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## **Group : DOLPHIN**

### ***Case 1***

#### **AMERICA ONLINE INC.**

1. Prior to 1995, why was America Online (AOL) so successful in the commercial on-line industry relative to its competitor, CompuServe and Prodigy?

In the new and fast growing commercial on-line industry, AOL took advantage of its strengths to become one of a few leading companies in the market.

The key factors that contributed in the AOL success to place itself ahead the other companies were:

- AOL provided a wide range of features to meet the needs of its customers, such as on-line community, education and references, news and personal finance, travel and shopping, entertainment and children's programming.
  - AOL continued developing new services and content to its customers.
  - It promoted a simple price structure. Compare to its competitor, AOL's pricing structure was the easiest for customer to understand and enable them to anticipate their spending.
  - AOL developed specialized retention programs to maximize customers subscription life. It regularly scheduled online events, conferences, and promotions of up-coming events. In addition, AOL created new features and added services and software programs by entering into strategic business alliances with many leading companies in related industries, such as American Express, ABC, Reuters, etc.
  - AOL implemented an aggressive marketing strategy for attracting new subscribers using both independent marketing efforts (such as direct mail package with software disk, television, etc) and co-marketing efforts (with computer magazine publishers, personal computer hardware and software producers).
2. As of 1995, what are the key changes taking place in the commercial on-line industry? How are they likely to affect AOL's future prospects?

As of 1995, there were significant changes in the commercial on-line industry wherein Microsoft Network (MSN) and Internet World Wide Web (WWW) entering the market with more attractive services. With MSN, content providers had wider discretionary in controlling the contents and obtain 70% commission (AOL paid only 20% for the commission), while with WWW everyone could directly access the internet without

intermediary which also enable the content providers to be their own publishers and had a full control on their products. These changes resulted in a switch of numerous content providers to the new entrants (MSN and WWW) as the formers (AOL, CompuServe and Prodigy) controlled the products very closely and only paid the content providers modest royalties.

The entrance of new players in the market with product differentiation providing relatively more benefit to the customers had become a serious threat to AOL to maintain its position as a market leader. With relatively low price the customers can easily switch to other on-line service providers that resulted in a higher competition between those providers. As the products were continuously developed and new products might enter the market at anytime, it also provided higher bargaining power to the customers. Should AOL not able to create new products, it was more likely to have a narrower role in the future, probably as an internet service provider only.

3. Was AOL's policy to capitalize subscriber acquisition cost justified prior to 1995?

Yes, it was.

Prior to 1995, from our point of view, the company's policy was realistic considering that the cost was associated with acquiring customers in oligopoly market wherein AOL was the leader with a strong customer base and the cost was considered to be beneficial over the period of amortization. This was in compliance with the accounting standard of matching the expenses with the revenues generated.

4. Given the changes discussed in question 2, do you think AOL should change its accounting policy as of 1995? Is the company's response consistent with your view?

Yes. Considering the significant changes in the industry that have an adverse impact on AOL's business, it should change the accounting policy. As of 1995 there were two new entrants, MSN and Internet World Wide Web, which influenced greatly the customers' preferences. Consequently, AOL lost its market share and faced difficulty in retaining its customer base that threatened its business prospect. With more on-line service providers and broader range of products, the customers had more options and could switch easily. Considering the uncertainty in the subscription life, in order to provide more accurate report

AOL should change its accounting policy and charge the subscriber acquisition cost to the period when incurred.

The company's response was not consistent with our point of view. On the contrary, it increased the amortization period from 12-18 months to 24 months. Despite the higher market competition and uncertainty in the subscription life, AOL was too confident that it could maintain the retention period to be 41 months. This reporting strategy will cause a trouble to AOL as the market situation did not reflect its optimistic opinion.

The question is what motivated the company to do such changes? From the company point of view, they want to have accounting system that reflects their industry more accurately. Matching the timing of expenses with period over which the revenues would be received.

Other possible reason is that the company desperately needs money to finance its business activity. Therefore to make investor interested to buy its new equity offered, the company keeps its accounting policy even when the new economic environment does not support the policy.

The issues raised in this content is whether the company tries to manage its earnings. In AOL's case, the company tries to manage earnings by capitalizing and deferring its marketing cost.

So, how do the shareholders and analysts react to this practice?

There has been the perception among the shareholders and financial analysts that this accounting method has been a continual drag on their stock because the income statement didn't fully reflect the reality of the business.

As the market lost its confidence in the company, AOL's stock price dropped to its 52-week low, trading at \$22.75 on October 14, 1996, compared to \$65.25 in October 1995.

As the company realized its mistake and to stop from the further downward fall on the stock price, on October 29, 1996, AOL announced that it would change its accounting practice and would also immediately begin to take any future expenses as they occur. This change has a substantial impact on its earnings, but as a whole, it's a positive move for the company. The market reacted positively toward the announcement as the stock price climbed and increased since then.

5. What would be the effect on AOL's 1995 balance sheets if all the capitalized subscriber acquisition costs were written off? If AOL expensed all the subscriber acquisition costs incurred in fiscal 1995 during the same year, what would be the effect on its income statement?

If all the capitalized subscriber acquisition costs were written off, the total assets would decrease by \$79,591 thousand resulting from deduction in Deferred Subscriber Acquisition Costs amounting to \$77,229 thousand and Deferred Income Tax amounting to \$28,619 thousand, and incurrence of Tax Refund amounting to \$26,257 thousand. On the Liabilities and Stockholders' Equity accounts, Deferred Income Tax would also be reduced by \$28,619 thousand and Accumulated Deficit would increase by \$50,792 thousand.

Charging the Deferred Subscriber Acquisition Costs of 1995 to the same year would increase the Cost of Revenue by \$77,229 thousand and decrease the Provision for Income Tax by \$26,257 thousand. As a result, the overall net loss would increase by \$50,972 thousand (from \$33,647 thousand to \$84,619 thousand).

Please see consolidated balance sheets and statement of operations attached for detail calculation.