

TIME WARNER INC
Form 10-Q
August 01, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
for the quarterly period ended June 30, 2007 or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
for the transition period from _____ to _____
Commission file number 001-15062

TIME WARNER INC.

(Exact name of Registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

13-4099534

*(I.R.S. Employer
Identification No.)*

One Time Warner Center
New York, NY 10019-8016

(Address of Principal Executive Offices) (Zip Code)

(212) 484-8000

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2 of the Act). Yes ☐ No ☒

Description of Class

Shares Outstanding
as of July 27, 2007

Common Stock \$.01 par value

3,729,302,758

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AND OTHER FINANCIAL INFORMATION**

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

INTRODUCTION

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

Overview. This section provides a general description of Time Warner's business segments, as well as recent developments the Company believes are important in understanding the results of operations and financial condition or in understanding anticipated future trends.

Results of operations. This section provides an analysis of the Company's results of operations for the three and six months ended June 30, 2007. This analysis is presented on both a consolidated and a business segment basis. In addition, a brief description is provided of significant transactions and events that impact the comparability of the results being analyzed.

Financial condition and liquidity. This section provides an analysis of the Company's financial condition as of June 30, 2007 and cash flows for the six months ended June 30, 2007.

Caution concerning forward-looking statements. This section provides a description of the use of forward-looking information appearing in this report, including in MD&A and the consolidated financial statements. Such information is based on management's current expectations about future events, which are inherently susceptible to uncertainty and changes in circumstances. Refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2006 (the 2006 Form 10-K) for a discussion of the risk factors applicable to the Company.

As discussed more fully in Note 1 to the accompanying consolidated financial statements, the 2006 financial information has been recast so that the basis of presentation is consistent with that of the 2007 financial information. Specifically, amounts were recast to reflect the retrospective presentation of certain businesses that were sold or that the Company has entered into agreements to sell as discontinued operations.

Use of Operating Income before Depreciation and Amortization

The Company utilizes Operating Income before Depreciation and Amortization, among other measures, to evaluate the performance of its businesses. Operating Income before Depreciation and Amortization is considered an important indicator of the operational strength of the Company's businesses and it provides an indication of the Company's ability to service debt and fund capital expenditures. Operating Income before Depreciation and Amortization eliminates the uneven effect across all business segments of considerable amounts of noncash depreciation of tangible assets and amortization of certain intangible assets that were recognized in business combinations. A limitation of this measure, however, is that it does not reflect the periodic costs of certain capitalized tangible and intangible assets used in generating revenues in the Company's businesses. Management evaluates the investments in such tangible and intangible assets through other financial measures, such as capital expenditure budgets, investment spending levels and return on capital.

Operating Income before Depreciation and Amortization should be considered in addition to, not as a substitute for, the Company's Operating Income, Net Income and various cash flow measures (e.g., Cash provided by operations) as well as other measures of financial performance reported in accordance with U.S. generally accepted accounting principles (GAAP). A reconciliation of Operating Income before Depreciation and Amortization to Operating Income is presented under Results of Operations.

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OVERVIEW

Time Warner is a leading media and entertainment company, whose major businesses encompass an array of the most respected and successful media brands. Among the Company's brands are HBO, CNN, AOL, *People*, *Sports Illustrated*, *Time* and Time Warner Cable. The Company produces and distributes films through Warner Bros. and New Line Cinema, including *Harry Potter and the Order of the Phoenix*, *300*, *Happy Feet* and *Ocean's 13*, as well as television programs, including *ER*, *Two and a Half Men*, *Cold Case* and *Without a Trace*. During the six months ended June 30, 2007, the Company generated revenues of \$22.164 billion (up 8% from \$20.599 billion in 2006), Operating Income before Depreciation and Amortization of \$6.640 billion (up 29% from \$5.129 billion in 2006), Operating Income of \$4.476 billion (up 25% from \$3.571 billion in 2006), Net Income of \$2.270 billion (down 8% from \$2.477 billion in 2006) and Cash Provided by Operations of \$3.119 billion (down 25% from \$4.157 billion in 2006).

Time Warner Businesses

Time Warner classifies its operations into five reportable segments: AOL, Cable, Filmed Entertainment, Networks and Publishing.

AOL. AOL LLC (together with its subsidiaries, AOL) is a leader in interactive services. In the U.S. and internationally, AOL operates a leading network of web brands, offers free client software and services to users who have their own Internet connection and provides services to advertisers on the Internet. In addition, AOL operates one of the largest Internet access subscription services in the United States. At June 30, 2007, AOL had 10.9 million AOL brand subscribers in the U.S., which does not include registrations for the free AOL service. For the six months ended June 30, 2007, AOL reported total revenues of \$2.711 billion (12% of the Company's overall revenues) and had \$1.695 billion in Operating Income before Depreciation and Amortization and \$1.444 billion in Operating Income, both of which included a pretax gain of approximately \$670 million related to the sale of AOL's German access business.

Historically, AOL's primary product offering has been an online subscription service that includes dial-up Internet access, and this product currently generates the majority of AOL's revenues. AOL continued to experience significant declines in the first half of 2007 in the number of its U.S. subscribers and related revenues, due primarily to AOL's decisions to focus on its advertising business and offer most of its services (other than Internet access) for free, AOL's reduction of subscriber acquisition and retention efforts, and the industry-wide decline of the premium dial-up ISP business and growth in the broadband Internet access business. The decline in subscribers has had an adverse impact on AOL's Subscription revenues. However, dial-up network costs have also decreased and are anticipated to continue to decrease as subscribers decline. AOL's Advertising revenues, in large part, are generated from the traffic to and usage of the AOL service by AOL's subscribers. Therefore, the decline in subscribers also could have an adverse impact on AOL's Advertising revenues to the extent that subscribers canceling their subscriptions do not maintain their relationship with and usage of the AOL Network (as defined below).

