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HEADLINE: Do AOL's Ads Add Up?;
Despite an ad slump, the online service reported great sales. Some critics question the numbers.

BYLINE: Jeremy Kahn

BODY:
The advertising market, as media executives across the country are painfully aware, has been in free fall. But if there's an ad depression going on, somebody forgot to tell the AOL division of AOL Time Warner. While rivals watch ad dollars shrivel, AOL thrives. In April, FORTUNE's parent company announced that advertising and e-commerce revenue at its America Online division hit a record $ 721 million in the first quarter, up 37% from a year earlier and up 5% from the prior quarter.

How did AOL pull it off? Simple, says Myer Berlow, president of worldwide interactive marketing: As the world's premier Web company, America Online is enjoying a flight to quality. That is undoubtedly true, but it's not the whole story. AOL's ad revenues would be lower were it not for what critics consider some controversial sales tactics and accounting games. These fall into two broad categories: so-called ads-for-equity deals, a barter transaction that was all the rage during the Web boom, and deals in which AOL invests in a dot-com that in turn pays AOL for advertising and marketing services.

Let's start with ads for equity. During the Internet bubble, AOL, CBS, Yahoo, and many others offered multiyear advertising packages to dot-coms in exchange for stock or warrants. The big guys liked these deals, which allowed them to assemble a portfolio of seemingly hot startups on the cheap. The asset value of the stock was recorded on the company's balance sheet, going up or down over time as the share price rose or fell. Thanks to a quirk in accounting rules, AOL and the others could also recognize "revenue" from the deals. AOL, for example, got $ 20 million in cash and four million shares of Homestore.com in exchange for advertising space in April 2000. The Homestore shares were then worth $ 186 million, and the marketing alliance is to last five years. So AOL can recognize $ 9.3 million of revenue from the deal each quarter--even though none of that is cash. This represents slightly more than 1% of the ad revenue it reported last quarter. The company did similar deals with the likes of Drkoop.com, Net2Phone, and TheKnot.com, arrangements collectively worth hundreds of millions of dollars. AOL CFO Michael Kelly insists that the noncash portions of AOL's ads-for-equity transactions are "immaterial" to its overall advertising revenue in any given quarter.

Accounting for the deals in this manner is perfectly legal. In fact, it's mandated by GAAP rules. But it makes it difficult to gain a clear picture of how well AOL's online advertising sales are holding up. Robert Olstein, who manages the Olstein Financial Alert fund, is among those who argue that such deals inflate operating income,

giving investors a false impression of a company's ability to generate sales in the future. What's more, the "phantom revenue," as Olstein terms it, is slippery stuff. AOL gets a steady cushion of "revenue" even if the value of the underlying stocks or warrants collapses; the write-offs that it incurs as a result reduce net income but leave operating income--the metric that AOL urges investors to watch--untouched. In the past two quarters alone AOL has taken $ 1.1 billion in noncash charges to write down the value of its Internet investments. Kelly says that stock or warrants received for advertising make up only a tiny fraction of those write-offs, but he will not divulge specific numbers.

AOL also has been able to boost its ad sales with a second kind of deal, where companies in which it has previously invested--including PurchasePro, Kinko's, Chinadotcom, iVillage, Switchboard, and Travelocity--buy advertising and marketing services from AOL. This year, for example, AOL acquired 5.7% of PurchasePro in a complicated deal involving warrants and other considerations. At the same time, PurchasePro announced plans to spend an additional $ 5 million on AOL Time Warner cable channels and magazines--upping its total promised spending on AOL Time Warner software, marketing, and advertising to $ 75 million. (AOL itself is investigating the deal and has suspended a top dealmaker, Eric Keller, pending the results of that inquiry. The company won't comment on the inquiry or the suspension.)

Analysts like Tom Wolzien of Sanford Bernstein and John Corcoran of CIBC World Markets find these deals less valuable than ones in which the advertiser has no relationship with AOL. Says Corcoran: "We're always skeptical when they have a prior relationship with their customers." Wolzien and others also question whether in some cases AOL may be recycling its own cash: In other words, is AOL using cash on its balance sheet to invest in these companies, which then buy ads and services from AOL, thus bolstering AOL's income statement? "It's hard to say," explains Wolzien, "how much revenue is coming from their own balance sheet." For example, last year AOL acquired an 11.5% stake in Kinko's in a deal that involved an unspecified amount of cash. This March the copy services company announced that it was buying advertising across the many media platforms of AOL Time Warner.

Kelly says AOL is not trying to inflate revenues through these deals. He says each investment must stand on its own, and he notes that most of the ad agreements were signed months after AOL bought stock in a company. Berlow, meanwhile, emphatically asserts that it is AOL's marketing power--not accounting gimmicks--that explains the company's ability to weather the advertising slowdown. He's probably right. Trouble is, investors can't really know for sure without greater disclosure from AOL.

FEEDBACK: jkahn@fortunemail.com

GRAPHIC: COLOR PHOTO: TIMOTHY GREENFIELD-SANDERS, Kelly says nothing is funky about AOL's figures.

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