In the Matter of

James W. Barge,
Pascal Desroches, and
Wayne H. Pace,
Respondents.

ORDER INSTITUTING PUBLIC
CEASE-AND-DESIST
PROCEEDINGS, MAKING
FINDINGS, AND IMPOSING A
CEASE-AND-DESIST ORDER
PURSUANT TO SECTION 21C OF
THE SECURITIES EXCHANGE ACT
OF 1934

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against James W. Barge, Pascal Desroches, and Wayne H. Pace (collectively, “Respondents”).

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the “Offers”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Public Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.
III.

On the basis of this Order and Respondents’ Offers, the Commission finds the following:

A. Summary

This matter involves Respondents’ roles in the accounting treatment accorded to improperly recognized revenue by Time Warner Inc. (formerly AOL Time Warner Inc., and hereinafter referred to as “AOLTW” or the “Company”), a publicly traded media and entertainment company. In 2001 and 2002, the AOL Division (“AOLD”) of AOLTW improperly inflated its online advertising revenue by $400 million in connection with transactions with Bertelsmann AG (“BAG”). In substance, BAG paid $400 million as consideration for amendments to a multi-billion-dollar contract governing AOLTW’s purchase of BAG’s interest in AOL Europe, S.A. The contract amendments had substantial value, and BAG offered to compensate AOLTW for the amendments. AOLTW proposed that, in exchange for the two amendments, BAG purchase advertising in the aggregate amount of $400 million. AOLD then improperly and materially inflated its online advertising revenues by recognizing the $400 million as advertising revenue rather than as consideration received for amending the AOL Europe purchase agreement. AOLD’s financial results were consolidated in AOLTW’s financial statements, and the $400 million payment was improperly reflected as online advertising revenue in AOLTW’s financial statements that were filed with the Commission.

Respondents were corporate-level finance and accounting executives at AOLTW who were responsible for, among other things, reviewing and approving the accounting treatment recommended by the Company’s business units, including AOLD. Respondents approved AOLTW’s accounting for the $400 million as advertising revenue. In doing so, they based their accounting decisions on the form of the transactions and oral and written representations, some of which were false and omitted material facts, by other AOLTW and AOLD employees. They failed to pursue facts and circumstances that evidenced the true economic substance of the transactions. As a result, although others were responsible for negotiating the $400 million transactions, Respondents each were a cause of AOLTW’s improperly accounting for the $400 million in annual and periodic reports filed with the Commission.

B. Respondents

James W. Barge, age 49, served as Vice President and Controller of AOLTW from January 2001 to September 2001, and he served as Vice President in charge of AOLTW’s Financial Planning and Analysis from September 2001 through December 2001. Since January 2002, Barge assumed both the Controller and Financial Planning and Analysis

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1 These findings are made pursuant to Respondents’ Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.
responsibilities, and Barge was promoted to Senior Vice President and Controller. Prior to the merger of America Online, Inc. (“AOL”) and Time Warner Inc. in January 2001, Barge was Vice President and Controller of Time Warner. Barge formerly was an audit partner with Ernst & Young LLP and a Professional Accounting Fellow with the Commission’s Office of the Chief Accountant. Barge is a certified public accountant (“CPA”).

Pascal Desroches, age 40, joined AOLTW in 2001 as Assistant Controller and has served as Vice President and Deputy Controller of AOLTW since May 2002. Desroches formerly was a partner with KPMG LLP and a Professional Accounting Fellow with the Commission’s Office of the Chief Accountant. Desroches is a CPA.

Wayne H. Pace, age 58, has served as Chief Financial Officer (“CFO”) of AOLTW since November 2001. Prior to assuming that position, Pace had served as CFO of Turner Broadcasting Systems, Inc., an AOLTW subsidiary, since 1993. Pace formerly was an audit partner with Price Waterhouse LLP. Pace was a CPA, but he allowed his license to lapse in 1995.

C. Relevant Entities

Time Warner Inc., the corporate parent of AOLD, is a media and entertainment company. Time Warner is incorporated in Delaware and headquartered in New York, New York. Time Warner’s common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the New York Stock Exchange. Time Warner files annual and quarterly reports with the Commission on Forms 10-K and 10-Q. Time Warner was formed by the merger of AOL and Time Warner on January 11, 2001. The merged company was named AOL Time Warner Inc. It changed its name to Time Warner Inc. on October 16, 2003.

AOLD is an Internet service provider. AOLD provides its subscribers with access to the Internet, e-mail accounts, and content. AOLD’s headquarters are located in Dulles, Virginia.

Bertelsmann AG is a media and entertainment company. BAG is incorporated in Germany and headquartered in Guetersloh, Germany.

