Exchange, the American Stock Exchange, and the Pacific Stock Exchange.

Recent Sales of Unregistered Securities

On May 28, 1999, the Company acquired Spinner Networks Incorporated in exchange for the issuance of approximately 2.4 million shares of Company common stock. The transaction was a private placement and exempt from registration pursuant to Regulation D of the Securities Act of 1933, as amended.

On May 28, 1999, the Company acquired Nullsoft, Inc. in exchange for the issuance of approximately 720,000 shares of Company common stock. The transaction was a private placement and exempt from registration pursuant to Regulation D of the Securities Act of 1933, as amended.

Item 6. Selected Financial Data

	Year Ended June 30,				
	1999	1998	1997	1996	1995
	(Amounts in millions, except per share data)				
Statement of Operations Data:					
Subscription services	$3,321	$2,183	$1,478	$1,024	$352
Advertising, commerce and other	1,000	543	308	111	50
Enterprise solutions	456	365	411	188	23
Total revenues	4,777	3,091	2,197	1,323	425
Income (loss) from operations	458	(120)	(485)	64	(41)
Net income (loss) (1)	762	(74)	(485)	35	(55)
Income (loss) per common share:					
Net income (loss) per share-diluted	$ 0.60	$(0.08)	$(0.58)	$ 0.04	$(0.09)
Net income (loss) per share-basic	$ 0.73	$(0.08)	$(0.58)	$ 0.05	$(0.09)
Weighted average shares outstanding:					
Diluted	1,277	925	838	944	587
Basic	1,041	925	838	751	587

	As of June 30,				
	1999	1998	1997	1996	1995
	(Amounts in millions)				
Balance Sheet Data:					
Working capital (deficiency)	$254	$108	$(40)	$72	$18
Total assets	5,348	2,874	1,501	1,271	459
Total debt	364	372	52	25	24
Stockholders' equity	3,033	996	610	707	242

	Year Ended June 30,				
	1999	1998	1997	1996	1995
	(Amounts in millions)				
Other Selected Data:					
Net cash provided by operating activities	$1,099	$437	$131	$2	$18
Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)(2)	968	302	111	138	11

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(1) Net income in the fiscal year ended June 30, 1999, includes special charges of $95 million related to mergers and restructurings, $25 million in transition costs and a net gain of $567 million related to the sale of investments in Excite, Inc. Net loss in the fiscal year ended June 30, 1998,

includes special charges of $75 million related to mergers and restructurings, $94 million related to acquired in-process research and development and $17 million related to settlements. Net loss in the fiscal year ended June 30, 1997, includes special charges of $385 million for the write-off of deferred subscriber acquisition costs, $49 million for restructuring, $24 million for contract terminations, $24 million for a legal settlement and $9 million related to acquired in-process research and development. Net income in the fiscal year ended June 30, 1996, includes special charges of $17 million for acquired in-process research and development and $8 million in merger related costs. Net loss in the fiscal year ended June 30, 1995, includes special charges of $50 million for acquired in-process research and development and $2 million for merger expenses.

(2) EBITDA is defined as net income plus: (1) provision/(benefit) for income taxes, (2) interest expense, (3) depreciation and amortization and (4) special charges. For the fiscal years ended June 30, 1997 and prior, EBITDA does not add back the amortization of subscriber acquisition costs. The Company considers EBITDA an important indicator of the operational strength and performance of its business including the ability to provide cash flows to service debt and fund capital expenditures. EBITDA, however, should not be considered an alternative to operating or net income as an indicator of the performance of the Company, or as an alternative to cash flows from operating activities as a measure of liquidity, in each case determined in accordance with generally accepted accounting principles ("GAAP").

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Founded in 1985, America Online, Inc., ("America Online" or the "Company") based in Dulles, Virginia, is the world's leader in interactive services, Web brands, Internet technologies, and electronic commerce services. The Company operates two worldwide subscription based Internet online services, America Online, with more than 17 million members, and CompuServe, with approximately 2 million members; several leading Internet brands including ICQ, AOL Instant Messenger and Digital City, Inc.; the Netscape Netcenter and AOL.COM Internet portals; and the Netscape Communicator client software, including the Netscape Navigator browser; AOL MovieFone, the nation's number one move listing guide and ticketing service; and Spinner Networks Incorporated and Nullsoft, Inc., leaders in Internet music. Through its strategic alliance with Sun Microsystems, Inc. the Company also develops and offers easy-to-deploy, end-to-end electronic commerce and enterprise solutions for companies operating in and doing business on the Internet.

The Company currently has two major lines of businesses organized into four product groups. These groups are supported by a common infrastructure. This organization structure allows the Company to develop and grow multiple revenue streams by utilizing the common infrastructure across the multiple brands it currently has, as well as cost-effectively compete in new and emerging markets.

Interactive Online Services Business

The Interactive Services Group

The Interactive Services Group operates the Company's interactive products: the AOL and CompuServe services and their related brand and product extensions, including AOL Instant Messenger and AOL.COM; Netscape Netcenter; and the Netscape Communicator client software, including the Netscape Navigator browser. This group is also charged with rapidly delivering high-quality, world-class products, features and functionality across all branded services and properties and also has responsibility for broadband development and AOL devices like AOL TV.

The Interactive Properties Group

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The Interactive Properties Group operates ICQ, Digital City, MovieFone, Direct Marketing Services ("DMS"), Spinner Networks Incorporated and Nullsoft, Inc., developer of the Winamp and SHOUTcast brands. This group is responsible for building new revenue streams by seeking out opportunities to build or acquire branded properties that operate across multiple services or platforms.

The AOL International Group

The AOL International Group oversees the AOL and CompuServe services outside of the U.S., as well as the recently announced Netscape Online service. The AOL International Group operates the AOL and CompuServe brands in Europe with its joint venture partner Bertelsmann AG; AOL Canada, a wholly-owned subsidiary of America Online, Inc.; AOL Japan, with its joint venture partners Mitsui and Nikkei; and AOL in Australia with Bertelsmann. America Online plans to launch services in Hong Kong with China Internet Corporation and in Latin America with the Cisneros Group.

Netscape Enterprise Solution Business

The Netscape Enterprise Group

The Netscape Enterprise Group serves Netscape's enterprise customers and contributes to America Online's part of the strategic alliance with Sun. In combination with dedicated resources from Sun, the Netscape Enterprise Group delivers easy-to-deploy, end-to-end solutions to help business partners and other companies put their businesses online.

