\$ 0.18	\$ 0.18	\$ 0.18	\$ 0.18
Average common shares:						
Basic	1,267.0	1,194.7	1,194.7	1,135.4	862.4	767.6
Diluted	1,398.3	1,194.7	1,194.7	1,135.4	862.4	767.6

(a) 1999 Business segment operating income includes a net pretax gain of approximately \$215 million relating to early termination and settlement of a long-term, home video distribution agreement, a pretax gain of \$97 million relating to the sale of an interest in CanalSatellite and a one-time and noncash pretax charge of \$106 million relating to Warner Bros.'s retail stores.

(b) Business segment operating income includes net pretax gains related to the sale or exchange of certain cable television systems and investments of approximately \$2.247 billion in 1999, \$18 million in 1998 (\$108 million on a pro forma basis) and \$12 million in 1997.

(c) Business segment operating income in 1995 includes \$85 million in losses relating to certain businesses and joint ventures owned by the Music division which were restructured or closed.

(d) Time Warner's equity in the pretax income of the Entertainment Group includes approximately \$120 million of net losses in 1998 and \$450 million of gains in 1997 relating to the sale or exchange of various cable television systems and other investment-related activity.

(e) Interest and other, net includes an approximate \$115 million pretax gain in 1999 recognized in connection with the initial public offering of a 20% interest in Time Warner Telecom, Inc. and a net pretax charge of \$210 million on a pro forma basis in 1998 relating to the write-down of TWE's carrying value of Primestar.

(f) 1997 Interest and other, net includes a \$200 million pretax gain relating to the disposal of Time Warner's interest in Hasbro and the related redemption of certain mandatorily redeemable preferred securities of a subsidiary.

(g) Net income (loss) includes an extraordinary loss on the retirement of debt of \$12 million in 1999, \$55 million in 1997, \$35 million in 1996 and \$42 million in 1995.

(h) 1998 preferred dividend requirements include a one-time effect of \$234 million relating to the premium paid in connection with the redemption of Time Warner's Series M Preferred Stock.

TIME WARNER INC.
SELECTED FINANCIAL INFORMATION — (Continued)

Selected Balance Sheet Information	December 31,					
	1999 Historical	1998 Pro Forma	1998 Historical	1997 Historical	1996 Historical	1995 Historical
	(millions)					
Cash and equivalents	\$ 1,284	\$ 529	\$ 442	\$ 645	\$ 514	\$ 1,185
Total assets	51,239	47,951	31,640	34,163	35,064	22,132
Debt due within one year.....	22	25	19	8	11	34
Long-term debt.....	18,083	17,503	10,925	11,833	12,713	9,907
Borrowings against future stock option proceeds	1,243	895	895	533	488	—
Company-obligated mandatorily redeemable preferred securities of subsidiaries	575	792	575	575	949	949
Series M exchangeable preferred stock...	—	—	—	1,857	1,672	—
Shareholders' equity:						
Preferred stock liquidation preference ..	840	2,260	2,260	3,539	3,559	2,994
Equity applicable to common stock ...	8,873	6,592	6,592	5,817	5,943	673
Total shareholders' equity.....	9,713	8,852	8,852	9,356	9,502	3,667
Total capitalization	29,636	28,067	21,266	24,162	25,335	14,557

TIME WARNER INC.
QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

Quarter	Revenues	Operating Income of Business Segments	Equity in Pretax Income (Loss) of Entertainment Group	Net Income (Loss)	Net Income (Loss) Applicable to Common Shares ^(e)	Basic Net Income (Loss) Per Common Share ^{(e)(f)(g)}	Diluted Net Income (Loss) Per Common Share ^{(e)(f)(g)}	Dividends Per Common Share ^{(f)(g)}	Basic Average Common Shares ^(f)	Diluted Average Common Shares ^(f)	Common Stock ^(g)	
											High	Low

(millions, except per share amounts)