D. The Bertelsmann Advertising Contracts

AOL’s Purchase of BAG’s Interest in AOL Europe

AOL and BAG formed a joint venture in 1995 that created AOL Europe, which owns and operates European Internet services (including AOL UK and AOL Germany). In March 2000, AOL and BAG entered into a contingent purchase agreement concerning AOL’s acquisition of BAG’s interest in AOL Europe. The contingent agreement was structured as a put/call option (the “Put/Call Agreement”). Under the Put/Call Agreement, BAG could exercise an option to “put” its AOL Europe shares to AOL by selling them to AOL for $6.75 billion; if BAG did not exercise its option, AOL could “call” BAG’s AOL
Europe shares by purchasing BAG’s shares for $8.25 billion. BAG’s Put rights under the Put/Call Agreement had two settlement dates: January 2002 for 80% of BAG’s AOL Europe shares, and July 2002 for the remaining 20% of BAG’s AOL Europe shares. Following the merger of AOL and Time Warner, AOLTW became AOL’s successor in interest under the contract. The Put/Call Agreement provided AOLTW the option to pay in cash or stock. AOLTW retained the further option to settle in cash or stock for 12 days after the price of AOLTW stock was fixed for settlement (the “free-look period”). If AOLTW’s stock price at the end of the free-look period was below the price fixed for settlement under the Put/Call, AOLTW could deliver stock worth less than the Put/Call Agreement price.

At the same time in March 2000, BAG and AOL executed an online advertising agreement committing BAG to purchase $150 million in online ads from AOL over four years (the “Premier Ad Deal”). The Premier Ad Deal provided BAG “premier status,” entitling it to valuable advertising placement and exclusivity rights and “preferred” pricing, defined as rates and terms no worse, when taken as a whole, than those generally offered by AOL to third parties for similar programs. By December 2000, the parties agreed that BAG was entitled to an across-the-board 40% discount to AOL’s list price under the preferred pricing provision. Under the Premier Ad Deal, BAG negotiated the content, placement, and timing of the advertising.

$125 Million Put/Call Amendment Deal

Shortly after entering into the Put/Call Agreement, BAG attempted to realize some or all of the $6.75 billion it would be due when it exercised its Put rights, which according to the contract could not be settled until 2002. In the fall of 2000, BAG tried to sell its interest in the Put/Call Agreement to an investment banking firm. However, the investment bankers were unwilling to purchase BAG’s interest because of the uncertainty inherent in its terms. Specifically, the free-look period put BAG at risk of receiving AOL stock worth substantially less than $6.75 billion, and AOL’s option to pay with stock, rather than cash, created material, and potentially costly, obstacles to the ability of a purchaser of BAG’s interest to realize the value of the stock. As a result of the uncertainty arising from these circumstances, BAG could not monetize, or realize value from, its rights under the Put/Call prior to settlement. The most effective way to reduce the uncertainty was to obtain AOLTW’s agreement to pay the Put price in cash rather than stock.

In January 2001, BAG proposed to amend the Put/Call Agreement to require AOLTW to pay some or all of the $6.75 billion in cash to enable BAG to monetize its interest. BAG offered to compensate AOLTW with cash, a reduction in the Put/Call Agreement price, or other means. AOLTW proposed that the consideration take the form of BAG’s purchasing online advertising. Respondents did not participate in these discussions and relied on others to describe them accurately. While Barge and Desroches were not directly involved in the process, they learned of the proposed amendment shortly before it was executed, and they were involved, to varying degrees, in approving the manner in which AOLTW accounted for the transaction.
From January through March 2001, AOLTW and BAG negotiated the terms of the Put/Call amendment. Almost all of the negotiations focused on the value and structure of the Put/Call amendment. There were few, if any, negotiations concerning terms of the advertising deal, other than the overall price, which was determined by the negotiated value of the Put/Call amendment. During negotiations, AOLTW and BAG consulted with finance experts and investment bankers concerning the value of various Put/Call Amendments, which included the value of the free-look period and the value of avoiding a block sale discount for large blocks of stock. Values asserted by AOLTW during negotiations with BAG ranged from $200 million to $412 million.

On March 30, 2001, AOLTW and BAG amended the Put/Call Agreement to require AOLTW to pay at least $2.5 billion in cash if BAG exercised its $6.75 billion Put (the “First Put/Call Amendment”). As consideration for the First Put/Call Amendment, BAG agreed to pay AOLTW $125 million in the form of an advertising purchase (the “March ’01 Deal”). Internal AOLTW documents stated that BAG agreed to enter into the advertising transaction “as compensation for” or “in exchange for” the amendment to the Put/Call.