Competition

The Company competes with a wide range of other companies in the communications, advertising, entertainment, information, media, Web-based services, software, technology, direct mail and electronic commerce fields for subscription, advertising, and commerce revenues, and in the development of distribution technologies and equipment in its Interactive Online Services business. The Company also competes with a wide range of companies in the development and sale of electronic commerce infrastructure and applications in its Enterprise Solutions business.

o Competitors for subscription revenues include:
  -- online services such as the Microsoft Network, AT&T Worldnet and Prodigy Classic
  -- national and local Internet service providers, such as MindSpring and EarthLink
  -- long distance and regional telephone companies offering access as part of their telephone service, such as AT&T Corp., MCI WorldCom, Inc., Sprint Corporation and regional Bell operating companies
  -- cable television companies
  -- cable Internet access services offered by companies such as Excite@Home and Road Runner Group

o Competitors for advertising and commerce revenues include:
  -- online services such as the Microsoft Network, AT&T Worldnet and Prodigy Classic
  -- Web-based navigation and search service companies such as Yahoo! Inc., Infoseek Corporation (to be acquired by the Walt Disney Company), Lycos, Inc. and Excite@Home.
  -- global media companies including newspapers, radio and television stations and content providers, such as the National Broadcasting Corporation, CBS Corporation, The Walt Disney Company, Time Warner Inc., The Washington Post Company and Conde Nast Publications, Inc.
  -- cable Internet access services offered by companies such as Excite@Home and Road Runner Group
  -- Web sites focusing on content, commerce, community and similar features such as Amazon.com and eBay.

o Competition in the development of distribution technologies and equipment includes:
  -- broadband distribution technologies used in cable Internet access services offered by companies such as Excite@Home and

Road Runner Group
- -- advanced telephone-based access services offered through digital subscriber line technologies offered by local telecommunications companies
- -- other advanced digital services offered by broadcast, satellite and wireless companies
- -- television-based interactive computer services, such as those offered by Microsoft's WebTV
- -- personal digital assistants or handheld computers, enhanced mobile phones and other equipment offering functional equivalents to the Company's features

- o Competitors in the development and sale of electronic commerce infrastructure and applications include:
  - -- providers of electronic commerce infrastructure such as server software, including International Business Machines Corporation, Microsoft Corporation, Oracle Corporation, Novell, Inc., Software.com, Inc., BEA Systems, Inc. and the provider of the Apache Web Server
  - -- providers of electronic commerce applications including International Business Machines Corporation, Oracle Corporation, General Electric Information Systems, Microsoft Corporation, PeopleSoft, Inc., SAP A.G., Open Market, Inc., Ariba Technologies, CommerceOne, Sterling Commerce, Inc. and BroadVision, Inc.

Some of the present competitors and potential future competitors of the Company may have greater financial, technical, marketing or personnel resources than the Company. In addition, as a result of acquisitions, certain competitors are able to offer both Internet access and other services, such as cable television or telephone service, and such consolidation may continue. The competitive environment could have a variety of adverse effects on the Company. For example, it could:

- o negatively impact the Company's ability to generate greater revenues and profits from sources other than online service subscription revenues, such as advertising and electronic commerce
- o limit the Company's opportunities to enter into or renew agreements with content providers and distribution partners
- o limit the Company's ability to develop new products and services
- o limit the Company's ability to continue to grow or sustain its subscriber base
- o require price reductions in the subscription fees for online services and require increased spending on marketing, network capacity, content procurement and product and features development
- o require price reductions in the Company's enterprise software products
- o result in a loss of the Company's market share in the enterprise software industry
- o require an increase in the Company's sales and marketing expenditures

Any of the foregoing events could have an adverse impact on revenues or result in an increase in costs as a percentage of revenues, either of which could have a material adverse effect on the Company's business, financial condition and operating results.

Consolidated Results of Operations

Revenues

The following table and discussion highlights the revenues of the Company for the years ended June 30, 1999, 1998 and 1997.

	Year ended June 30,					
	1999		1998		1997	
	(Dollars in millions)					
Revenues:						
Subscription services	$3,321	69.5%	$2,183	70.6%	$1,478	67.3%

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Advertising, commerce and other	1,000	21.0	543	17.6	308	14.0
Enterprise solutions	456	9.5	365	11.8	411	18.7
Total revenues	$4,777	100.0%	$3,091	100.0%	$2,197	100.0%

The Company generates three main types of revenues: subscription services; advertising, commerce and other; and enterprise solutions revenues. Subscription services revenues are generated from customers subscribing to the Company's AOL service and, effective February 1, 1998, the CompuServe service. Advertising, commerce and other revenues are non-subscription based and are generated mainly from businesses marketing to the Company's base of subscribers and users across its multiple brands. Advertising, commerce and other revenues mainly consist of advertising and related revenues, fees associated with electronic commerce and the sale of merchandise. Enterprise solutions revenues consist principally of product licensing fees and fees from technical support, consulting and training services.

Subscription Services Revenues

Currently, the Company's Interactive Online Services business generates subscription services revenue primarily from subscribers paying a monthly membership fee. Prior to December 1, 1996, a significant portion of online service revenues were comprised of hourly charges based on usage in excess of the number of hours of usage provided as part of the monthly fee. With the introduction of flat-rate pricing, as described below, the portion of online service revenues which are generated from hourly charges has decreased substantially.

Effective December 1, 1996, the Company began offering several pricing alternatives to the AOL service in the U.S. aimed at providing a variety of price points designed to appeal to a wide range of consumers. The Company's current pricing options are as follows:

- o A standard monthly membership fee of $21.95, with no additional hourly charges (the "Flat-Rate Plan"). Subscribers can also choose to prepay for one year in advance at the monthly rate of $19.95. The Company increased the price of its Flat-Rate Plan from $19.95 per month to $21.95 per month, and the effective monthly rate of the annual plan from $17.95 per month to $19.95 per month, effective at the start of each member's monthly billing cycle in April 1998. Those subscribers who were currently on the annual plan were not subject to an increase until their renewal date. These increases were implemented in order to fund the continued improvement of members' online experience and to keep pace with the cost to the Company of members' increased usage.

- o An alternative offering of three hours for $4.95 per month, with additional time priced at $2.50 per hour.

- o An alternative offering of $9.95 per month for unlimited use--for those subscribers who have an Internet connection other than through AOL and use this connection to access AOL services.

Prior to December 1, 1996, the Company's standard monthly membership fee for its AOL service in the U.S., which included five hours of service, was $9.95 per month, with a $2.95 hourly fee for usage in excess of five hours per month. Existing members at December 1, 1996, could retain the $9.95 / five hour pricing upon request. For the period July 1, 1996 through November 30, 1996, the Company also offered a pricing plan which included 20 hours of service for $19.95 per month, with a $2.95 hourly fee for usage in excess of 20 hours per month (the "Value Plan"). This plan was discontinued upon the availability of the Flat-Rate Plan on December 1, 1996.

Effective February 1, 1998, the Company offered the following price plans for the CompuServe service:

- o A standard monthly membership offering of five hours for $9.95 per month, with additional time priced at $2.95 per hour.
- o An alternative offering of $24.95 per month with no additional hourly

charge.

During fiscal 1999, the Company launched CompuServe 2000 which utilizes the same platform and infrastructure as the AOL service. This service offered the following price plans:

- A standard monthly membership offering of 20 hours for $9.95 per month, with additional time priced at $2.95 per hour.
- An alternative offering of $19.95 per month with no additional hourly charge.

At June 30, 1999, the Company had approximately 17.6 million AOL brand subscribers, including approximately 15.5 million in North America and approximately 2.1 million in the rest of the world. Also at that date, the Company had approximately 2 million CompuServe brand subscribers, including approximately 1 million in North America and approximately 1 million in the rest of world. At June 30, 1998, the Company had approximately 12.5 million AOL brand subscribers, including approximately 11.2 million in North America and approximately 1.3 million in the rest of the world. Also at that date, the Company had approximately 2 million CompuServe brand subscribers, including approximately 1 million in North America and approximately 1 million in the rest of world.