AOL's strategy (as announced on August 2, 2006) is to transition from a business that has relied heavily on Subscription revenues from dial-up subscribers to one that attracts and engages more Internet users and takes advantage of the growth in online advertising. AOL's focus is on growing its global web services business and managing costs in its access services business. A goal of AOL's strategy is to maintain and expand relationships with current and former AOL subscribers, whether they continue to purchase the dial-up Internet access subscription service or not. Another component of the strategy is to permit access to most of the AOL services, including use of the AOL client software and AOL e-mail accounts, without charge. Therefore, as long as an individual has a means to connect to the Internet, that person can access and use most of the AOL services for free.

The components of this strategy primarily include the following:

- providing advertising services domestically and internationally on the AOL Network and on Internet sites of third-party entities (referred to as Partner Sites) through display advertising and paid-search advertising;

attracting highly-engaged users to and retaining those users on AOL's interactive properties, including AIM, AOL.com, MapQuest and Moviefone, as well as attracting and retaining former and current subscribers, by:
offering compelling content, features and tools, including e-mail, instant messaging and the AOL client software, which generally are available to Internet users for free; and

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implementing a cost-effective distribution strategy for its free and paid products and services by entering into or maintaining relationships with computer manufacturers, retailers, third-party high-speed Internet access providers, or other aggregators of Internet activity, and search engine optimization and search engine marketing;

providing paid services, including certain online safety and security products on a subscription basis; and

providing software for mobile devices that will further the distribution of AOL products and services.

The AOL Network consists of a variety of websites, related applications and services, and the AOL and low-cost ISP services. Specifically, the AOL Network includes AOL.com, AIM, MapQuest, Moviefone, ICQ and Netscape as well as other co-branded websites for which certain criteria have been met, including that the Internet traffic has been assigned to AOL. Advertising services on Partner Sites are provided primarily through AOL's wholly owned subsidiary, Advertising.com, but also directly by AOL, and paid-search advertising activities on the AOL Network are conducted primarily through AOL's strategic relationship with Google Inc. (Google). Following the expansion of this strategic alliance in April 2006, 95% of the equity interests in AOL are indirectly held by the Company and 5% are indirectly held by Google.

Consistent with its strategy, in the second quarter of 2007, AOL acquired Third Screen Media, Inc., a mobile advertising network and mobile ad-serving management platform provider, and a controlling interest in ADTECH AG, an international online ad-serving company. In addition, as noted under Recent Developments, in the third quarter of 2007, the Company entered into an agreement to purchase TACODA, Inc. (TACODA), an online behavioral targeting advertising network.

In connection with its strategy, AOL undertook certain restructuring and related activities in 2006 and the first half of 2007, including involuntary employee terminations, contract terminations, facility closures and asset write-offs. Additional restructuring and related activities of this nature are anticipated during the remainder of 2007.

Cable. Time Warner's cable business, Time Warner Cable Inc. and its subsidiaries (TWC), is the second-largest cable operator in the U.S. and is an industry leader in developing and launching innovative video, data and voice services. At June 30, 2007, TWC had approximately 13.4 million basic video subscribers in technologically advanced, well-clustered systems located mainly in five geographic areas New York state, the Carolinas, Ohio, southern California and Texas. As of June 30, 2007, TWC was the largest cable operator in a number of large cities, including New York City and Los Angeles. For the six months ended June 30, 2007, TWC delivered revenues of \$7.865 billion (35% of the Company's overall revenues), \$2.751 billion in Operating Income before Depreciation and Amortization and \$1.290 billion in Operating Income.

On July 31, 2006, a subsidiary of TWC, Time Warner NY Cable LLC (TW NY), and Comcast Corporation (together with its subsidiaries, Comcast) completed the acquisition of substantially all of the cable assets of Adelphia Communications Corporation (Adelphia) and related transactions. In addition, effective January 1, 2007, TWC began consolidating the results of certain cable systems located in Kansas City, south and west Texas and New Mexico (the

Kansas City Pool) upon the distribution of the assets of Texas and Kansas City Cable Partners, L.P. (TKCCP) to TWC and Comcast. Prior to January 1, 2007, TWC's interest in TKCCP was reported as an equity method investment. Refer to Recent Developments for further details.

TWC principally offers three services video, high-speed data and voice, which have been primarily targeted to residential customers. Video is TWC's largest service in terms of revenues generated. TWC expects to continue to increase video revenues through the offering of advanced digital video services such as video-on-demand (VOD), subscription-video-on-demand (SVOD), high definition television (HDTV) and set-top boxes equipped with digital video recorders (DVRs), as well as through price increases and subscriber growth. TWC's digital video subscribers provide a broad base of potential customers for additional advanced services. Providing basic video services is a competitive and highly penetrated business, and, as a result, TWC expects slower incremental growth in the number of basic video subscribers compared to the growth in TWC's advanced service offerings. Video programming costs

represent a major component of TWC's expenses and are expected to continue to increase, reflecting contractual rate increases, subscriber growth and the expansion of service offerings, and it is expected that TWC's video service margins will decline over the next few years as programming cost increases outpace growth in video revenues.

High-speed data has been one of TWC's fastest-growing services over the past several years and is a key driver of its results. As of June 30, 2007, TWC had approximately 7.2 million residential high-speed data subscribers. TWC expects continued strong growth in residential high-speed data subscribers and revenues for the foreseeable future; however, the

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rate of growth of both subscribers and revenues is expected to slow over time as high-speed data services become increasingly well-penetrated. In addition, as narrowband Internet users continue to migrate to broadband connections, TWC anticipates that an increasing percentage of its new high-speed data customers will elect to purchase its entry-level high-speed data service, which is generally less expensive than TWC's flagship service. As a result, over time, TWC's average high-speed data revenue per subscriber may decline reflecting this shift in mix. TWC also offers commercial high-speed data services and had approximately 263,000 commercial high-speed data subscribers as of June 30, 2007.