The March ’01 Deal provided online advertising that was qualitatively different from the online advertising provided under the Premier Ad Deal. Among other things, the March ’01 Deal stripped BAG of the preferred pricing and special rights that it enjoyed under the Premier Ad Deal, and it essentially eliminated BAG’s ability to control the content, placement, and frequency of the advertising delivered pursuant to the March ’01 Deal. Unknown to the Respondents at the time they initially approved the accounting treatment, BAG had no need to enter into the $125 million advertising agreement.

AOLTW decided each quarter how much online advertising to run under the March ’01 Deal by determining the amount of online ad revenues it needed during the period to reach its targets. Often, the advertising for BAG ran late in the reporting period, after AOL had determined the amounts by which it could not otherwise attain its revenue goals. BAG generally signed the advertising purchase orders after AOLTW had already run the advertising. Negotiations, to the extent they occurred, concerned mostly the allocation of the ads among BAG’s various subsidiaries and not the placement or frequency of the ads.\(^2\) AOLTW ran the advertising and recorded almost the entire $125 million in online advertising revenue from the March ’01 Deal in the first three quarters of 2001.

\(^2\) Unknown to Respondents at the time they initially approved the accounting treatment, AOLD knew that BAG did not need or value the online advertising. An AOLD internal summary of the March ’01 Deal described the online advertising as “pure gravy” and a “freebie,” explaining “these plans are not to be negotiated.” A later AOLD internal memorandum described the March ’01 Deal as an “aggressive revenue recognition plan” under which “AOL policy has been focused on maximum revenue recognition without regard to the quality of the carriage or input from the BAG Brands on either participation or carriage.”
$275 Million Put/Call Amendment Deal

In September 2001, BAG asked AOLTW to commit to pay in cash the remaining $4.25 billion under the Put/Call, although doing so reduced AOLTW’s financial flexibility and represented a significant opportunity cost to the Company. AOLTW again accounted for a payment from BAG for a Put/Call amendment as if it were a purchase of advertising.

From late November through mid-December 2001, AOLTW and BAG negotiated the second amendment to the Put/Call. Virtually all of the negotiations concerned the value and structure of the proposed Put/Call amendment. There were few, if any, negotiations concerning terms of the advertising deal, other than the overall price, which was determined by the negotiated value of the Put/Call amendment. Throughout negotiations, AOLTW and BAG consulted with finance experts and investment bankers concerning the value of a second Put/Call amendment. During negotiations, AOLTW asserted that the value of the amendment ranged from $250 million to $420 million. Respondents did not participate in these discussions and relied on others to describe them accurately. While Respondents were not directly involved in the process, they knew of the proposed transaction, and they were involved, to varying degrees, in approving the manner in which AOLTW accounted for the transaction.

On December 21, 2001, AOLTW and BAG amended the Put/Call Agreement to require AOLTW to pay the remaining $4.25 billion Put amount in cash (the “Second Put/Call Amendment”). As consideration for the Second Put/Call Amendment, BAG agreed to pay AOLTW $275 million in the form of an advertising purchase (the “December ’01 Deal”). Internal AOLTW e-mails stated that BAG agreed to enter into the advertising transaction in “exchange for” the amendments to the Put/Call.

Like the March ’01 Deal, the December ’01 Deal stripped BAG of the preferred pricing and special rights that it enjoyed under the Premier Ad Deal, and it essentially eliminated BAG’s ability to control the content, placement, and frequency of the advertising delivered. Unknown to Respondents at the time, BAG had no need for additional online advertising. AOLTW administered the December ’01 Deal substantially the same as it did the March ’01 Deal. AOLTW ran the advertising and booked almost the entire $275 million in online advertising from the December ’01 Deal in 2002.

E. Respondents were Each a Cause of AOLTW’s Improperly Recognizing Revenue on the Bertelsmann Transactions and Filing Inaccurate Reports with the Commission

A fundamental tenet of generally accepted accounting principles (“GAAP”) is that the accounting for a transaction should reflect its economic substance, and the form of a transaction is not necessarily controlling. For example, revenue should not be recorded in a round-trip transaction in which the essence of the transaction is merely a circular flow of cash and the customer does not need the goods or services provided, would not normally purchase the goods or services at that time, or purchases quantities in excess of its needs. For those charged with preparing financial statements, an important and
fundamental responsibility is to ensure that companies account for transactions based on their economic substance. In some cases, this requires looking beyond the terms of the agreements and even beyond assurances from company employees, whose compensation may be affected by the accounting decisions.