For fiscal 1999, subscription services revenues increased from $2,183 million to $3,321 million, or 52%, over fiscal 1998. This increase was comprised of an increase in AOL subscription services revenues of $1,020 million, as well as CompuServe subscription services revenues of $118 million, which began in February 1998. The increase in AOL subscription services revenues was primarily attributable to a 38% increase in the average number of AOL North American subscribers for fiscal 1999, compared to fiscal 1998, as well as a 8.2% increase in the average monthly subscription services revenue per AOL North American subscriber. The average monthly subscription services revenue per AOL North American subscriber increased from $17.95 in fiscal 1998 to $19.42 in fiscal 1999. This increase was principally attributable to the increase in the Flat-Rate Plan membership fee from $19.95 to $21.95, which became effective in April 1998.

For fiscal 1998, subscription services revenues increased from $1,478 million to $2,183 million, or 48%, over fiscal 1997. This increase was comprised of an increase in AOL subscription services revenues of $637 million, as well as CompuServe subscription services revenues of $88 million, which began in February 1998, partially offset by a $20 million decrease in subscription services revenues from the Company's Internet service, Global Network Navigator ("GNN"), which was discontinued in fiscal 1997. The increase in AOL subscription services revenues was primarily attributable to a 39% increase in the average number of AOL North American subscribers for fiscal 1998, compared to fiscal 1997, as well as a 2.7% increase in the average monthly subscription services revenue per AOL North American subscriber. The average monthly subscription services revenue per AOL North American subscriber increased from $17.48 in fiscal 1997 to $17.95 in fiscal 1998. This increase was principally attributable to a reduction in the amount of refunds/credits issued to subscribers in fiscal 1998.

Advertising, Commerce and Other Revenues

An important component of the Company's business strategy in its Interactive Online Services business is an increasing reliance on advertising, commerce and other revenues. These revenues include advertising and electronic commerce fees, the sale of merchandise, as well as other revenues, which consist primarily of royalty fees and development revenues, as well as data network service revenues generated by ANS Communications, Inc. ("ANS") (through its sale in January 1998). The growth of advertising, commerce and other revenues is important to the Company's business objectives, as these revenues provide an important contribution to the Company's operating results. Advertising revenues are expected to grow in importance as the Company continues to leverage its large, active and growing user base. This user base not only includes the paying subscribers of the AOL and CompuServe services, it also includes users of the Company's other branded portals and services such as AOL MovieFone, Netcenter (with more than 17 million registered users), AOL.COM, ICQ (with almost 15 million active registered users) and Digital City. Affecting the growth in

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advertising, commerce and other revenues is the backlog balance as of June 30, 1999, 1998 and 1997 of $1,519 million, $511 million and $180 million, respectively. During fiscal 2000, approximately $680 million of revenue will be generated from the June 30, 1999 backlog.

The following table summarizes the material components of advertising, commerce and other revenues for the years ended June 30, 1999, 1998 and 1997.

	Year ended June 30,					
	1999		1998		1997	
	(Dollars in millions)					
Advertising and electronic commerce fees	$ 765	76.5%	$ 358	65.9%	$ 147	47.7%
Merchandise	134	13.4	103	19.0	109	35.4
Other	101	10.1	82	15.1	52	16.9
Total advertising, commerce and other revenues	$1,000	100.0%	$ 543	100.0%	$ 308	100.0%

Advertising, commerce and other revenues increased by 84%, from $543 million in fiscal 1998 to $1,000 million in fiscal 1999. More advertising on the Company's AOL service and Netcenter portal, as well as an increase in electronic commerce fees drove the increase. Advertising and electronic commerce fees increased by 114%, from $358 million in fiscal 1998 to $765 million in fiscal 1999.

Advertising, commerce and other revenues increased by 76%, from $308 million in fiscal 1997 to $543 million in fiscal 1998. More advertising on the Company's AOL service and Netcenter portal, as well as an increase in electronic commerce fees primarily drove the increase. Advertising and electronic commerce fees increased by 144%, from $147 million in fiscal 1997 to $358 million in fiscal 1998.

Enterprise Solutions Revenues

The Netscape Enterprise Solutions business generates revenues that consist principally of product licensing fees and fees from technical support, consulting and training services. The Netscape Enterprise Group focuses on providing businesses a range of software products, technical support, consulting and training services. These products and services enable businesses and users to share information, manage networks and facilitate electronic commerce on the Internet. In November 1998, the Company entered into a strategic alliance with Sun Microsystems, Inc. ("Sun"), a leader in network computing products and services, to accelerate the growth of electronic commerce. The strategic alliance provides that, over a three year period, the Company will develop and market, together with Sun, client software and network application and server software for electronic commerce, extended communities and connectivity, including software based in part on the Netscape code base, on Sun code and technology and on certain America Online services features, to business enterprises.

Enterprise solutions revenues increased by 25%, from $365 million in fiscal 1998 to $456 million in fiscal 1999. The increase was due to an increase in product sales related to server applications and consulting services coupled with the decline in revenues in fiscal 1998 due to offering the Netscape Communicator client software, including the Netscape Navigator browser for free starting in January 1998.

Enterprise solutions revenues decreased by 11%, from $411 million in fiscal 1997 to $365 million in fiscal 1998. The decrease was due to offering the Netscape Communicator client software, including the Netscape Navigator browser for free starting in January 1998, offset by an 18% increase in product sales related to server applications and consulting services.

Costs and Expenses

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The following table and discussion highlights the costs and expenses of the Company for the years ended June 30, 1999, 1998 and 1997.

	Year ended June 30,					
	1999		1998		1997	
	(Dollars in millions)					
Total revenues	$4,777	100.0%	$3,091	100.0%	$2,197	100.0%
Costs and expenses:						
Cost of revenues	$2,657	55.6%	$1,811	58.6%	$1,162	52.9%
Sales and marketing						
Sales and marketing	808	16.9	623	20.2	608	27.7
Write-off of deferred subscriber acquisition costs	-	-	-	-	385	17.5
Product development	286	6.0	239	7.7	195	8.9
General and administrative	408	8.5	328	10.6	220	10.0
Amortization of goodwill and other intangible assets	65	1.4	24	0.8	6	0.3
Acquired in-process research and development	-	-	94	3.0	9	0.4
Merger, restructuring and contract termination charges	95	2.0	75	2.4	73	3.3
Settlement charges	-	-	17	0.5	24	1.1
Total costs and expenses	$4,319	90.4%	$3,211	103.9%	$2,682	122.1%

Cost of Revenues

Cost of revenues includes network-related costs, consisting primarily of data network costs, personnel and related costs associated with operating the data centers, data network and providing customer support, consulting, technical support/training and billing, host computer and network equipment costs, the costs of merchandise sold, royalties paid to information and service providers and royalties paid for licensed technologies.

Since the introduction of the Flat-Rate Plan for the AOL service in December 1996, the Company has experienced a significant increase in both: 1) subscriber usage, which is mainly due to the growth of the subscriber base, and 2) the average monthly usage per subscriber as subscribers spend more and more time online. These increases have the potential to increase network cost on both an absolute dollar basis, as well as a percentage of revenue basis. While the growth in subscriber usage and the related costs generally are consistent with the increases in subscription service revenues, the increase in usage and related costs per subscriber could impact operating margins. Average monthly subscriber usage in the first quarter of fiscal 1997, the last quarter before the introduction of flat-rate pricing, was approximately 7 hours. In fiscal 1998, average monthly subscriber usage ranged between 20 and 23 hours, and was approximately 22 hours in the fourth quarter of fiscal 1998. In fiscal 1999, average monthly subscriber usage ranged between 24 and 27 hours and was approximately 27 hours in the fourth quarter of fiscal 1999. The Company has, and plans to continue to minimize the impact of the aforementioned increases by increasing advertising, commerce and other revenues and by reducing network costs, on a relative basis (either on a per-hour basis or as a percentage of total revenues). An important factor in reducing network costs is the reduction of the costs of operating the Company's data network, on a per-hour basis, through volume discounts and more efficient utilization of AOLnet, the Company's TCP/IP network. The Company expects that the growth in advertising, commerce and other revenues, assuming such growth continues, will provide the Company with the opportunity and flexibility to fund the costs associated with the increased usage resulting from flat-rate pricing, as well as programs designed to grow the subscriber base and meet other business objectives.