Approximately 2.3 million subscribers received Digital Phone service, TWC's voice service, as of June 30, 2007. Under TWC's primary calling plan, for a monthly fixed fee, Digital Phone customers typically receive the following services: an unlimited local, in-state and U.S., Canada and Puerto Rico calling plan, as well as call waiting, caller ID and E911 services. TWC is also currently deploying lower-priced calling plans to serve those customers that do not use interstate and/or long-distance calling plans extensively and intends to offer additional plans with a variety of callings plan options in the future. Digital Phone enables TWC to offer its customers a convenient package, or bundle, of video, high-speed data and voice services, and to compete effectively against bundled services available from its competitors. TWC expects strong increases in Digital Phone subscribers and revenues for the foreseeable future. TWC has begun to introduce Business Class Phone, a commercial Digital Phone service, to small- and medium-sized businesses and will continue to roll out this service during the remainder of 2007 in most of the systems TWC owned before and retained after the transactions with Adelphia and Comcast (the Legacy Systems). TWC is also introducing this service in some of the systems acquired in and retained after the transactions with Adelphia and Comcast (the Acquired Systems).

Some of TWC's principal competitors, in particular, direct broadcast satellite operators and incumbent local telephone companies, either offer or are making significant capital investments that will allow them to offer services that provide features and functions comparable to the video, data and/or voice services that TWC offers and they are aggressively seeking to offer them in bundles similar to TWC's. TWC expects that the availability of these bundled service offerings will continue to intensify competition.

In addition to the subscription services described above, TWC also earns revenues by selling advertising time to national, regional and local businesses.

As of July 31, 2006, the date the transactions with Adelphia and Comcast closed, the penetration rates for basic video, digital video and high-speed data services were generally lower in the Acquired Systems than in the Legacy Systems. Furthermore, certain advanced services were not available in some of the Acquired Systems, and an IP-based telephony service was not available in any of the Acquired Systems. To increase the penetration of these services in the Acquired Systems, TWC is in the midst of a significant integration effort that includes upgrading the capacity and technical performance of these systems to levels that will allow the delivery of these advanced services and features. Such integration-related efforts are expected to be largely complete by the end of 2007. As of June 30, 2007, Digital Phone was available to over 40% of the homes passed in the Acquired Systems. TWC expects to continue to roll out Digital Phone service across the Acquired Systems during the remainder of 2007.

Improvement in the financial and operating performance of the Acquired Systems depends in part on the completion of these initiatives and the subsequent availability of TWC's bundled advanced services in the Acquired Systems. In addition, due to various operational and competitive challenges, TWC expects that the acquired systems located in Los Angeles, CA and Dallas, TX will continue to require more time and resources than the other acquired systems to stabilize and then meaningfully improve their financial and operating performance. As of June 30, 2007, the Los Angeles and Dallas acquired systems together served approximately 1.9 million basic video subscribers (about 50% of the basic video subscribers served by the Acquired Systems). TWC believes that by upgrading the plant and integrating the Acquired Systems into its operations, there is a significant opportunity over time to increase service penetration rates, and improve Subscription revenues and Operating Income before Depreciation and Amortization in the Acquired Systems.

Filmed Entertainment. Time Warner's Filmed Entertainment businesses, Warner Bros. Entertainment Group (Warner Bros.) and New Line Cinema Corporation (New Line), generated revenues of \$4.996 billion (22% of the Company's overall revenues), \$506 million in Operating Income before Depreciation and Amortization and \$324 million in Operating Income for the six months ended June 30, 2007. The Filmed Entertainment segment experienced a decline in revenues and operating results for the six months ended June 30, 2007 due to difficult comparisons to the six months ended June 30, 2006.

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One of the world's leading studios, Warner Bros. has diversified sources of revenues with its film and television businesses, including an extensive film library and global distribution infrastructure. This diversification has helped Warner Bros. deliver consistent long-term performance. New Line is the world's oldest independent film company. Its primary source of revenues is the creation and distribution of theatrical motion pictures.

Warner Bros. continues to develop its industry-leading television business, including the successful releases of television series on home video. Throughout the 2006-2007 television season, Warner Bros. produced prime-time series for all five broadcast networks (including *ER*, *Two and a Half Men*, *Without a Trace*, *Cold Case*, *Smallville* and *Men In Trees*), as well as original series for cable networks (including *The Closer* and *Nip/Tuck*). For the 2007-2008 television season, Warner Bros. anticipates having approximately 25 prime-time series across the five broadcast networks, as well as original series for cable networks.

The sale of DVDs has been one of the largest drivers of the segment's profit over the last several years, and Warner Bros.' extensive library of theatrical and television titles positions it to continue to benefit from sales of home video product to consumers. However, the industry and the Company have experienced a leveling of DVD sales due to several factors, including increasing competition for consumer discretionary spending, piracy, the maturation of the standard definition DVD format and the fragmentation of consumer time.

Piracy, including physical piracy as well as illegal online file-sharing, continues to be a significant issue for the filmed entertainment industry. Due to technological advances, piracy has expanded from music to movies and television programming. The Company has taken a variety of actions to combat piracy over the last several years, including the launch of new services for consumers at competitive price points, aggressive online and customs enforcement, compressed release windows and educational campaigns, and will continue to do so, both individually and together with cross-industry groups, trade associations and strategic partners.

Networks. Time Warner's Networks segment comprises Turner Broadcasting System, Inc. (Turner) and Home Box Office, Inc. (HBO). On September 17, 2006, Warner Bros. and CBS Corp. (CBS) ceased the stand-alone operations of The WB Network and UPN, respectively, and formed The CW, an equity method investee of the Company. The Networks segment results included the operations of The WB Network through the date of its shutdown on September 17, 2006. For the six months ended June 30, 2007, the Networks segment delivered revenues of \$5.011 billion (21% of the Company's overall revenues), \$1.649 billion in Operating Income before Depreciation and Amortization and \$1.494 billion in Operating Income.