The economic substance of the exchanges between AOLD and BAG was that BAG paid $400 million for amendments to the Put/Call. AOLD ignored the substance of these transactions and improperly recognized $400 million of online advertising revenue on these transactions in 2001 and 2002. This caused material overstatements of AOLTW’s reported online advertising and commerce revenues, consolidated operating income, and consolidated net income for each reporting period from the quarter ended June 30, 2001 through the year ended December 31, 2002. Specifically, AOLTW improperly recognized the following amounts: $16.3 million in the first quarter of 2001, $65.5 million in the second quarter of 2001, $39.8 million in the third quarter of 2001, $80.3 million in the first quarter of 2002, $84.4 million in the second quarter of 2002, $51.6 million in the third quarter of 2002, and $58.0 million in the fourth quarter of 2002.

Respondents were charged with ensuring that AOLTW filed accurate financial statements presented in conformity with GAAP. They recognized the possibility that BAG’s payments to AOLD were not advertising revenues, but rather compensation for amendments to the Put/Call. They consulted with executives of AOLD and AOLTW, including those who negotiated the deals, concerning the nature and terms of the transactions and were provided false and incomplete information. They were not told that BAG had offered cash or to reduce the purchase price for AOL Europe in exchange for the amendments, and they did not know how the advertising programs were administered. They requested, and were assured, that the advertising to be provided to BAG would be priced at fair value. However, they were aware of facts and circumstances that called those representations into question. They knew the following:

- BAG purchased advertising under the March and December ’01 Deals in exchange for the First and Second Put/Call Amendments.

- The Put/Call Amendments had significant value to BAG because they provided cash certainty that would be costly to acquire in the marketplace, and cash certainty was important to BAG’s effort to monetize or otherwise borrow against the underlying value of their Put.

- AOLTW’s agreement to pay in cash rather than stock reduced the Company’s flexibility and represented a significant opportunity cost.

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3 Desroches, with the concurrence of the other Respondents, also consulted with the Company’s auditors concerning their proposed accounting treatment for the December ’01 deal and received the auditors’ approval. However, at the time of the consultation, the Respondents had not performed an inquiry sufficient to determine the nature of the transaction.
• The proposed accounting treatment assigned no value to the Put/Call Amendments and recognized $400 million of advertising revenue.

• Advertising revenue was important to AOLD because of its high profit margin and because analysts and investors considered advertising revenue a key measure of AOLD’s current and future financial performance.

• The March and December ’01 Deals represented two of the largest purchases of online ads in AOL’s history.

In addition, at least Desroches received documents indicating that the $400 million March and December ’01 Deals granted substantially less favorable terms to BAG than the $150 million Premier Ad Deal, and the March and December ’01 Deals deprived BAG of any contractual means to manage or control the advertising it received.

Nevertheless, Barge and Desroches did not review the terms of the final agreements for the March and December ’01 Deals before approving the accounting for the transactions. Likewise, Pace did not review the terms of the agreement for the December ’01 Deal before approving the accounting treatment. Further, neither Barge nor Desroches reviewed the negotiating history of the Put/Call Amendments or the March and December ’01 Deals before approving the accounting treatment. Similarly, Pace did not review the negotiating history of the Second Put/Call Amendment or the December ’01 Deal before approving the accounting treatment for the $275 million.


In light of matters discussed above and the magnitude of these transactions and their impact on AOLD’s and AOLTW’s financial results, the Respondents should have obtained more information concerning the transactions and should have looked beyond the assurances of employees whose compensation may have been affected by the accounting decisions. Because they failed to obtain more information before they approved the accounting, Respondents lacked a reasonable basis for their accounting conclusion. Thus, each of them was a cause of AOLTW’s improper accounting for, and reporting of, the BAG revenue.

F. Legal Conclusions

The Exchange Act and Exchange Act rules require every issuer of registered securities to file reports with the Commission that accurately reflect the issuer’s financial performance and provide other true and accurate information to the public.
As a result of the conduct described above, AOLTW violated Section 13(a) of the Exchange Act and Exchange Act Rules 13a-1 and 13a-13 by filing materially misleading annual and quarterly reports with the Commission.

Based on the foregoing, Barge, Desroches, and Pace caused AOLTW's violations of Section 13(a) of the Exchange Act and Exchange Act Rules 13a-1 and 13a-13.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents’ Offers.

Accordingly, it is hereby ORDERED that:

Respondents James W. Barge, Pascal Desroches, and Wayne H. Pace cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act and Exchange Act Rules 13a-1 and 13a-13.

By the Commission.

Jonathan G. Katz
Secretary