For fiscal 1999, cost of revenues increased from $1,811 million to $2,657 million, or 47%, over fiscal 1998, and decreased as a percentage of total revenues from 58.6% to 55.6%. The increase in cost of revenues in fiscal 1999 was primarily attributable to increases in data network costs, host computer and network equipment costs and personnel and related costs associated with operating the data centers, data network, providing customer support, consulting, technical support/training and billing. Data network costs increased primarily as a result of the larger member base and more usage per member. Host computer and network equipment costs, consisting of lease, depreciation and maintenance expenses, increased as a result of additional host computer and network equipment, necessitated by the larger member base and more usage by members. Personnel and related costs associated with operating the data centers, data network, providing customer support and billing increased primarily as a result of the requirements of supporting a larger data network, a larger member base and increased subscription services revenues. Personnel and related costs associated with consulting and technical support/training increased due to providing additional customer support and professional services. The decrease in cost of revenues as a percentage of total revenues was primarily attributable to growth of the higher margin advertising, commerce and other revenues, as well as a decrease in network-related costs as a percentage of subscription services revenue.

For fiscal 1998, cost of revenues increased from $1,162 million to $1,811 million, or 56%, over fiscal 1997, and increased as a percentage of total revenues from 52.9% to 58.6%. The increase in cost of revenues in fiscal 1998 was primarily attributable to increases in data network costs, host computer and network equipment costs and personnel and related costs associated with operating the data centers, data network, providing customer support, consulting, technical support/training and billing. Data network costs increased primarily as a result of the larger member base and more usage per member. Host computer and network equipment costs, consisting of lease, depreciation and maintenance expenses, increased as a result of additional host computer and network equipment, necessitated by the larger member base and more usage by members. Personnel and related costs associated with operating the data centers, data network, providing customer support and billing increased primarily as a result of the requirements of supporting a larger data network, a larger member base and increased subscription services revenues. Personnel and related costs associated with consulting and technical support/training increased due to providing additional customer support and professional services. The increase in cost of revenues, as a percentage of total revenues, in fiscal 1998 was primarily attributable to an increase, as a percentage of total revenues, in host computer and network equipment costs coupled with the decrease in revenues related to the high margin Netscape Communicator client software (including the Netscape Navigator browser) partially offset by a decrease, as a percentage of total revenues, in royalties paid to information and service providers.

Sales and Marketing

Sales and marketing expenses include the costs to acquire and retain subscribers, the operating expenses associated with the sales and marketing organizations and other general marketing costs.

Marketing expenses have declined as a percentage of revenues primarily as a result of the improved value proposition offered by flat-rate pricing, which has resulted in improved subscriber acquisition and retention rates, as compared to rates achieved prior to flat-rate pricing. The Company's marketing strategy is expected to continue to emphasize brand advertising across multiple brands as well as cost-effective bundling agreements, where the Company's products are widely distributed with new personal computers, the Windows operating system and other peripheral computer equipment and software. Additionally, the Company will continue to market its products via direct mail programs.

For fiscal 1999, sales and marketing expenses increased from $623 million to $808 million, or 30%, over fiscal 1998, and decreased as a percentage of total revenues from 20.2% to 16.9%. The increase in sales and marketing expenses for fiscal 1999 was mainly attributable to an increase in direct subscriber acquisition costs, brand advertising across multiple brands and personnel costs associated with expanding the Netscape Enterprise business. The decrease as a percentage of total revenues was primarily a result of the substantial growth in revenues.

For fiscal 1998, sales and marketing expenses increased from $608 million to $623 million, or 2%, over fiscal 1997, and decreased as a percentage of total revenues from 27.7% to 20.2%. The increase in sales and marketing expenses for fiscal 1998 was mainly attributable to an increase in Netcenter staffing and related sales commissions, partially offset by a decrease in subscriber acquisition costs. The decrease as a percentage of total revenues was mainly due to the decrease in subscriber acquisition costs.

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The Company made a change in the first quarter of fiscal 1997 which resulted in subscriber acquisition costs being expensed for periods subsequent to the first quarter of fiscal 1997, versus being capitalized and amortized over twenty-four months in the first quarter of fiscal 1997 and prior. As a result of the aforementioned change in accounting estimate, the balance of deferred subscriber acquisition costs as of September 30, 1996, totaling $385 million, was written off. For additional information regarding this change, refer to Note 3 of the Notes to Consolidated Financial Statements.

For fiscal 1998, sales and marketing expenses, before capitalization and amortization, decreased from $679 million to $623 million, or 8.2%, over fiscal 1997, and decreased as a percentage of total revenues from 30.9% to 20.2%. The decrease in sales and marketing expenses for fiscal 1998, before capitalization and amortization, was primarily attributable to a decrease in subscriber acquisition costs. The Company was able to decrease its subscriber acquisition costs primarily as a result of the improved value proposition offered by flat-rate pricing, which has resulted in improved acquisition and retention rates, as compared to rates achieved prior to flat-rate pricing.

Product Development

Product development costs consist of personnel and related costs for research and development efforts and other product development costs either prior to the development effort reaching technological feasibility or once the product has reached the maintenance phase of its life cycle.

For fiscal 1999, product development costs increased from $239 million to $286 million, or 20%, over fiscal 1998, and decreased as a percentage of total revenues from 7.7% to 6.0%. The increase in product development costs was primarily due to an increase in the number of technical employees to support additional products across multiple brands. The decrease in product development costs as a percentage of total revenues was primarily a result of the substantial growth in revenues.

For fiscal 1998, product development costs increased from $195 million to $239 million, or 23%, over fiscal 1997, and decreased as a percentage of total revenues from 8.9% to 7.7%. The increase in product development costs was primarily due to an increase in personnel costs resulting from the Company's acquisitions of Actra Business Systems LLC ("Actra"), KIVA Software Corporation ("KIVA") and the online service of CompuServe (see Note 8 of the Notes to Consolidated Financial Statements). The decrease in product development costs as a percentage of total revenues was primarily a result of the substantial growth in revenues.

General and Administrative

For fiscal 1999, general and administrative expenses increased from $328 million to $408 million, or 24%, over fiscal 1998, and decreased as a percentage of total revenues from 10.6% to 8.5%. The increase in general and administrative costs for fiscal 1999, was primarily attributable to higher personnel costs, including payroll taxes associated with employee stock option exercises. The decrease in general and administrative costs as a percentage of total revenues was primarily attributable to the substantial growth in revenues.

For fiscal 1998, general and administrative expenses increased from $220 million to $328 million, or 49%, over fiscal 1997, and increased slightly as a percentage of total revenues from 10.0% to 10.6%. The increase in general and administrative costs for fiscal 1998, and such costs as a percentage of total revenues, was primarily attributable to higher personnel and related costs, which included compensatory stock options and other charges primarily related to the sale of ANS, as well as increases in professional fees, principally related to legal matters.