1999^(a)												
1st ^(b)	\$ 6,091	\$ 943	\$ —	\$ 138	\$ 120	\$.10	\$.10	\$.045	1,243.1	1,243.1	\$72.44	\$58.88
2nd ^(b)	6,531	1,701	—	593	575	.46	.43	.045	1,249.3	1,403.7	78.25	62.00
3rd ^(b)	6,723	1,287	—	369	360	.28	.27	.045	1,288.9	1,397.8	77.31	58.50
4th ^(b)	7,988	2,104	—	848	841	.65	.62	.045	1,286.5	1,391.8	72.31	59.63
Year ^(b)	27,333	6,035	—	1,948	1,896	1.50	1.42	.18	1,267.0	1,398.3	78.25	58.50
1998^(a)												
1st	\$ 3,137	\$ 170	\$107	\$ (62)	\$(144)	\$ (.12)	\$ (.12)	\$.045	1,156.6	1,156.6	\$37.75	\$29.06
2nd ^{(c)(d)}	3,672	384	166	101	23	.02	.02	.045	1,192.6	1,192.6	44.44	36.06
3rd	3,578	315	164	39	(37)	(.03)	(.03)	.045	1,202.6	1,202.6	50.00	39.00
4th ^{(c)(d)}	4,195	627	(81)	90	(214)	(.17)	(.17)	.045	1,227.2	1,227.2	63.13	37.56
Year ^{(c)(d)}	14,582	1,496	356	168	(372)	(.31)	(.31)	.18	1,194.7	1,194.7	63.13	29.06

- (a) The 1999 quarterly financial information reflects the consolidation of the Entertainment Group, which substantially consists of TWE, retroactive to the beginning of 1999. Time Warner's 1998 historical quarterly financial information has not been changed.
- (b) Time Warner's income per common share in 1999 has been affected by certain significant nonrecurring items. These items consisted of (i) a net pretax gain of approximately \$215 million in the first quarter relating to the early termination and settlement of a long-term, home video distribution agreement, (ii) a net pretax gain of approximately \$97 million in the fourth quarter in connection with the sale of an interest in CanalSatellite, (iii) a noncash pretax charge of approximately \$106 million in the fourth quarter relating to Warner Bros.' retail stores, (iv) an approximate \$115 million pretax gain in the second quarter in connection with the initial public offering of a 20% interest in Time Warner Telecom Inc., (v) gains relating to the sale and exchange of various cable television systems and investments of \$771 million in the second quarter, \$477 million in the third quarter and \$999 million in the fourth quarter, thereby aggregating to \$2.247 billion for the year and (vi) an extraordinary loss of \$12 million in the third quarter relating to the retirement of debt. The aggregate net effect of these items in 1999 was to increase income per common share by \$.10 in the first quarter, \$.34 in the second quarter, \$.20 in the third quarter and \$.45 in the fourth quarter, thereby aggregating to \$1.11 per common share for the year.
- (c) Time Warner's income (loss) per common share in 1998 has been affected by certain significant nonrecurring items. These items consisted of gains and losses relating to the sale or exchange of various cable television systems and other investment-related activity and the effect of redeeming Time Warner's Series M Preferred Stock. The aggregate net effect of these items in 1998 was to increase (decrease) income per common share by \$.03 in the second quarter of 1998, and \$(.28) in the fourth quarter of 1998, thereby aggregating to \$(.25) per common share for the year.
- (d) Time Warner's equity in the pretax income (loss) of the Entertainment Group for 1998 includes net gains of approximately \$90 million for the year relating to the sale or exchange of certain cable television systems and investments, of which approximately \$70 million was recorded in the second quarter of 1998. In addition, Time Warner's equity in the pretax income (loss) of the Entertainment Group for the fourth quarter of 1998 includes a charge of approximately \$210 million principally to reduce the carrying value of an interest in Primestar.
- (e) After preferred dividend requirements. Preferred dividend requirements for the fourth quarter of 1998 include a one-time increase of \$234 million (\$.19 loss per common share) relating to the premium paid in connection with the redemption of Time Warner's Series M Preferred Stock.
- (f) Per common share amounts for the quarters and full years have each been calculated separately. Accordingly, quarterly amounts may not add to the annual amounts because of differences in the average common shares outstanding during each period and, with regard to diluted per common share amounts only, because of the inclusion of the effect of potentially dilutive securities only in the periods in which such effect would have been dilutive.
- (g) Previously reported amounts give effect to the two-for-one common stock split that occurred on December 15, 1998.