The Turner networks—including such recognized brands as TNT, TBS, CNN, Cartoon Network and CNN Headline News—are among the leaders in advertising-supported cable TV networks. For five consecutive years, more prime-time viewers have watched advertising-supported cable TV networks than the national broadcast networks. For the six months ended June 30, 2007, TNT ranked first among advertising-supported cable networks in total-day delivery of its key demographics, Adults 18-49 and Adults 25-54 and in prime-time delivery ranked second for Adults 18-49 and Adults 25-54. TBS ranked second among advertising-supported cable networks in prime-time delivery of its key demographic, Adults 18-34.

The Turner networks generate revenues principally from the sale of advertising time and monthly subscriber fees paid by cable system operators, direct-to-home satellite operators and other affiliates. Key contributors to Turner's success are its continued investments in high-quality programming focused on sports, network movie premieres, licensed and original series, news and animation, leading to strong ratings and Advertising and Subscription revenue growth, as well as strong brands and operating efficiency.

HBO operates the HBO and Cinemax multichannel pay television programming services, with the HBO service ranking as the nation's most widely distributed pay television network. HBO generates revenues principally from monthly subscriber fees from cable system operators, direct-to-home satellite operators and other affiliates. An additional source of revenue is the ancillary sales of its original programming, including *The Sopranos*, *Sex and the City*, *Rome* and *Entourage*.

Publishing. Time Warner's Publishing segment consists principally of magazine publishing and a number of direct-marketing and direct-selling businesses. The segment generated revenues of \$2.301 billion (10% of the Company's overall

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revenues), \$386 million in Operating Income before Depreciation and Amortization and \$294 million in Operating Income for the six months ended June 30, 2007.

As of June 30, 2007, Time Inc. published over 125 magazines globally, including *People*, *Sports Illustrated*, *In Style*, *Southern Living*, *Real Simple*, *Entertainment Weekly*, *Time*, *Cooking Light* and *Fortune*. It generates revenues primarily from advertising, magazine subscriptions and newsstand sales, and its growth is derived from higher circulation and advertising on existing magazines, new magazine launches, acquisitions and advertising from digital properties. Time Inc. owns IPC Media, the U.K.'s largest magazine company (IPC), and the magazine subscription marketer Synapse Group, Inc. The Company's Publishing segment has experienced sluggish print advertising sales as advertisers are shifting advertising expenditures to digital media. As a result, Time Inc. continues to invest in developing digital content, including the launch of MyRecipes.com, increased functionality for CNNMoney.com, the expansion of *Sports Illustrated*'s digital properties and the launch of various digital sites in the U.K. by IPC. Time Inc.'s direct-selling division, Southern Living At Home, sells home decor products through independent consultants at parties hosted in people's homes throughout the U.S.

On March 3, 2007, the Company sold its Parenting Group and most of the Time4 Media magazine titles, consisting of 18 of Time Inc.'s smaller niche magazines, to a subsidiary of Bonnier AB, a Swedish media company (Bonnier). Refer to Recent Developments for further discussion.

Recent Developments

Common Stock Repurchase Program

In July 2005, Time Warner's Board of Directors authorized a common stock repurchase program that, as amended over time, allowed the Company to purchase up to an aggregate of \$20 billion of common stock during the period from July 29, 2005 through December 31, 2007. As of June 30, 2007, the Company completed this common stock repurchase program, having repurchased approximately 1.1 billion shares of common stock from the program's inception through such date.

On July 26, 2007, Time Warner's Board of Directors authorized a new common stock repurchase program that allows the Company to purchase, from time to time, up to an aggregate of \$5 billion of common stock. Purchases under this new stock repurchase program may be made from time to time on the open market and in privately negotiated transactions. Size and timing of these purchases are based on a number of factors, including price and business and market conditions (Note 6).

Transaction with Liberty

On May 16, 2007, the Company completed a transaction in which Liberty Media Corporation (Liberty) exchanged 68.5 million shares of Time Warner common stock for the stock of a subsidiary of Time Warner that owned assets including the Atlanta Braves baseball franchise (the Braves) and Leisure Arts, Inc. (Leisure Arts) (at a fair value of \$473 million) and \$960 million of cash (collectively, the Liberty Transaction). Included in the 68.5 million shares of Time Warner common stock are 4 million shares expected to be delivered to the Company upon the resolution of a working capital adjustment that is expected to be completed in the third quarter of 2007. The 4 million shares have a value of \$83 million and have been reflected as common stock due from Liberty in the accompanying consolidated balance sheet at June 30, 2007. In the second quarter of 2007, the Company recorded a pretax gain of \$72 million on the sale of the Braves, which is net of indemnification obligations valued at \$60 million. The Company has agreed to indemnify Liberty for, among other things, increases in the amount due by the Braves under Major League Baseball's revenue sharing rules from expected amounts for fiscal years 2007 to 2027, to the extent attributable to local broadcast and other contracts in place prior to the Liberty Transaction. The Liberty Transaction was designed to qualify as a tax-free split-off under Section 355 of the Internal Revenue Code of 1986, as amended, and, as a result, the historical deferred tax liabilities of \$83 million associated with the Braves were no longer required. In the first quarter of 2007, the Company recorded an impairment charge of \$13 million on its investment in Leisure Arts. The results of operations of the Braves and Leisure Arts have been reflected as discontinued operations for all periods presented (Note 3).

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TACODA

On July 23, 2007, the Company entered into an agreement to purchase TACODA, an online behavioral targeting advertising network, for approximately \$275 million in cash. The transaction, which is subject to customary closing conditions, is expected to close in the third quarter of 2007 (Note 3).