Amortization of Goodwill and Other Intangible Assets

Amortization of goodwill and other intangible assets increased to $65 million in fiscal 1999 from $24 million in fiscal 1998 and $6 million in fiscal 1997. The increase in amortization expense over the three years is primarily attributable to goodwill associated with the acquisitions of Mirabilis, Ltd. ("Mirabilis") in June 1998, CompuServe in January 1998, DigitalStyle Corporation

("DigitalStyle") and Portola Communications, Inc. ("Portola") in June 1997, and Actra in December 1997, as well as purchases of various companies made by the Company in late fiscal 1997 and early fiscal 1998. The increase is partially offset by a decrease in goodwill amortization resulting from the disposition of ANS in January 1998 and the shutdown of GNN in the Company's fiscal 1997 restructuring.

Acquired In-Process Research and Development

The Company incurred a total of $94 million in acquired in-process research and development charges in fiscal 1998 related to the acquisitions of Mirabilis, Actra, Personal Library Software, Inc. ("PLS") and NetChannel, Inc. ("NetChannel").

In June 1998, the Company acquired the assets, including the developmental ICQ instant communications and chat technology, and assumed certain liabilities of Mirabilis. The ICQ technology is an enabling technology for online communication. At the date of acquisition, Mirabilis reported 12 million registered trial users of which approximately half were active. The Company paid $287 million in cash and may pay up to $120 million in additional contingent purchase payments based on future performance levels. The Company's Consolidated Statements of Operations reflect a one-time write-off of the amount of purchase price allocated to in-process research and development of approximately $60 million.

The Company allocated the excess purchase price over the fair value of net tangible assets acquired to identified intangible assets. In performing this allocation, the Company considered, among other factors, the attrition rate of the active users of the technology at the date of acquisition (estimated to be similar to the rate experienced by the AOL service) and the research and development projects in-process at the date of acquisition. With regard to the in-process research and development projects, the Company considered, among other factors, the stage of development of each project at the time of acquisition, the importance of each project to the overall development plan, and the projected incremental cash flows from the projects when completed and any associated risks. Associated risks include the inherent difficulties and uncertainties in completing each project and thereby achieving technological feasibility and risks related to the impact of potential changes in future target markets.

During fiscal 1999, the Company incurred approximately $5 million, related primarily to salaries, to develop the in-process technology into commercially viable products and the Company intends to incur approximately $9 million more over the next year. Remaining development efforts are focused on addressing security issues, architecture stability and electronic commerce capabilities, and completion of these projects will be necessary before revenues are produced. The Company expects to begin to benefit from the purchased in-process research and development by its fiscal year 2000. If these projects are not successfully developed, the Company may not realize the value assigned to the in-process research and development projects. In addition, the value of the other acquired intangible assets may also become impaired.

The Company acquired Actra, a developer of commerce applications for conducting business-to-business and business-to-consumer commerce on the Internet in December 1997, PLS, a developer of information indexing and search technologies in January 1998 and NetChannel, a Web-enhanced television company, in June 1998. These transactions were accounted for under the purchase method of accounting. In connection with the purchase of Actra, the Company recorded a charge for acquired in-process research and development of $14 million. In connection with the purchases of PLS and NetChannel, the Company recorded charges for acquired in-process research and development in fiscal 1998 of $10 million related to each acquisition.

The Company incurred a total of $9 million ($5 million and $4 million, respectively) in acquired in-process research and development charges in fiscal 1997 related to the acquisitions of Portola and DigitalStyle in June 1997.

The technology, market and development risk factors discussed above for the Mirabilis acquisition are also relevant and should be considered with regard to the acquisitions of Actra, PLS, NetChannel, Portola and DigitalStyle.

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Merger, Restructuring and Contract Termination Charges

In fiscal 1999, the Company recognized charges that totaled $95 million related to restructurings and mergers.

- In connection with the mergers of MovieFone, Inc., Spinner Networks Incorporated, NullSoft, Inc. and AtWeb, Inc., the Company recorded direct merger-related costs of $17 million.
- In connection with plans announced and implemented in March 1999, the Company recorded a charge of $78 million for direct costs related to the merger with Netscape and the Company's reorganization plans to integrate Netscape's operations and build on the strengths of the Netscape brand and capabilities as well as the merger with When, Inc.

In fiscal 1998, the Company recognized net charges of $75 million related to restructurings and mergers.

- In connection with a restructuring plan adopted in the third quarter of fiscal 1998, the Company recorded a $35 million restructuring charge associated with the restructuring of its AOL Studios brand group. The restructuring included the exiting of certain business activities, the termination of approximately 160 employees and the shutdown of certain subsidiaries and facilities.
- At the end of the second and beginning of the third quarters of fiscal 1998, the Company recorded a $35 million restructuring charge related to the implementation of certain restructuring actions mainly related to the Enterprise Solution business. These actions were aimed at reducing its cost structure, improving its competitiveness and restoring sustainable profitability. The restructuring plan resulted from decreased demand for certain Enterprise products and the adoption of a new strategic direction. The restructuring included a reduction in the workforce (approximately 400 employees), the closure of certain facilities, the write-off of non-performing operating assets and third-party royalty payment obligations relating to canceled contracts.
- In the fiscal year ended 1998, the Company recognized merger costs of $6 million related to the acquisition of Kiva Software Corporation consisting mainly of investment banking, legal and accounting services.
- In connection with a restructuring plan adopted in the second quarter of fiscal 1997, the Company recorded a $49 million restructuring charge associated with the Company's change in business model, the reorganization of the Company into three operating units, the termination of approximately 300 employees and the shutdown of certain operating divisions and subsidiaries. As of the first quarter of fiscal 1998, substantially all of the restructuring activities had been completed and the Company reversed $1 million of the original restructuring accrual in the first quarter of fiscal 1998.

In fiscal 1997, the Company recognized net charges of $73 million related to restructurings and contract terminations.

- In connection with a restructuring plan adopted in the second quarter of fiscal 1997, the Company recorded a $49 million restructuring charge associated with the Company's change in business model, the reorganization of the Company into three operating units, the termination of approximately 300 employees and the shutdown of certain operating divisions and subsidiaries.

- In the fourth quarter of fiscal 1997, the Company recorded a contract termination charge of $24 million, which consists of unconditional payments associated with terminating certain information provider contracts, which became uneconomic as a result of the Company's introduction of flat-rate pricing in December 1996.

Refer to Notes 4 and 5 of the Notes to Consolidated Financial Statements for further information related to the restructurings, contract terminations and merger costs.

Settlement Charges

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In fiscal 1998, the Company recorded a net settlement charge of $18 million in connection with the settlement of the Orman v. America Online, Inc. class action lawsuit filed in U.S. District Court for the Eastern District of Virginia alleging violations of federal securities laws between August 1995 and October 1996. Included in the net settlement charge is an estimate of $17 million in insurance receipts.

In fiscal 1997, the Company recorded a settlement charge of $24 million in connection with a legal settlement reached with various State Attorneys General and a preliminary legal settlement reached with various class action plaintiffs, to resolve potential claims arising out of the Company's introduction of flat-rate pricing and its representation that it would provide unlimited access to subscribers. Pursuant to these settlements, the Company agreed to make payments to subscribers, according to their usage of the AOL service, who may have been injured by their reliance on the Company's claim of unlimited access. These payments do not represent refunds of online service revenues, but are rather the compromise and settlement of allegations that the Company's advertising of unlimited access under its flat-rate pricing plan violated consumer protection laws. In the second quarter of fiscal 1998, the Company revised its estimate of the total liability associated with these matters, and reversed $1 million of the original settlement accrual.