Texas/Kansas City Cable Joint Venture

TKCCP was a 50-50 joint venture between a consolidated subsidiary of TWC (Time Warner Entertainment-Advance/Newhouse Partnership (TWE-A/N)) and Comcast. On January 1, 2007, TKCCP distributed its assets to TWC and Comcast. TWC received the Kansas City Pool, which served approximately 788,000 basic video subscribers as of December 31, 2006, and Comcast received the pool of assets consisting of the Houston cable systems (the Houston Pool), which served approximately 795,000 basic video subscribers as of December 31, 2006. TWC began consolidating the results of the Kansas City Pool on January 1, 2007. TKCCP was formally dissolved on May 15, 2007. For accounting purposes, the Company has treated the distribution of TKCCP's assets as a sale of the Company's 50% equity interest in the Houston Pool and as an acquisition of Comcast's 50% equity interest in the Kansas City Pool. As a result of the sale of the Company's 50% equity interest in the Houston Pool, the Company recorded a pretax gain of approximately \$146 million in the first quarter of 2007, which is included as a component of other income, net in the accompanying consolidated statement of operations for the six months ended June 30, 2007 (Note 2).

Bookspan

On April 9, 2007, the Company sold its 50% interest in Bookspan, a joint venture accounted for as an equity method investment that primarily owns and operates book clubs via direct mail and e-commerce, to a subsidiary of Bertelsmann AG (Bertelsmann) for a purchase price of \$145 million, which resulted in a pretax gain of approximately \$100 million (Note 3).

Parenting and Time4 Media

On March 3, 2007, the Company sold its Parenting Group and most of the Time4 Media magazine titles, consisting of 18 of Time Inc.'s smaller niche magazines, to a subsidiary of Bonnier for approximately \$220 million, which resulted in a pretax gain of approximately \$54 million. The results of operations of the Parenting Group and Time4 Media magazine titles that were sold have been reflected as discontinued operations for all periods presented (Note 3).

Sales of AOL's European Access Businesses

On February 28, 2007, the Company completed the sale of AOL's German access business to Telecom Italia S.p.A. for \$850 million in cash, resulting in a pretax gain of approximately \$670 million. In connection with this sale, the Company entered into a separate agreement to provide ongoing web services, including content, e-mail and other online tools and services to Telecom Italia S.p.A. As a result of the historical interdependency of AOL's European access and audience businesses, the historical cash flows and operations of the access and audience businesses were not clearly distinguishable. Accordingly, AOL's German access business and its other European access businesses, which were sold in 2006, have not been reflected as discontinued operations in the accompanying consolidated financial statements (Note 3).

Divestitures of Certain Non-Core AOL Wireless Businesses

On June 21, 2007, the Company announced an agreement to sell Tegic Communications, Inc. (Tegic), a wholly owned subsidiary of AOL, to Nuance Communications, Inc. (Nuance) for approximately \$265 million in cash. This transaction, which is subject to customary closing conditions, is expected to close in the third quarter of 2007. The Company expects to record a pretax gain on this sale ranging from approximately \$160 million to \$190 million. In addition, in the second quarter of 2007, the Company agreed to transfer the assets of Wildseed LLC (Wildseed), a wholly owned subsidiary of AOL, to a third party. The Company recorded a pretax charge of approximately \$7 million related to this divestiture in the second quarter of 2007 and an impairment charge of approximately \$18 million on the long-lived assets of Wildseed in the first quarter of 2007. The results of operations of both Tegic and Wildseed have been reflected as discontinued operations for all periods presented (Note 3).

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OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION (Continued)**

Claxson

On December 14, 2006, Turner announced an agreement with Claxson Interactive Group, Inc. (Claxson) to purchase seven pay television networks operating in Latin America for approximately \$235 million (net of cash acquired). The transaction, which is subject to customary closing conditions, is expected to close in the second half of 2007 (Note 3).

Transactions with Adelphia and Comcast

On July 31, 2006, TW NY and Comcast completed their respective acquisitions of assets comprising in the aggregate substantially all of the cable assets of Adelphia (the Adelphia Acquisition). Additionally, on July 31, 2006, immediately before the closing of the Adelphia Acquisition, Comcast's interests in TWC and Time Warner Entertainment Company, L.P. (TWE), a subsidiary of TWC, were redeemed (the Redemptions). Following the Redemptions and the Adelphia Acquisition, on July 31, 2006, TW NY and Comcast swapped certain cable systems, most of which were acquired from Adelphia, in order to enhance TWC's and Comcast's respective geographic clusters of subscribers (the Exchange and, together with the Adelphia Acquisition and the Redemptions, the Adelphia/Comcast Transactions). The results of the systems acquired in connection with the Adelphia/Comcast Transactions have been included in the accompanying consolidated statement of operations since the closing of the transactions. As a result of the closing of the Adelphia/Comcast Transactions, TWC acquired systems with approximately 4.0 million basic video subscribers and disposed of systems with approximately 0.8 million basic video subscribers previously owned by TWC that were transferred to Comcast in connection with the Redemptions and the Exchange for a net gain of approximately 3.2 million basic video subscribers.

On February 13, 2007, Adelphia's Chapter 11 reorganization plan became effective and, under applicable securities law regulations and provisions of the U.S. bankruptcy code, TWC became a public company subject to the requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act). Under the terms of the reorganization plan, the shares of TWC's Class A common stock that Adelphia received in the Adelphia Acquisition (representing approximately 16% of TWC's outstanding common stock) are being distributed to Adelphia's creditors. On March 1, 2007, TWC's Class A common stock began trading on the New York Stock Exchange under the symbol TWC. As of June 30, 2007, Time Warner owned approximately 84% of TWC's outstanding common stock (Note 2).

Amounts Related to Securities Litigation

During the first and second quarters of 2007, the Company reached agreements to settle substantially all of the remaining securities litigation claims, a substantial portion of which had been reserved for at December 31, 2006. For the three and six months ended June 30, 2007, the Company recorded charges of approximately \$1 million and \$153 million, respectively, for these settlements. At June 30, 2007, the Company's remaining reserve related to these matters is approximately \$17 million, including approximately \$8 million that has been reserved for an expected attorneys' fee award related to a previously settled matter. The Company believes the potential exposure in the securities litigation matters that remain pending at June 30, 2007 to be de minimis.

The Company recognizes insurance recoveries when it becomes probable that such amounts will be received. The Company recognized insurance recoveries related to Employee Retirement Income Security Act (ERISA) matters of approximately \$1 million and \$9 million for the three and six months ended June 30, 2007, respectively, and approximately \$3 million and \$53 million for the three and six months ended June 30, 2006, respectively (Note 1).

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RESULTS OF OPERATIONS

Changes in Basis of Presentation

Discontinued Operations

As discussed more fully in Note 1 to the accompanying consolidated financial statements, the 2006 financial information has been recast so that the basis of presentation is consistent with that of the 2007 financial information. Specifically, the Company has reflected as discontinued operations for all periods presented the financial condition and results of operations of certain businesses sold during the first six months of 2007, which include the Parenting Group, most of the Time4 Media magazine titles, *The Progressive Farmer* magazine, Leisure Arts and the Braves, as well as certain businesses the Company entered into agreements to sell during the first six months of 2007, which include Tegic and Wildseed.

Consolidation of Kansas City Pool

On January 1, 2007, the Company began consolidating the results of the Kansas City Pool it received upon the distribution of the assets of TKCCP to TWC and Comcast.

Recent Accounting Standards

Accounting for Sabbatical Leave and Other Similar Benefits

On January 1, 2007, the Company adopted the provisions of Emerging Issues Task Force (EITF) Issue No. 06-02, *Accounting for Sabbatical Leave and Other Similar Benefits* (EITF 06-02), related to certain sabbatical leave and other employment arrangements that are similar to a sabbatical leave. EITF 06-02 provides that an employee's right to a compensated absence under a sabbatical leave or similar benefit arrangement in which the employee is not required to perform any duties during the absence is an accumulating benefit. Therefore, such arrangements should be accounted for as a liability with the cost recognized over the service period during which the employee earns the benefit. Adoption of this guidance resulted in an increase to accumulated deficit of approximately \$97 million (approximately \$59 million, net of tax) on January 1, 2007. The resulting change in the accrual for the six months ended June 30, 2007 was not material.

Accounting for Uncertainty in Income Taxes

On January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in income tax positions. This interpretation requires the Company to recognize in the consolidated financial statements only those tax positions determined to be more likely than not of being sustained upon examination, based on the technical merits of the positions. Upon adoption, the Company recognized approximately \$445 million of tax benefits for positions that were previously unrecognized, of which approximately \$433 million was accounted for as a reduction to the accumulated deficit balance and approximately \$12 million was accounted for as an increase to the paid-in-capital balance as of January 1, 2007. Additionally, the adoption of FIN 48 resulted in the recognition of additional tax reserves for positions where there is uncertainty about the timing or character of such deductibility. These additional reserves were largely offset by increased deferred tax assets (Note 1).

Accounting for Deferred Compensation and Postretirement Benefit Aspects of Split-Dollar Life Insurance Arrangements

The EITF has reached consensus on EITF Issue No. 06-10, *Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements* (EITF 06-10), and EITF Issue No. 06-04, *Deferred Compensation and Postretirement Benefits Aspects of Endorsement Split-Dollar Life Insurance Arrangements* (EITF 06-04), which require that a company recognize a liability for the postretirement benefits associated with endorsement and collateral assignment split-dollar life insurance arrangements. The provisions of EITF 06-10 and EITF 06-04 will be effective for Time Warner as of January 1, 2008 and will impact the Company in instances where the Company has contractually agreed to maintain a life insurance policy (i.e., the Company pays the premiums) for an employee in

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periods in which the employee is no longer providing services. The provisions of EITF 06-10 and EITF 06-04 are not expected to have a material impact on the Company's consolidated financial statements.

Significant Transactions and Other Items Affecting Comparability

As more fully described herein and in the related notes to the accompanying consolidated financial statements, the comparability of Time Warner's results from continuing operations has been affected by certain significant transactions and other items in each period as follows (millions):

	Three Months Ended		Six Months Ended	
	6/30/07	6/30/06	6/30/07	6/30/06
		(recast)		(recast)
Amounts related to securities litigation and government investigations	\$ (4)	\$ (32)	\$ (167)	\$ (61)
Asset impairments	(34)		(35)	
Gain (loss) on disposal of assets, net	(1)		669	22
Impact on Operating Income (Loss)	(39)	(32)	467	(39)
Investment gains, net	111	20	274	315
Impact on Other income, net	111	20	274	315
Minority interest impact			(57)	
Pretax impact	72	(12)	684	276
Income tax impact	(31)	6	(321)	(99)
Other tax items affecting comparability	77	9	80	102
After-tax impact	\$ 118	\$ 3	\$ 443	\$ 279

In addition to the items affecting comparability above, the Company incurred merger-related, restructuring and shutdown costs of approximately \$33 million and \$101 million during the three and six months ended June 30, 2007, respectively, and approximately \$102 million and \$132 million during the three and six months ended June 30, 2006, respectively.

The Company incurred restructuring costs for the three and six months ended June 30, 2007 of approximately \$30 million and \$94 million, respectively, primarily related to various employee terminations and other exit activities, including \$4 million and \$27 million, respectively, at the AOL segment for the three and six months ended June 30, 2007, \$3 million and \$9 million, respectively, at the Cable segment for the three and six months ended June 30, 2007, \$16 million at the Networks segment for the three and six months ended June 30, 2007 and \$7 million and \$42 million, respectively, at the Publishing segment for the three and six months ended June 30, 2007. In addition, for the three and six months ended June 30, 2007, the Cable segment also expensed approximately \$3 million and \$7 million, respectively, of non-capitalizable merger-related and restructuring costs associated with the Adelphia/Comcast Transactions.