Other Income, net

Other income, net consists primarily of investment income and non-operating gains net of interest expense and non-operating charges. The Company had other income of $638 million and $30 million in fiscal 1999 and fiscal 1998, respectively. The increase in other income in fiscal 1999 was primarily attributable to a net gain of approximately $567 million on the sale of Excite, Inc. investments. The additional increase is mainly due to an increase in net interest income and a reduction of non-operating losses related to various investments. The Company had other income of $30 million and $10 million in fiscal 1998 and fiscal 1997, respectively. The increase in other income in fiscal 1998 was primarily attributable to gains on the sale of certain available-for-sale securities and increases in net interest income partially offset by decreases in the allocation of losses to minority stockholders and increases in non-operating losses related to various investments.

(Provision) Benefit for Income Taxes

The (provision) benefit for income taxes was $(334), $16 and $(10) million in fiscal 1999, fiscal 1998 and fiscal 1997, respectively. The substantial increase in the provision for income taxes in fiscal 1999 is a direct result of the Company's increase in pre-tax income. For additional information regarding income taxes, refer to Note 14 of the Notes to Consolidated Financial Statements.

Segment Results of Operations

The Company operates its two major lines of businesses as Interactive Online Services and Enterprise Solutions. For further information regarding segments, refer to Note 9 of the Notes to Consolidated Financial Statements.

A summary of the segment financial information is as follows:

	Years ended June 30,		
	1999	1998	1997
	(Amounts in millions)		
Revenues:			
Interactive Online Services	$4,321	$2,726	$1,786
Enterprise Solutions	456	365	411
Total revenues	$4,777	$3,091	$2,197

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Income (loss) from operations:			
Interactive Online Services (1).(2)..........	$ 955	$ 412	$ (257)
Enterprise Solutions. (2)....................	6	(18)	98
General & Administrative.....................	(408)	(328)	(220)
Other (3)....................................	(95)	(186)	(106)
Total income (loss) from operations.....	$ 458	$ (120)	$ (485)

(1) Loss from operations for the year ended June 1997 includes $385 million write-off of deferred subscriber acquisition costs.
(2) In fiscal 1999, Enterprise Solutions and Interactive Online services include $5 million and $60 million, respectively, of goodwill and other intangible assets amortization.
(3) Other consists of all special items; merger, restructuring, contract termination, acquired in-process research and development and settlement charges.

For an overview of the segment revenues, refer to the consolidated results of operations discussion earlier in this section.

Interactive Online Services income from operations increased from $128 million (excluding $385 million write-off of deferred subscriber acquisitions costs) in fiscal 1997 to $412 million in fiscal 1998 and $955 million in fiscal 1999. These increases are mainly the result of increases in subscription services and advertising, commerce and other revenues coupled with improved margins and a decrease in marketing expenses (as a percentage of revenues) resulting from the improved value proposition offered by flat-rate pricing.

Enterprise Solutions income (loss) from operations decreased from $98 million in fiscal 1997 to a loss of $(18) million in fiscal 1998 and increased to income of $6 million in fiscal 1999. The decrease from fiscal 1997 to 1998 was mainly a result of offering the Netscape Communicator client software (including the Netscape Navigator browser) for free starting in January 1998. The increase from fiscal 1998 to 1999 was mainly attributable to the increase in revenues.

Liquidity and Capital Resources

The Company is currently financing its operations primarily through cash generated from operations. During fiscal 1999, the Company generated more than $1 billion in cash from operations. In addition, the Company has generated cash from the sale of its capital stock, the sale of its convertible notes as well as the sale of marketable securities it held. The Company has financed its investments in telecommunications equipment principally through leasing. Net cash provided by operating activities was $1,099 million, $437 million and $131 million in fiscal 1999, 1998 and 1997, respectively, and increased primarily due to the Company's increase in net income. Net cash used in investing activities was $1,776 million; $531 million and $367 million in fiscal 1999, fiscal 1998 and fiscal 1997, respectively. The increase in cash used in investing activities is mainly due to the Company's $1.5 billion investment in a General Motors equity security related to the strategic alliance the Company entered with Hughes Electronics Corporation ("Hughes"). For additional information regarding this investment, refer to Note 8 of the Notes to the Consolidated Financial Statements. The increase in cash used in investing activities was offset by net proceeds of approximately $600 million related to the sale of Excite, Inc. investments during fiscal 1999. Net cash provided by financing activities was $887 million, $580 million and $250 million in fiscal 1999, fiscal 1998 and fiscal 1997, respectively. Included in financing activities for the fiscal 1999, were $550 million in aggregate net proceeds from a public stock offering of its common stock.

The Company uses its working capital to finance ongoing operations and to fund marketing and the development of its products and services. The Company plans to continue to invest in subscriber acquisition, retention and brand marketing to expand its subscriber base, as well as in network, computing and support infrastructure. Additionally, the Company expects to use a portion of its cash for the acquisition and subsequent funding of technologies, content,

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products or businesses complementary to the Company's current business. The Company anticipates that cash on hand and cash provided by operating activities will be sufficient to fund its operations for the next twelve months. The Company currently has approximately $450 million available under a shelf registration filed in June 1998. In May 1999, the Company filed a registration statement to raise an additional $4.5 billion by sale of the Company's debt securities, common stock, preferred stock depositary shares, warrants or stock purchase contracts to purchase common stock or preferred stock. The total offering price of these securities, in the aggregate, will not exceed $5 billion.

At June 30, 1999, the Company had working capital of $254 million, compared to working capital of $108 million at June 30, 1998. In addition, the Company had investments including available-for-sale securities of $2,151 million and $531 million at June 30, 1999 and 1998, respectively. Current assets increased by $716 million, from $1,263 million at June 30, 1998 to $1,979 million at June 30, 1999, while current liabilities increased by $570 million, from $1,155 million to $1,725 million, over this same period. The increase in current assets was primarily attributable to an increase in cash and short-term investments resulting from cash generated by operations. The change in current liabilities was due to increases in other accrued expenses and liabilities, primarily related to an increase in accrued telecommunications costs, as well an increase in deferred revenues.

During July 1998, the Company improved its cash and working capital balances as a result of a public offering of common stock. The Company sold 21,560,000 shares of common stock and raised a total of $550 million in new equity which was used to fund general corporate purposes. In November 1997, the Company sold $350 million of 4% Convertible Subordinated Notes due November 15, 2002 (the "Notes"). The Notes are convertible into the Company's common stock at a conversion rate of 76.63752 shares of common stock for each $1,000 principal amount of the Notes (equivalent to a conversion price of $13.04844 per share), subject to adjustment in certain events. Interest on the Notes is payable semiannually on May 15 and November 15 of each year, commencing on May 15, 1998. The Notes may be redeemed at the option of the Company on or after November 14, 2000, in whole or in part, at the redemption prices set forth in the Notes.

In June 1998, the Company purchased Mirabilis for $287 million in cash (and contingent purchase price payments of up to $120 million) and NetChannel for $16 million in cash. For additional information regarding these acquisitions, see Note 8 of the Notes to Consolidated Financial Statements.