The Company incurred restructuring costs for the three and six months ended June 30, 2006 of approximately \$41 million and \$64 million, respectively, primarily related to various employee terminations, including \$15 million at the AOL segment for the three and six months ended June 30, 2006, \$4 million and \$10 million, respectively, at the Cable segment for the three and six months ended June 30, 2006, \$22 million and \$34 million, respectively, at the Publishing segment for the three and six months ended June 30, 2006 and \$5 million at the Corporate segment for the six months ended June 30, 2006. The Company also expensed \$2 million and \$4 million, respectively, at the Filmed

Entertainment segment for the three and six months ended June 30, 2006 and \$1 million at the AOL segment for the six months ended June 30, 2006 as a result of changes in estimates of previously established restructuring accruals. In addition, during the three and six months ended June 30, 2006, the Cable segment expensed approximately \$7 million and \$11 million, respectively, of non-capitalizable merger-related costs associated with the Adelphia Acquisition. The results for the three and six months ended June 30, 2006 include shutdown costs of \$81 million at The WB Network in connection with the agreement between Warner Bros. and CBS to form The CW. Included in the shutdown costs are termination charges related to terminating intercompany programming arrangements with other Time Warner divisions, of which \$29 million has been eliminated in consolidation, resulting in a net pretax charge of \$52 million.

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Amounts Related to Securities Litigation

The Company recognized legal reserves as well as legal and other professional fees related to the defense of various shareholder lawsuits, totaling \$5 million and \$176 million for the three and six months ended June 30, 2007, respectively, and \$35 million and \$114 million for the three and six months ended June 30, 2006, respectively. In addition, the Company recognized related insurance recoveries of \$1 million and \$9 million for the three and six months ended June 30, 2007, respectively, and \$3 million and \$53 million for the three and six months ended June 30, 2006, respectively.

Asset Impairments

During the three and six months ended June 30, 2007, the Company recorded a \$34 million noncash charge at the Networks segment related to the impairment of the Court TV tradename as a result of rebranding the Court TV network name to truTV, effective January 1, 2008. During the six months ended June 30, 2007, the Company recorded a \$1 million noncash asset impairment charge at the AOL segment related to asset write-offs in connection with facility closures primarily as a result of AOL's revised strategy.

Gains on Disposal of Assets, Net

For the three and six months ended June 30, 2007, the Company recorded a net \$1 million reduction to the gains on the sales of AOL's German and U.K. access businesses, and for the six months ended June 30, 2007 the Company recorded a gain of approximately \$670 million on the sale of AOL's German access business.

For the six months ended June 30, 2006, the Company recorded a gain of approximately \$20 million at the Corporate segment related to the sale of two aircraft and a \$2 million gain at the AOL segment from the resolution of a previously contingent gain related to the 2004 sale of Netscape Security Solutions (NSS).

Investment Gains, Net

For the three and six months ended June 30, 2007, the Company recognized net gains of \$111 million and \$274 million, respectively, primarily related to the sale of investments, including an approximate \$100 million gain on the Company's sale in April 2007 of its 50% interest in Bookspan, and for the six months ended June 30, 2007 a \$146 million gain on TWC's deemed sale of its 50% interest in the Houston Pool in connection with the distribution of TKCCP's assets at the Cable segment. For the three and six months ended June 30, 2007, investment gains, net also included a \$2 million loss and a \$4 million gain, respectively, which resulted from market fluctuations in equity derivative instruments.

For the three and six months ended June 30, 2006, the Company recognized net gains of \$20 million and \$315 million, respectively, primarily related to the sale of investments, including for the six months ended June 30, 2006 a \$239 million gain on the sale of a portion of the Company's investment in Time Warner Telecom Inc. (TWT) and a \$51 million gain on the sale of the Company's investment in Canal Satellite Digital. For the three and six months ended June 30, 2006, investment gains, net also included gains of \$4 million and \$11 million, respectively, which resulted from market fluctuations in equity derivative instruments.

Minority Interest Impact

For the six months ended June 30, 2007, income of \$57 million was attributed to minority interests, which primarily reflects the respective minority owner's share of the gains on TWC's deemed sale of the Houston Pool interest and on the sale of AOL's German access business.

Income Tax Impact and Other Tax Items Affecting Comparability

The income tax impact reflects the estimated tax or tax benefit associated with each item affecting comparability. Such estimated taxes or tax benefits vary based on certain factors, including the taxability or deductibility of the items and foreign tax on certain gains. The Company's tax provision may also include certain other items affecting comparability. For the three and six months ended June 30, 2007, these items included approximately \$77 million and \$80 million, respectively, of tax benefits related primarily to the realization of tax attribute carryforwards and changes in certain state tax

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laws. For the three and six months ended June 30, 2006, these items included approximately \$9 million and \$102 million, respectively, of tax benefits related primarily to the realization of tax attribute carryforwards.

Three and Six Months Ended June 30, 2007 Compared to Three and Six Months Ended June 30, 2006

Consolidated Results

Revenues. The components of revenues are as follows (millions):

	Three Months Ended			Six Months Ended		
	6/30/07	6/30/06 (recast)	% Change	6/30/07	6/30/06 (recast)	% Change
Subscription	\$ 6,229	\$ 5,668	10%	\$ 12,468	\$ 11,162	12%
Advertising	2,268	2,173	4%	4,200	3,922	7%
Content	2,243	2,269	(1%)	5,022	5,015	
Other	240	251	(4%)	474	500	(5%)
Total revenues	\$ 10,980	\$ 10,361	6%	\$ 22,164	\$ 20,599	8%

The increase in Subscription revenues for the three and six months ended June 30, 2007 was primarily related to increases at the Cable and Networks segments, offset partially by a decline at the AOL segment. The increase at the Cable segment was driven by the impact of the Acquired Systems, the consolidation of the Kansas City Pool, the continued penetration of digital video services, video price increases and growth in basic video, high-speed data and Digital Phone subscriber levels in the Legacy Systems. The increase at the Networks segment was due primarily to higher subscription rates and, to a lesser extent, an increase in the number of subscribers at Turner. The decline in Subscription revenues at the AOL segment resulted from decreases in the number of AOL brand domestic subscribers and related revenues as a result of AOL's revised strategy, as well as the sales of AOL's European access businesses in the fourth quarter of 2006 and first quarter of 2007.

The increase in Advertising revenues for the three and six months ended June 30, 2007 was primarily due to growth at the AOL and Cable segments, offset partially by a decline at the Networks segment. The increase at the AOL segment was due to growth in Advertising revenues on both the AOL Network and on Partner Sites. The increase at the Cable segment was primarily attributable to the impact of the Acquired Systems and, to a lesser extent, the consolidation of the Kansas City Pool and growth in the Legacy Systems. The decline at the Networks segment was primarily driven by the impact of the shutdown of The WB Network on September 17, 2006, partially offset by higher Advertising revenues across Turner's primary networks.

Each of the revenue categories is discussed in greater detail by segment in **Business Segment Results**.

Costs of Revenues. For the three months ended June 30, 2007 and 2006, costs of revenues totaled \$6.417 billion and \$5.814 billion, respectively, and as a percentage of revenues were 58% and 56%, respectively. For the six months ended June 30, 2007 and 2006, costs of revenues totaled \$12.913 billion and \$11.491 billion, respectively, and as a percentage of revenues were 58% and 56%, respectively. The increase in costs of revenues as a percentage of revenues for the three and six months ended June 30, 2007 was primarily attributable to increases at the Cable segment, primarily related to the Acquired Systems and the consolidation of the Kansas City Pool, and at the Filmed Entertainment segment, primarily reflecting the change in the quantity and mix of products released, partially offset by a decline at the AOL segment, primarily reflecting a shift to Advertising revenues, which have higher margins. The segment variations are discussed in detail in **Business Segment Results**.

Selling, General and Administrative Expenses. For the three months ended June 30, 2007, selling, general and administrative expenses decreased 6% to \$2.397 billion in 2007 from \$2.555 billion in 2006. For the six months ended June 30, 2007, selling, general and administrative expenses decreased 6% to \$4.806 billion in 2007 from

\$5.110 billion in 2006. The decrease in selling, general and administrative expenses for the three and six months ended June 30, 2007 related primarily to a significant decline at the AOL segment, substantially due to reduced subscriber acquisition marketing as part of AOL's revised strategy, partially offset by an increase at the Cable segment related to the Acquired Systems and the consolidation of the Kansas City Pool. The segment variations are discussed in detail in Business Segment Results.

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Amounts Related to Securities Litigation. As previously noted in Recent Developments, the Company recognized legal reserves as well as legal and other professional fees related to the defense of various shareholder lawsuits, totaling \$5 million and \$176 million for the three and six months ended June 30, 2007, respectively, and \$35 million and \$114 million for the three and six months ended June 30, 2006, respectively. In addition, the Company recognized related insurance recoveries of \$1 million and \$9 million for the three and six months ended June 30, 2007, respectively, and \$3 million and \$53 million for the three and six months ended June 30, 2006, respectively.

Reconciliation of Operating Income before Depreciation and Amortization to Operating Income.

The following table reconciles Operating Income before Depreciation and Amortization to Operating Income. In addition, the table provides the components from Operating Income to net income for purposes of the discussions that follow (millions):

	Three Months Ended			Six Months Ended		
	6/30/07	6/30/06 (recast)	% Change	6/30/07	6/30/06 (recast)	% Change
Operating Income before Depreciation and Amortization	\$ 3,022	\$ 2,511	20%	\$ 6,640	\$ 5,129	29%
Depreciation	(928)	(653)	42%	(1,829)	(1,302)	40%
Amortization	(158)	(127)	24%	(335)	(256)	31%
Operating Income	1,936	1,731	12%	4,476	3,571	25%
Interest expense, net	(574)	(336)	71%	(1,125)	(635)	77%
Other income, net	108	47	130%	233	358	(35%)
Minority interest expense, net	(91)	(105)	(13%)	(221)	(176)	26%
Income before income taxes, discontinued operations and cumulative effect of accounting change	1,379	1,337	3%	3,363	3,118	8%
Income tax provision	(434)	(505)	(14%)	(1,231)	(1,103)	12%
Income before discontinued operations and cumulative effect of accounting change	945	832	14%	2,132	2,015	6%
Discontinued operations, net of tax	122	182	(33%)	138	437	(68%)
Cumulative effect of accounting change, net of tax					25	NM
Net income	\$ 1,067	\$ 1,014	5%	\$ 2,270	\$ 2,477	(8%)

Operating Income before Depreciation and Amortization. Operating Income before Depreciation and Amortization increased 20% to \$3.022 billion for the three months ended June 30, 2007 from \$2.511 billion for the

three months ended June 30, 2006. Excluding the items previously noted under Significant Transactions and Other Items Affecting Comparability totaling \$39 million and \$32 million of expense, net for 2007 and 2006, respectively, Operating Income before Depreciation and Amortization increased \$518 million, principally as a result of growth at the Cable, Networks and Publishing segments, partially offset by declines at the AOL and Filmed Entertainment segments.

Operating Income before Depreciation and Amortization increased 29% to \$6.640 billion for the six months ended June 30, 2007 from \$5.129 billion for the six months ended June 30, 2006. Excluding the items previously noted under Significant Transactions and Other Items Affecting Comparability totaling \$467 million of income, net and \$39 million of expense, net for 2007 and 2006, respectively, Operating Income before Depreciation and Amortization increased \$1.005 billion, principally as a result of growth at the AOL, Cable and Networks segments, partially offset by a decline at the Filmed Entertainment segment.

The segment variations are discussed in detail under Business Segment Results.

Depreciation Expense. Depreciation expense increased to \$928 million and \$1.829 billion for the three and six months ended June 30, 2007, respectively, from \$653 million and \$1.302 billion for the three and six months ended June 30, 2006, respectively. The increase in depreciation expense for the three and six months ended June 30, 2007 primarily related to an

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