In January 1998, the Company consummated a Purchase and Sale Agreement (the "Purchase and Sale") by and among the Company, ANS Communications, Inc. ("ANS"), a then wholly-owned subsidiary of the Company, and MCI WorldCom, Inc. ("WorldCom") pursuant to which the Company transferred to WorldCom all of the issued and outstanding capital stock of ANS in exchange for the online services business of CompuServe Corporation ("CompuServe"), which was acquired by WorldCom shortly before the consummation of the Purchase and Sale, and $147 million in cash (excluding $15 million in cash received as part of the CompuServe online services business and after purchase price adjustments made at closing). Immediately after the consummation of the Purchase and Sale, the Company's European partner, Bertelsmann AG, paid $75 million to the Company for a 50% interest in a newly created joint venture to operate the CompuServe European online service. Each company invested an additional $25 million in cash in this joint venture. The Company generated $207 million in net cash as a result of the aforementioned transactions.

The Company enters into multiple-year data communications agreements in order to support AOLnet. In connection with those agreements, the Company may commit to purchase certain minimum data communications services. Should the Company not require the delivery of such minimums, the Company's per hour data communications costs may increase. For additional information regarding the Company's commitments, see Note 11 of the Notes to Consolidated Financial Statements.

In May 1996, the Company entered into a joint venture with Mitsui & Co., ("Mitsui") and Nihon Keizai Shimbun, Inc. ("Nikkei") to offer interactive online services in Japan. In connection with the agreement, the Company received approximately $28 million through the sale of convertible preferred stock to

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Mitsui. The preferred stock had an aggregate liquidation preference of approximately $28 million and accrued dividends at a rate of 4% per annum. Accrued dividends could be paid in the form of additional shares of preferred stock. During May 1998, the preferred stock, together with accrued but unpaid dividends, was converted into 1,568,000 shares of common stock based on the fair market value of common stock at the time of conversion.

The Company leases the majority of its equipment under non-cancelable operating leases. It is building AOLnet, its data communications network, as well as expanding its data center capacity. The buildout of AOLnet and the expansion of data center capacity requires a substantial investment in telecommunications and server equipment. The Company plans to continue making significant investments in these areas. The Company is funding these investments, which are anticipated to total approximately $1 billion in fiscal 2000, through a combination of leases, debt financing and cash purchases.

Earning Before Interest, Taxes, Depreciation and Amortization ("EBITDA")

The following table and discussion summarizes EBITDA for the years ended June 30, 1999, 1998 and 1997:

	Years ended June 30,		
	1999	1998	1997
	(Amounts in millions)		
EBITDA...............................	$968	$302	$111

The Company defines EBITDA as net income plus: (1) provision/(benefit) for income taxes, (2) interest expense, (3) depreciation and amortization and (4) special charges. For the fiscal years ended June 30, 1997, EBITDA does not add back the amortization of subscriber acquisition costs. EBITDA is presented and discussed because the Company considers EBITDA an important indicator of the operational strength and performance of its business including the ability to provide cash flows to service debt and fund capital expenditures. EBITDA, however, should not be considered an alternative to operating or net income as an indicator of the performance of the Company, or as an alternative to cash flows from operating activities as a measure of liquidity, in each case determined in accordance with generally accepted accounting principles ("GAAP").

For fiscal 1999, EBITDA increased from $302 million to $968 million or 221% over fiscal 1998. For fiscal 1998, EBITDA increased from $111 million to $302 million or 172%. The increase from fiscal 1998 to 1999 is mainly due to the significant increase in income before taxes (excluding special charges) from $96 million in fiscal 1998 to $649 million in fiscal 1999, as well as an increase of approximately $100 million in depreciation and amortization. The increase from fiscal 1997 to 1998 is due to the increase in income before taxes (excluding special charges) from $16 million in fiscal 1997 to $96 million in fiscal 1998, as well as an increase of approximately $100 million in depreciation and amortization.

Seasonality

The growth in subscriber acquisitions and usage in the Company's online services appears to be highest in the second and third fiscal quarters, when sales of new computers and computer software are highest due to the holiday season and following the holiday season, when new computer and software owners are discovering Internet online services while spending more time indoors due to winter weather. However, the Company does not definitively know whether such increases in subscriber acquisitions and usage are primarily attributable to seasonal factors or to increased demand for Internet online services as a result of the growing market demand and utility for such services.

Since making advertising revenue a key component of the Company's strategy in its Interactive Online Services business, the Company has experienced difficulty in distinguishing seasonality in advertising sales from the overall market growth. Seasonal factors seem to be mitigated by advertisers' growing interest in the overall online medium, as well as gaining access to the Company's large and growing subscriber/user base across multiple branded distribution channels. When the online advertising industry matures and online advertising budgets experience normal growth, the Company expects to experience the effects of seasonality in securing advertising commitments.

Year 2000 Compliance

The Company utilizes a significant number of computer software programs and operating systems across its entire organization, including applications used in operating its online services and Web sites, the proprietary software of the AOL and CompuServe services, Netscape software products, member and customer services, network access, content providers, joint ventures and various administrative and billing functions. To the extent that these applications contain source codes that are unable to appropriately interpret the upcoming calendar year 2000, some level of modification, or even possibly replacement may be necessary.

In 1997, the Company appointed a Year 2000 Task Force to perform an audit to assess the scope of the Company's risks and bring its applications into compliance. This Task Force oversees testing and is continuing its assessment of the Company's company-wide compliance. The Company's system hardware components, client and host software, current versions of Netscape software products and corporate business and information systems are currently undergoing review and testing. To date, the Company has experienced few problems related to Year 2000 testing, and the problems that have been identified are in the process of being addressed.

The Company intends to make Year 2000 compliant certain versions of the client software for the AOL service and the CompuServe service that are available on the Windows and Macintosh operating systems, as well as versions of Netscape software products that are currently shipped. While the majority of AOL and CompuServe members use proprietary client software that will be compliant, a third-party Internet browser utilized in most versions of the client software may not be Year 2000 compliant. A free patch or upgrade will be required for members using some versions of the client software or browser to achieve Year 2000 compliance. In the coming months, the Company will encourage members of its online services to upgrade their browser and/or their software to versions that are expected to be Year 2000 compliant, if they have not already done so. The Company will make available to members, and communicate that availability, free patches or upgrades that can be downloaded from the online services. The Company has not tested, and does not expect to certify as Year 2000 compliant, certain older versions of the AOL and CompuServe software. The Company has developed, and will be implementing over the remainder of the year, a communication program that informs members how to obtain the free patch or upgrade to a Year 2000 compliant version of the client software or browser.

With respect to the Company's Netscape software business, testing continues on currently shipped products. The Company also will make available at no additional cost to customers any required patch to the versions of Netscape software products currently being shipped to customers and communicate their availability. In addition, the Company will be encouraging customers to upgrade to versions of the software that are expected to be Year 2000 compliant, if they have not already done so.

In addition, the Company is continuing to gather information from its vendors, joint venture partners and content partners about their progress in identifying and addressing problems that their computer systems may face in correctly processing date information related to the Year 2000. The Company intends to continue its efforts to seek reassurances regarding the Year 2000 compliance of vendors, joint venture partners and content partners. In the event any third parties cannot timely provide the Company with content, products, services or systems that meet the Year 2000 requirements, the content on the Company's services, access to the Company's services, the ability to offer products and services and the ability to process sales could be materially adversely affected.

The costs incurred through June 30, 1999 to address Year 2000 compliance were approximately $11 million. The Company currently estimates it will incur a total of approximately $20 million in costs to support its compliance initiatives. The Company cannot predict the outcome of its Year 2000 program, whether third party systems and component software are, or will be Year 2000 compliant, the costs required to address the Year 2000 issue, or whether a failure to achieve substantial Year 2000 compliance will have a material adverse effect on the Company's business, financial condition or results of operations. Failure to achieve Year 2000 compliance could result in some interruptions in the work of some employees, the inability of some members and customers to access the Company's online services and Web sites or errors and defects in the Netscape products. This, in turn, may result in the loss of subscription services revenue, advertising and commerce revenue or enterprise solution revenue, the inability to deliver minimum guaranteed levels of traffic, diversion of development resources, or increased service and warranty costs. Occurrence of any of these may also result in additional remedial costs and damage to reputation.

The Company has developed a contingency plan to address possible Year 2000 risks to its systems. The plan identifies a hierarchy of critical functions, acceptable delay times, recovery strategies to return functions to operational status and defines the core team for managing this recovery process. The Company will continue to modify this plan to address systems of its recent acquisitions.

Inflation

The Company believes that inflation has not had, and will not have in the future, a material effect on its results of operations.

Forward-Looking Statements

This report and other oral and written statements made by the Company to the public contain and incorporate by reference forward-looking statements within the meaning of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. The forward-looking statements are based on management's current expectations or beliefs and are subject to a number of factors and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. Such statements address the following subjects: future operating results; subscriber growth and retention; advertising, commerce and other revenues; earnings growth and expectations; development and success of multiple brands; new products and services (such as AOL 5.0, and the "You've Got Pictures," "My Calendar," AOL Search and AOL Plus features); corporate spending; liquidity; network capacity; new access and distribution technologies; regulatory developments, including the Company's ability to shape public policy in, for example, telecommunications, privacy and tax areas.

The following factors, among others, could cause actual results to differ materially from those described in the forward-looking statements:

The risk that the Company and its data communications access providers will be unable to provide adequate server and network capacity. Risks associated with the fixed costs and minimum commitment nature of a substantial majority of the Company's network services, such that a significant decrease in demand for online services would not result in a corresponding decrease in network costs. Risks related to the build-out of AOLnet and the expansion of server and network capacity; the risk that demand will not develop for the capacity created; the risk that supply shortages for hardware and equipment and for local exchange carrier lines from local telephone companies could impede the provision of adequate network and system capacity; and the risk of the failure to obtain the necessary financing.

Any damage or failure to the Company's computer equipment and the information stored in its data centers.

Factors related to increased competition, including: price reductions and increased spending; inability to generate greater revenues and profits from advertising and electronic commerce; limitations on the Company's opportunities to enter into or renew agreements with content providers and distribution partners; limitations on the Company's ability to develop new products and services; limitations on the Company's ability to continue to grow or sustain its subscriber base; loss of the Company's market share in the enterprise software industry; and an adverse impact on gross and operating margins.

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The failure to increase revenues at a rate sufficient to offset the increase in data communications and equipment costs resulting from increasing usage.

The risk of loss of services of executive officers and other key employees.

The risk that because of seasonal and other factors, the Company is unable to predict growth in sales, usage, subscriber acquisitions and advertising commitments.

The failure of the Company to establish new relationships with electronic commerce, advertising, marketing, technology and content providers or the loss of a number of relationships with such providers or the risk of significantly increased costs or decreased revenues needed, to maintain, or resulting from the failure to maintain, such relationships, as the case may be.

The risk associated with accepting warrants in lieu of cash in certain electronic commerce agreements, as the value of such warrants is dependent upon the common stock price of the warrant issuer at the time the warrants are earned.

The risks related to the acquisition of businesses, including the failure to successfully integrate and manage acquired technology, operations and personnel, the loss of key employees of the acquired companies and diversion of the Company's management's attention from other ongoing business concerns; and the risk of significant charges for in-process research and development or other matters.

The inability of the Company to introduce new products and services; and its inability to develop, or achieve commercial acceptance for, these new products and services. The failure to resolve issues concerning commercial activities via the Internet, including security, reliability, cost, ease of use and access. The risk of adverse changes in the U.S. regulatory environment surrounding interactive services.

The failure of the Company or its partners to successfully market, sell and deliver its services in international markets; and risks inherent in doing business on an international level, such as laws that differ greatly from those in the United States, unexpected changes in regulatory requirements, political risks, export restrictions and controls, tariffs and other trade barriers and fluctuations in currency exchange rates.

The Company's inability to offer its services through advanced distribution technologies such as cable and broadcast, and the resulting inability to offer advanced services such as voice and full motion video. The Company's inability to develop new technology or modify its existing technology to keep pace with technological advances and the pursuit of these technological advances requiring substantial expenditures.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The Company is exposed to immaterial levels of market risks, including changes in foreign currency exchange rates and interest rates. Market risk is the potential loss arising from adverse changes in market rates and prices, such as foreign currency exchange and interest rates. The Company does not enter into derivatives or other financial instruments for trading or speculative purposes. The Company only enters into financial instruments to manage and reduce the impact of changes in foreign currency exchange rates. In June 1998, the Company initiated hedging activities to mitigate the impact on intercompany balances of changes in foreign exchange rates. The Company is using foreign currency forward exchange contracts as a vehicle for hedging these intercompany balances. A foreign currency forward exchange contract obligates the Company to exchange predetermined amounts of specified foreign currencies at specified exchange rates on specified dates and to make or receive an equivalent U.S. dollar payment equal to the value of such exchange. For these contracts that are designated and effective as hedges, realized and unrealized gains and losses resulting from changes in the spot exchange rate (including those from open, matured and terminated contracts) are included in other income and net discounts or premiums (the difference between the spot exchange rate and the forward exchange rate at inception of the contract) are also accreted or amortized to other income, over the life of each contract, using the straight-line method. These gains and losses offset gains and losses on intercompany balances, which are also included in other income. The related amounts due to or from counterparties are included in other assets or other liabilities. In general, these foreign currency forward exchange contracts mature in three months or less. The estimated fair value of the contracts are immaterial due to their short-term nature.

Item 8. Financial Statements and Supplementary Data

Reference is made to the financial statements listed under the heading "(a) (1) Consolidated Financial Statements" of Item 14 hereof, which financial statements are incorporated herein by reference in response to this Item 8.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

PART III

Item 10. Directors and Executive Officers of the Registrant

The response to this item is incorporated by reference from the Sections titled "Management" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Registrant's Proxy Statement for its 1999 Annual Meeting of Stockholders.

Item 11. Executive Compensation

The response to this item is incorporated by reference from the Section titled "Executive Compensation," but not from the Sections titled "Executive Compensation--Performance Graph" and "Executive Compensation--Report on Executive Compensation by the Compensation and Management Development Committee of the Board of Directors," in the Registrant's Proxy Statement for its 1999 Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The response to this item is incorporated by reference from the Section titled "Share Ownership" in the Registrant's Proxy Statement for its 1999 Annual Meeting of Stockholders.

Item 13. Certain Relationships and Related Transactions

The response to this item is incorporated by reference from the Section titled "Certain Relationships and Related Transactions" in the Registrant's Proxy Statement for its 1999 Annual Meeting of Stockholders.

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a)(1) Consolidated Financial Statements

The following consolidated financial statements of America Online, Inc. and the Report of Independent Auditors thereon are included in Item 8 above: