

TALK AMERICA HOLDINGS INC  
Form 10-K/A  
May 07, 2004

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

FORM 10-K/A  
(AMENDMENT NO. 1)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2003  
Commission File No. 000-26728

TALK AMERICA HOLDINGS, INC.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

23-2827736  
(I.R.S. Employer  
Identification Number)

12020 Sunrise Valley Drive, Suite 250  
Reston, Virginia  
(Address of principal executive offices)

20191  
(zip code)

(703) 391-7500  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
None	Not applicable

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, Par Value \$.01 Per Share  
Rights to Purchase Series A Junior Participating Preferred Stock  
(Title of class)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment of this Form 10-K. [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

As of June 30, 2003, the aggregate market value of the voting stock held by non-affiliates of the registrant, based on the average of the high and low prices of the common stock on June 30, 2003 of \$10.79 per share as reported on the Nasdaq National Market, was approximately \$280,519,337.15 (calculated by excluding solely for purposes of this form outstanding shares owned by directors and executive officers).

As of March 9, 2004, the registrant had issued and outstanding 26,670,050 shares of common stock, par value \$.01 per share.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2004 Annual Meeting of Stockholders. Part III

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#### Explanatory Note

Talk America Holdings, Inc. is filing this Amendment No. 1 on Form 10-K/A ( Amendment No. 1 ) to our Annual Report on Form 10-K originally filed with the Securities and Exchange Commission on March 12, 2004 (the Original Form 10-K ), solely for the purpose of reflecting the reclassification of \$15 million principal amount of our 12% Senior Subordinated Notes reported in the Original Form 10-K from long-term debt to current portion of long-term debt based on our November 5, 2003 notice and commitment to redeem \$15 million principal amount of these 12% Senior Subordinated Notes on January 5, 2004. This reclassification affects discussions in the following items of the Original Form 10-K: Item 6 ( Consolidated Balance Sheet Data amounts for 2003 of Current portion of long-term debt and Long-term debt ), Item 7 (references in the first two paragraphs, including in the maturities table in the second paragraph, of LIQUIDITY AND CAPITAL RESOURCES to long-term debt and to the maturities of our 12% Senior Subordinated Notes) and Item 8 (amounts of Current portion of long-term debt, Total current liabilities and Long-term debt in the December 31, 2003 Consolidated Balance Sheet, and corresponding references in Notes 5 and 16 of the Notes to Consolidated Financial Statements ). Unless otherwise expressly stated, this Amendment No. 1 does not reflect events occurring after the filing of the Original Form 10-K, nor does it modify or update in any way disclosures contained in the Original Form 10-K other than to reflect the reclassification discussed above.

## ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data should be read in conjunction with, and are qualified in their entirety by, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our Consolidated Financial Statements included elsewhere in this Form 10-K.

	Year Ended December 31,				
	2003	2002	2001	2000	1999
(In Thousands, Except For Per Share Amounts)					
Consolidated Statements of Operations Data:					
Revenue	\$ 382,663	\$ 317,507	\$ 488,158	\$ 525,712	\$ 516,548
Costs and expenses:					
Network and line costs	181,682	155,567	235,153	292,931	289,029
General and administrative expenses	57,503	53,510	82,202	65,360	39,954
Provision for doubtful accounts	11,599	9,365	92,778	53,772	28,250
Sales and marketing expenses	48,277	27,148	73,973	152,028	96,264
Depreciation and amortization	18,344	17,318	34,390	19,257	6,214
Impairment and restructuring charges	--	--	170,571	--	--
Significant other charges (income)	--	--	--	--	(2,718)
Total costs and expenses	317,405	262,908	689,067	583,348	456,993
Operating income (loss)	65,258	54,599	(200,909)	(57,636)	59,555
Other income (expense):					
Interest income	388	802	1,220	4,859	3,875
Interest expense	(7,353)	(9,087)	(6,091)	(5,297)	(4,616)
Other income (expense), net	2,470	28,448	17,950	(3,822)	20,115
Income (loss) before provision for income taxes	60,763	74,762	(187,830)	(61,896)	78,929
Provision (benefit) for income taxes	(17,698)	(22,300)	--	--	--
Income (loss) before cumulative effect of an accounting change	78,461	97,062	(187,830)	(61,896)	78,929
Cumulative effect of an accounting change	--	--	(36,837)	--	--
Net income (loss)	\$ 78,461	\$ 97,062	\$ (224,667)	\$ (61,896)	\$ 78,929
Income (loss) per share Basic:	\$ 2.97	\$ 3.56	\$ (7.11)	\$ (2.63)	\$ 3.87

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Income (loss) before cumulative effect of an accounting change per share					
Cumulative effect of an accounting change per share	--	--	(1.40)	--	--
Net income (loss) per share	\$ 2.97	\$ 3.56	\$ (8.51)	\$ (2.63)	\$ 3.87
Weighted average common shares outstanding	26,376	27,253	26,414	23,509	20,395
Income (loss) per share Diluted:					
Income (loss) before cumulative effect of an accounting change per share	\$ 2.75	\$ 3.15	\$ (7.11)	\$ (2.63)	\$ 3.68
Cumulative effect of an accounting change per share	--	--	(1.40)	--	--
Net income (loss) per share	\$ 2.75	\$ 3.15	\$ (8.51)	\$ (2.63)	\$ 3.68
Weighted average common and common equivalent shares outstanding	28,514	30,798	26,414	23,509	21,471

At December 31,

	2003 (1) (as restated)	2002	2001	2000	1999
(In Thousands)					
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 35,242	\$ 33,588	\$ 22,100	\$ 40,604	\$ 78,937
Total current assets	105,595	82,825	51,214	97,203	150,893
Goodwill and intangibles, net	24,169	26,882	29,672	218,639	1,068
Total assets	245,923	189,075	165,737	407,749	215,008
Current portion of long-term debt	16,806	61	14,454	2,822	--
Total current liabilities	94,441	64,754	87,789	100,271	71,168
Contingent obligations	--	--	--	114,630	114,630
Long-term debt	31,791	100,855	152,370	103,695	84,985
Stockholders' equity (deficit)	99,787	23,466	(74,422)	82,700	(69,375)

(1) The Selected Consolidated Financial Data for 2003 has been restated for matters related to a change in classification of long-term debt to current portion of long-term debt. See Note 16 to the Consolidated Financial Statements.

See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of items affecting the results of 2001, 2002 and 2003.

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## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Consolidated Financial Statements included elsewhere in this Form 10-K.

### Cautionary Note Concerning Forward-Looking Statements

Certain of the statements contained in this Form 10-K Report may be considered "forward-looking statements" for purposes of the securities laws. From time to time, oral or written forward-looking statements may also be included in other materials released to the public. These forward-looking statements are intended to provide our management's current expectations or plans for our future operating and financial performance, based on our current expectations and assumptions currently believed to be valid. For these statements, we claim protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. These forward-looking statements can be identified by the use of forward-looking words or phrases, including, but not limited to, "believes," "estimates," "expects," "expected," "anticipates," "anticipated," "plans," "strategy," "target," "prospects" and other words of similar meaning in connection with a discussion of future operating or financial performance. Although we believe that the expectations reflected in such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to have been correct.

All forward-looking statements involve risks and uncertainties that may cause our actual results to differ materially from those expressed or implied in the forward-looking statements. This Form 10-K Report includes important information as to risk factors in the "Business" section under the headings "Business Operations," "Competition" and "Regulation" and in "Management's Discussion and Analysis of Financial Condition and Results of Operations." In addition to those factors discussed in this Form 10-K Report, you should see our other reports on Forms 10-K, 10-Q and 8-K filed with the Securities and Exchange Commission from time to time for information identifying factors that may cause actual results to differ materially from those expressed or implied in the forward-looking statements.

### OVERVIEW

Talk America Holdings, Inc., through its subsidiaries, offers a bundle of local and long distance phone services to residential and small business customers in the United States. Our business strategy is to build a large, profitable base of bundled phone service customers using the wholesale operating platforms of the incumbent local exchange companies and then to migrate customers to our own networking platform and further increase our revenues and profitability by offering new products and services to these customers. We refer to this strategy as our "customer first" strategy.

In 2000, we decided to expand beyond our historical long distance service offerings and utilize the unbundled network element platform to enter the large local telecommunications market and diversify our product portfolio through the bundling of local service with our core long distance service offerings. We encountered a number of operational and business difficulties during the rollout of our bundled service offering in 2000 and worked to address the operational issues that we encountered. We focused on improving the overall efficiency of the bundled business model in 2001.

During 2002, our top operating priorities were to lower bad debt expense, reduce customer turnover, or "churn," and lower our customer acquisition costs. During 2003, our primary focus was increasing sales of our bundled services within the targets established by management for acquisition costs, customer turnover and bad debt expense. We ended 2003 with 557,000 billed bundled lines. We expect our existing base of long distance customers to continue to decline in 2004 through attrition due to our decision to focus our marketing efforts on the sale of our bundled product.

An integral element of our business strategy is our development of our own local networking capacity. This development, if successful, will enhance our operating flexibility and provide us with an alternative to the wholesale operating platforms of the incumbent local exchange companies. As the first step in enabling us to implement this stage of our business strategy, during 2003, we deployed networking assets in Michigan and have begun to carry test calls over our own switching platform. We are in the process of automating the business processes required to provide local network-based services and to support the proposed deployment of our own local network. Our objective is to develop a viable networking opportunity as an alternative to the wholesale operating platforms of the incumbent local exchange companies to provide us with operating flexibility. In addition, we will add new services and enhance our existing service and product offerings, as available, to increase our revenues and profitability from our customers.

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## RESULTS OF OPERATIONS

The following table sets forth for the periods indicated certain of our financial data as a percentage of revenue:

	Year Ended December 31,		
	2003	2002	2001
Revenue	100.0%	100.0%	100.0%
Costs and expenses:			
Network and line costs	47.5	49.0	48.2
General and administrative expenses	15.0	16.8	16.8
Provision for doubtful accounts	3.0	2.9	19.0
Sales and marketing expenses	12.6	8.6	15.2
Depreciation and amortization	4.8	5.5	7.0
Impairment and restructuring charges	--	--	35.0
Total costs and expenses	82.9	82.8	141.2
Operating income	17.1	17.2	(41.2)
Other income (expense):			
Interest income	0.1	0.3	0.3
Interest expense	(1.9)	(2.9)	(1.2)
Other, net	0.6	9.0	3.6
Income (loss) before income taxes	15.9	23.6	(38.5)
Provision (benefit) for income taxes	(4.6)	(7.0)	--
Income (loss) before cumulative effect of an accounting change	20.5	30.6	(38.5)

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Cumulative effect of an accounting change	--	--	(7.5)
Net income (loss)	20.5%	30.6%	(46.0)%

The following table sets forth for certain items of our financial data for each year the percentage increase or (decrease) in such item from the preceding fiscal year:

	Year Ended December 31,	
	2003	2002
Revenue	20.5%	(35.0)%
Costs and expenses:		
Network and line costs	16.8	(33.8)
General and administrative expenses	7.5	(34.9)
Provision for doubtful accounts	23.9	(89.9)
Sales and marketing expenses	77.8	(63.3)
Depreciation and amortization	5.9	(49.6)
Impairment and restructuring charges	--	(100.0)
Total costs and expenses	20.7	(61.8)
Operating income	19.5	127.2
Other income (expense):		
Interest income	(51.6)	(34.3)
Interest expense	(19.1)	49.2
Other, net	(91.3)	58.5
Income before income taxes	(18.7)	139.8
Benefit for income taxes	(20.6)	--
Income before cumulative effect of an accounting change	(19.2)	151.7
Cumulative effect of an accounting change	--	(100.0)
Net income (loss)	(19.2)%	143.2%

Revenue. The increase in revenue in 2003 from 2002 was due to the increase in bundled revenue offset by a decline in long distance revenue. In 2002 both long distance and bundled revenue decreased. In 2000, we decided to shift our focus to the bundled product and no longer actively market the long distance product. During 2003 and 2004, we increased certain fees and rates related to our long distance and bundled products and such changes in rates may adversely impact customer turnover.

The increase in bundled revenue to \$281.3 million in 2003 from \$171.2 million in 2002 was due to higher average bundled lines in 2003 as compared to 2002, partially offset by lower average monthly revenue per customer. We ended 2003 with 557,000 billed bundled lines. Approximately 58.6% of the bundled lines in December 2003 were in Michigan. While we have expanded our marketing efforts in additional states during 2003, including Georgia, Illinois, New York, New Jersey, Indiana, Wisconsin, Ohio and Maryland, continued growth in revenues will depend upon our ability to develop and scale various marketing programs in additional states or areas and to maintain or reduce the current level of customer turnover.

The decrease in bundled revenue to \$171.2 million in 2002 from \$196.5 million in 2001 was due to lower average revenue per bundled line in 2002 as compared to 2001. Such decrease resulted from our strategy to market lower priced products to be more competitive with incumbent and other competitive local exchange carriers. We ended 2002, with 333,000 billed bundled lines compared with approximately 179,000 billed bundled lines in 2001. Approximately 61.1% of the bundled lines in December 2002 were in Michigan.

Our long distance revenue decreased in 2003 to \$101.4 million from \$146.3 million in 2002, and from \$291.7 million in 2001. Our decision in 2000 to invest in building a bundled customer base, together with customer turnover, contributed to the decline in long distance customers and revenue, although the effect on revenue of the decline in customers was offset partially by an increase in average monthly revenue per customer due to price increases. We expect this decline in long distance customers and revenues to continue. Long distance revenues for 2002 and 2001 included non-cash amortization of deferred revenue of \$6.2 million and \$7.4 million, respectively, related to a telecommunications service agreement entered into in 1997. Deferred revenue relating to this agreement had been amortized over a five-year period. The agreement and related amortization terminated in October 2002.

**Network and Line Costs.** The increase of network and line costs in 2003 from 2002 is primarily due to the increase in bundled customers, partially offset by the decrease in long distance customers. The lower total network and line costs as a percentage of revenue were due primarily to lower network costs as a percentage of revenue for both the bundled and long distance products. This decrease was partially offset by a shift in our customer base to the higher cost bundled product from the lower cost long distance product.

Bundled network and line costs were \$141.9 million for 2003, as compared to \$96.1 million for 2002 and \$107.7 million for 2001. Long distance network and line costs were \$39.8 million for 2003, as compared to \$59.5 million for 2002 and \$127.5 million for 2001. As a percentage of bundled revenue, bundled and network line costs were 50.4% for 2003, as compared to 56.1% for 2002 and 54.8% for 2001. Long distance network and line costs as a percentage of long distance revenue were 39.2% for 2003, as compared to 40.6% for 2002 and 43.7% for 2001.

The decrease of network and line costs in 2002 from 2001 was primarily due to the decrease in long distance customers and a reduction in access and usage rates. Network and line costs for 2002 benefited from a credit of \$1.7 million in connection with a New York Public Service Commission mandated refund from Verizon New York of certain unbundled network element platform switching costs. The growth in 2002 of local bundled service as a percentage of total revenue from 2001 and product mix has contributed to the increase in overall network and line cost as a percentage of revenues.

We structure and price our products in order to maintain network and line costs as a percentage of revenue at certain targeted levels. While the control of the structure and pricing of our products assists us in mitigating risks of increases in network and line costs, the telecommunications industry is highly competitive and there can be no assurances that we will be able to effectively market these higher priced products. There are several factors that could cause our network and line costs as a percentage of revenue to increase in the future, including without limitation:

- determinations by the FCC, courts, or state commission(s) that make unbundled local switching and/or combinations of unbundled network elements effectively unavailable to us in some or all of our geographic service areas, requiring us to provide services in these areas through total service resale agreements with incumbent local



exchange companies, through network elements purchased from the Regional Bell Operating Companies at "just and reasonable" rates under Section 271 of the Act or through the switching facilities of other non-incumbent carriers, in any case at significantly increased costs, or to provide

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services over our own switching facilities, if they have been deployed. The Court of Appeals, on March 2, 2004, issued an order that reversed the FCC's Triennial Review Order in part and remanded to the FCC with instructions to revise the Order in material ways that may make unbundled local switching and/or combinations of unbundled network elements effectively unavailable to us in some or all of our geographic service areas (see Item 1 "Regulation," above and "Liquidity and Capital Resources, Other Matters," below);

- adverse changes to the current pricing methodology mandated by the FCC for use in establishing the prices charged to us by incumbent local telephone companies for the use of their unbundled network elements. The FCC's 2003 Triennial Review Order, which was reversed in part and remanded to the FCC with instructions to revise the Order in material ways, (see Item 1, "Regulation," above and "Liquidity and Capital Resources, Other Matters," below) clarified several aspects of these pricing principles related to depreciation, fill factors (i.e. network utilization) and cost of capital, which could enable incumbent local telephone companies to increase the prices for unbundled network elements. In addition, the FCC released a Notice of Proposed Rulemaking on December 15, 2003, which initiated a proceeding to consider making additional changes to its unbundled network element pricing methodology, including reforms that would base prices more on the actual network costs incurred by incumbent local exchange companies than on the hypothetical network costs that would be incurred when the most efficient technology is used. These changes could result in material increases in prices charged to us for unbundled network elements; and

- determinations by state commissions to increase prices for unbundled network elements in ongoing state cost dockets.

Changes in the pricing of our service plans could also cause network and line costs as a percentage of revenue to change in the future. See our discussion under "Liquidity and Capital Resources, Other Matters," below.

**General and Administrative Expenses.** General and administrative expenses increased in 2003 from 2002. In 2002, general and administrative expenses were reduced by a settlement of litigation relating to an obligation with a third party of \$1.7 million. The increase was also due to an increase in the number of employees for customer service and information technology to support our expanding base of bundled customers. As of December 31, 2003, we had 270 and 53 employees within customer service and information technology, respectively, as compared to 225 and 43 as of December 31, 2002. The decrease in general and administrative expenses in 2002 from 2001 was due primarily to significant reductions in workforce and other cost cutting efforts by us as we pursued improvements in operating efficiencies of our bundled business model and the litigation settlement.

While we expect general and administrative expense as a percentage of revenue to continue to decline as the customer base grows, realization of such efficiencies will be dependent on the ability of management to continue to control personnel costs in areas such as customer service and collections. There can be no assurances that we will be able to realize these efficiencies.

**Provision for Doubtful Accounts.** The provision for doubtful accounts increased in 2003 from 2002. In 2002, the provision for doubtful accounts was reduced by a reversal of the reserve for doubtful accounts of \$1.9 million due to better than expected collections experience on accounts receivable outstanding at year end 2001. The benefits of our actions taken during the third and fourth quarters of 2001 to reduce bad debt expense and improve the overall credit

quality of our customer base were reflected in the lower bad debt expense for 2002. In general, bad debt expense as a percentage of revenue of our long distance customers is lower than that of our bundled customers because of the relatively greater maturity of the long distance customer base, however, the impact of this lower bad debt expense is decreasing as our base of long distance customers continues to decline.

**Sales and Marketing Expenses.** The increase in sales and marketing expenses in 2003 from 2002 is primarily attributable to increased levels of sales and marketing activity to continue our bundled sales growth. The decrease in sales and marketing costs in 2002 from 2001 was primarily attributable to the reduction in marketing fees paid to AOL due to the termination of the marketing relationship with AOL effective September 30, 2001. Currently, substantially all of our sales and marketing expenses relate to the bundled product. Included in sales and marketing expenses are advertising expenses of \$6.8 million for 2003, \$1.5 million for 2002, and \$0.2 million for 2001. We expect sales and marketing expenses to increase in 2004 as we continue to target growth in the bundled product and invest in the development of our marketing programs.

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**Impairment and Restructuring Charges.** Included in impairment and restructuring charges for 2001 was an impairment charge of \$168.7 million primarily related to the write-down of goodwill associated with the August 2000 acquisition of Access One Communications Corp. In September 2001, we approved a plan to close one of our call center operations. We incurred expenses of \$1.9 million during 2001 to reflect the elimination of approximately 225 positions and lease exit costs in connection with the call center closure. There were no impairment or restructuring charges in 2002.

**Interest Expense.** The decrease in interest expense in 2003 from 2002 is primarily due to lower outstanding debt balances. As a result of the restructuring agreement with AOL on December 23, 2002, we recorded interest expense associated with the 8% Secured Convertible Notes on our consolidated statement of operations for 2003, partially offsetting the decrease due to lower outstanding debt. The increase in interest expense in 2002 from 2001 was primarily due to the higher yielding debt instruments delivered in the exchange of our 4-1/2% and 5% Convertible Subordinated Notes for 8% Convertible Senior Subordinated Notes and 12% Senior Subordinated Notes and the restructuring of our senior credit facility. The issuance in 2001 of the 8% Secured Convertible Notes was initially accounted for as a troubled debt restructuring. As such, the aggregate interest expense for these notes was recorded as a liability at such time and the subsequent interest expense associated with these notes of \$2.7 million and \$0.8 million for 2002 and 2001, respectively, were not reflected in the statement of operations.

**Depreciation and Amortization.** Amortization expense decreased significantly in 2002 from 2001 due to the write-down in 2001 of goodwill associated with the acquisition of Access One. Additionally, we adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," which established the impairment approach rather than amortization for goodwill, resulting in reduced amortization as a result of the elimination of goodwill amortization in 2002.

**Other Income, Net.** Other income for 2003 consists of gains from our repurchase of a portion of our 12% Senior Subordinated Notes at a discount to par. Other income in 2002 included \$28.9 million attributed to the restructuring and repurchase of a portion of our 8% Secured Convertible Notes and \$1.6 million attributed to the repurchase of a portion of our 12% Senior Subordinated Notes, partially offset by a loss of \$1.1 million related to the retirement of our senior credit facility.

Other income for 2001 of \$20.6 million include a \$16.9 million gain on the restructuring of the AOL contingent redemptions in accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt

Restructurings." In addition, we reacquired \$5.0 million of our 4-1/2% Convertible Subordinated Notes due 2002 at a \$3.8 million discount from the face amount. The amount for 2001 also consisted of a \$2.4 million unrealized loss on the increase in fair value of the AOL contingent redemptions in accordance with the fair value accounting treatment under EITF Abstract No. 00-19. This amount did not recur, as the AOL contingent redemptions had been restructured effective December 2001.

On January 1, 2003, we adopted Statement of Financial Accounting Standards No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statements No. 13, and Technical Corrections as of April 2002", issued in May 2002, by the Financial Accounting Standards Board, which eliminates the requirement to report gains and losses from extinguishment of debt as extraordinary items. The adoption of SFAS 145 resulted in a reclassification from extraordinary gains (losses) from the extinguishment of debt of \$29.3 million and \$20.7 million to other income (expense) for 2002 and 2001, respectively.

Provision for Income Taxes. In both 2003 and 2002, management evaluated the deferred tax asset valuation allowance and determined that a portion of the allowance should be reversed. The evaluation considered profitability of the business, the ability to utilize the deferred tax assets in the future and possible restrictions on use due to provisions of the Internal Revenue Code Section 382 "Change in Ownership." After consideration of each of these factors, we concluded certain deferred tax assets will more likely than not be utilized, and reversed deferred tax asset valuation allowances of \$41.4 million and \$22.3 million for 2003 and 2002, respectively, and recognized non-cash deferred income tax benefits in these amounts. In 2003, the tax benefit was partially offset by an income tax expense of \$23.7 million.

As a result of the application of net operating loss carryforwards, or NOLs, we currently need only pay accrued alternative minimum taxes and certain state income taxes. As of December 31, 2003, we had approximately \$207 million of NOLs of which approximately \$147 million are estimated to be available to offset taxable income. A valuation allowance has been recorded to reduce the carrying amounts of certain deferred tax assets for such assets that may not be realized. We will continue to assess the valuation allowance of these deferred tax assets, and will reverse such allowance if we conclude that it is more likely than not these deferred tax assets will be utilized. We expect that our NOLs will be fully utilized by 2006.

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Cumulative Effect of an Accounting Change. We adopted Emerging Issues Task Force (EITF) Abstract No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," in the quarter ended June 30, 2001. The cumulative effect of the adoption of this change in accounting principle resulted in a non-cash charge to operations of \$36.8 million in the second quarter of 2001, representing the change in fair value of contingent redemption features of warrants and common stock held by AOL from issuance on January 5, 1999 through June 30, 2001. The requirements under EITF 00-19 will not apply to future changes in the value of these instruments, as the AOL contingent redemptions have been restructured effective December 2001.

## LIQUIDITY AND CAPITAL RESOURCES

Our management assesses our liquidity in terms of our ability to generate cash to fund our operations, our capital expenditures and our debt service obligations. In 2003 and 2002, our operating activities provided net cash flow of \$73.2 million and \$51.9 million, respectively, more than half of which in each year was used by us to reduce our outstanding debt obligations and a significant portion of the balance of which was used to fund capital expenditures and capitalized software development costs. As of December 31, 2003, we had \$35.2 million in cash and cash equivalents and long-term debt (including current maturities) of \$48.6 million, compared to \$33.6 million and \$100.9

million, respectively, at December 31, 2002.

Our contractual obligations as of December 31, 2003 are summarized by years to maturity as follows (in thousands):

Contractual Obligations	Total	1 year or less (as restated)	2 3 Years	4 5 Years (as restated)	Thereafter
<b>Talk America Holdings, Inc.:</b>					
12% Senior Subordinated Notes due 2007 (1)	\$ 40,730	\$ 15,000	\$ --	\$ 25,730	\$ --
8% Convertible Senior Subordinated Notes due 2007 (2)	3,778	--	--	3,778	--
5% Convertible Subordinated Notes due 2004	670	670	--	--	--
<b>Talk America Inc. and other subsidiaries:</b>					
Capital lease obligations	3,419	1,136	2,283	--	--
	\$ 48,597	\$ 16,806	\$ 2,283	\$ 29,508	\$ --
Operating leases	\$ 8,248	\$ 2,960	\$ 4,306	\$ 501	\$ 481
Carrier commitments (3)	81,650	19,250	41,600	20,800	--
<b>Total Contractual Obligations</b>	<b>\$ 138,495</b>	<b>\$ 39,016</b>	<b>\$ 48,189</b>	<b>\$ 50,809</b>	<b>\$ 481</b>

(1) Reflects our November 5, 2003 notice and commitment to redeem \$15 million principal amount of these 12% Senior Subordinated Notes on January 5, 2004 and resulting change in the maturity of such principal amount to the noticed redemption date. Since the end of 2003 and through February 27, 2004, we have redeemed the \$15 million of these 12% Senior Subordinated Notes that we so noticed for redemption and we have noticed for redemption and committed to redeem on April 20, 2004 a further \$15.0 million principal amount of these 12% Senior Subordinated Notes.

(2) The amount of the 8% Convertible Senior Subordinated Notes include \$2.8 million of principal and \$1.0 million of future accrued interest.

(3) In December 2003, we entered into a new four-year master carrier agreement with AT&T. The agreement provides us with a variety of services, including transmission facilities to connect our network switches as well as services for international calls, local traffic, international calling cards, overflow traffic and operator assisted calls. The agreement also provides that, subject to certain terms and conditions, we will purchase these services exclusively from AT&T during the term of the agreement, provided, however, that we are not obligated to purchase exclusively in certain cases, including if such purchases would result in a breach of any contract with another carrier that was in place when we entered into the AT&T agreement, or if vendor diversity is required. Certain of our network service agreements, including the AT&T agreement, contain certain minimum usage commitments. Our contract with AT&T establishes pricing and provides for annual minimum revenue commitments based upon usage as follows: 2004

- \$25 million, 2005 - \$32 million, 2006 - \$32 million and 2007 - \$32 million and obligates us to pay 65 percent of the revenue shortfall, if any. A separate contract with a different vendor establishes pricing and provides for annual minimum payments for 2004 of \$3.0 million. While we believe we will meet these annual minimum revenue commitments, and that we will not have to pay the shortfalls, there can be no assurances of this, and, if we are required to pay any of the shortfall amounts under one of these agreements, our costs of purchasing the services under the agreement will correspondingly increase.

Cash Provided By Operating Activities. Net cash provided by operating activities was \$73.2 million in 2003 and \$51.9 million in 2002. In 2003, the major contributors to the net cash provided by operating activities were:

- Net income of \$78.5 million;
- Increases in accounts payable and accrued expenses of \$3.1 million, primarily due to increased levels of sales and marketing activity to continue our bundled sales growth, and an increase in network and line costs primarily due to the increase in bundled customers;
- A decrease in other assets of \$1.5 million, primarily from repayment of a related party loan;
- An increase in deferred revenue of \$4.4 million for advance customer billings, primarily due to the growth in bundled customers.

Partially offsetting these contributors to the net cash provided by operating activities were:

- Non-cash benefits of \$22.2 million, primarily consisting of a net deferred tax asset of \$19.7 million and gain from debt extinguishments of \$2.5 million. We recognized non-cash deferred income tax benefits of \$41.4 million because of our outlook for continued profitability and our ability to more likely than not utilize the deferred tax assets. The tax benefit was partially offset by income tax expense of \$23.7 million. The application of NOL carryforwards have limited our current payment of income taxes to cash taxes for alternative minimum taxes and state income taxes. We expect that our NOLs will be fully utilized by 2006;
- An increase in accounts receivable of \$24.1 million due to the continued shift in our customer base from long distance customers to local bundled customers with higher average monthly revenue per customer. We generally do not have a significant concentration of credit risk with respect to net trade accounts receivable, due to the large number of end-users comprising our customer base.

In 2002, the major contributors to the net cash provided by operating activities were:

- Net income of \$97.1 million; and
- An increase in other liabilities of \$2.6 million, primarily consisting of an increase in interest payable due to higher yielding debt instruments delivered in the exchange for our 4-1/2% and 5% Convertible Subordinated Notes for 8% Convertible Senior Subordinated Notes and 12% Senior Subordinated Notes, and the restructuring of our senior credit facility.

Partially offsetting these contributors to the net cash provided by operating activities were:

- An increase in accounts receivable of \$10.6 million, primarily due to the continued shift in our customer base from long distance customers to local bundled customers with higher average monthly revenue per customer;
- A decrease in accounts payable and accrued expenses of \$11.5 million, primarily due to decreases in 2002 of network and line costs, sales and marketing expenses and general and administrative expenses from 2001 and due to prompter payment of vendors; and
- Non-cash items of \$53.3 million, primarily consisting of a gain from restructuring and redemption of convertible debt of \$28.9 million and the deferred income tax valuation reserve reversal of \$22.3 million. On December 23, 2002, we restructured our 8% Secured Convertible Notes and, accordingly, these notes were no longer accounted for as a

troubled debt restructuring. The \$28.9 million gain from the restructuring and repurchase of these notes was related to the decrease in future accrued interest, which was reflected as a \$28.9 million reduction in long-term debt. We recognized non-cash deferred income tax benefits because of our outlook for continued profitability and our ability to utilize the deferred tax assets.

Net Cash Used in Investing Activities. In 2003, approximately 42% of our \$11.8 million in capital expenditures million consisted of costs related to our deployment of networking assets ( local switch and colocation equipment) in Michigan. Also in 2003, to support our customer growth, we opened a new customer service call center. Costs associated with our call center initiatives were approximately 12% of total capital expenditures. The remaining 2003 capital expenditures consisted primarily of upgrades to our

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information technology capabilities to support our customer growth. In addition, during 2003, we entered into a capital lease valued at \$3.4 million for upgrades to our customer data storage equipment. In 2004, we plan to add two more colocations and to start migrating local bundled customers over to our network, and expect to incur capital expenditures of approximately \$12 to \$15 million for both network and non-network assets. As we pursue our "customer first" strategy of building a large, profitable base of bundled service customers using the wholesale operating platforms of the incumbent local exchange companies and then migrate those customers to our own networking platform and offer new products and services to these customers, our capital expenditures are expected to increase significantly.

Capitalized software development costs consist of direct development costs associated with internal-use computer software including external direct costs of material and services and payroll costs for employees devoting time to the software projects. In 2003, capitalized software development costs totaled \$2.7 million and were primarily related to the development of customer relations management software. In 2004, we expect software development costs to increase moderately as we continue to develop the integrated information systems required to provide local switch-based service.

Net cash used in investing activities was \$7.3 million during 2002, consisting of capitalized software development costs of \$2.5 million and capital expenditures primarily for the purchase of equipment of \$4.8 million.

Net Cash Used in Financing Activities. Net cash used in financing activities for 2003 and 2002 was primarily attributable to debt repayment and purchases of \$52.9 and \$32.7 million, respectively. For 2002, \$2.8 million of interest was recorded as additional principal on the 12% Senior Subordinated Notes and 8% Secured Convertible Notes for payment of interest in kind rather than in cash. Since December 31, 2003 and through February 27, 2004, we have purchased \$15.0 million principal amount of our 12% Senior Subordinated Notes at par and committed to redeem an additional \$15 million principal amount in April 2004.

In addition, in 2003, pursuant to our share buyback program announced in January 2003, we purchased 1,315,789 shares for a purchase price of \$5.0 million. Under the buyback program, we are authorized to spend up to \$10.0 million for share purchases, with a cap of 2.5 million shares.

In 2004, we will continue to evaluate opportunities to purchase our debt prior to maturity, as well as to consider acquiring shares under the balance of our share buyback program. The remaining shares authorized under the program may be purchased, from time to time, in the open market and/or in private transactions.

Note Obligations

### 8% Secured Convertible Notes

In September 2001, we restructured our financial obligations with America Online, Inc. that arose under our 1999 investment agreement and, effective September 30, 2001, also ended our marketing relationship with AOL. In connection with the restructuring, we entered into a Restructuring and Note Agreement with AOL, pursuant to which we had outstanding as of December 31, 2002, \$30.2 million principal amount of our 8% Secured Convertible Notes. On December 23, 2002, we restructured these 8% Secured Convertible Notes to provide for: a new maturity date of September 19, 2006, the elimination of a pay-in-kind interest option and additional flexibility to purchase subordinated debt and common stock through September 30, 2003. During 2003, we purchased all of these 8% Secured Convertible Notes. In addition, we concurrently purchased from AOL the 1,315,789 shares of our common stock held by AOL for an aggregate price of \$5 million.

### Convertible Subordinated Notes and Exchange Offers

Effective April 4, 2002, we completed the exchange of \$57.9 million of the \$61.8 million outstanding principal balance of our 4-1/2% Convertible Subordinated Notes that matured on September 15, 2002 for \$53.2 million principal amount of new 12% Senior Subordinated PIK Notes due August 2007 and \$2.8 million principal amount of new 8% Convertible Senior Subordinated Notes due August 2007 and cash paid of \$0.5 million. In addition, we exchanged \$17.4 million of the \$18.1 million outstanding principal balance of our 5% Convertible Subordinated Notes that mature on December 15, 2004 for \$17.4 million principal amount of the new 12% Senior Subordinated Notes. In 2003 and 2002, we acquired \$25.2 million and \$5.7 million principal amount of our 12% Senior Subordinated Notes, respectively, at respective discounts from face amount of \$2.5 million and \$1.6 million, which discounts are reported as other income in our consolidated statement of operations. We paid at maturity the remaining \$3.9 million principal balance of our outstanding 4-1/2% Convertible Subordinated Notes due September 2002. Since December 31, 2003 and through February 27, 2004, we have purchased an additional \$15.0 million principal amount of our 12% Senior Subordinated Notes at face amount and have committed to redeem an additional \$15.0 million principal amount in April 2004.

### Other Matters

Our provision of telecommunication services is subject to government regulation. See Item 1, "Regulation," above. Changes in existing regulations could have a material adverse effect on us. Our local telecommunication services are provided almost exclusively through the use of unbundled network elements purchased from incumbent local telephone companies, and it is primarily the availability of cost-based unbundled network element rates that enables us to price our local telecommunications services competitively. The FCC currently requires incumbent local telephone companies to provide an unbundled network element platform, that includes all of the network elements required by a competitor to provide a retail telecommunications service, in most geographic areas. Through the use of such unbundled network element platforms we are able to provide retail local services entirely through the use of the incumbent local telephone company's facilities at lower prices than those available for local resale through total resale service agreements. In its UNE Triennial Review proceeding, the FCC sought to identify, among other issues, which if any network elements the incumbent local telephone companies should no longer be required to offer on an unbundled basis. The FCC also analyzed the issue of which elements must be unbundled in response to a remand of its previous rules by the U.S. Court of Appeals for the District of Columbia Circuit. In the FCC's UNE Triennial Review Order, released August 21, 2003 and effective as of October 2, 2003, the Commission determined that certain network elements will no longer be subject to unbundling, while other elements must continue to be offered subject to further,

more detailed review by the state public utility commissions. The Order was subject to numerous federal judicial appeals, which were consolidated in the U.S. Court of Appeals for the District of Columbia Circuit. The Court, on March 2, 2004, issued an order that reversed the FCC's Order in part and remanded to the FCC with instructions to revise the Order in material ways. The Court stayed its decision until the denial of any petitions for rehearing or for a 60-day period (i.e., until May 1, 2004), whichever is later.

Should the local circuit switching unbundled network element become effectively unavailable due to this adverse decision or otherwise, we would be unable to offer services on an unbundled network element platform basis and would instead have to serve customers through total service resale agreements with the incumbent local exchange companies, through network elements purchased from the Regional Bell Operating Companies at "just and reasonable" rates under Section 271 of the Act or through our own facilities or the switching facilities of other non-incumbent carriers. Our transition from providing telecommunications services on an unbundled network element platform basis could delay our service roll-out in some markets, increase our costs, and negatively impact our business, prospects, operating margins, results of operations, cash flows and financial condition. See Item 1, "Regulation."

We are party to a number of legal actions and proceedings arising from our provision and marketing of telecommunications services, as well as certain legal actions and regulatory matters arising in the ordinary course of business. During the second quarter 2003, we were made aware that AOL agreed to settle a class action case for approximately \$10 million; the claims in the case allegedly relate to marketing activities conducted pursuant to a former telecommunications marketing agreement, between us and AOL. At the time of the settlement agreement, AOL asserted that we are required to indemnify AOL in this matter under the terms of the marketing agreement and advised that it will seek such indemnification from us. We believe that we do not have an obligation to indemnify AOL in this matter and that any claim by AOL for this indemnification would be without merit. We have received no further information regarding this matter and it is our intention, if AOL initiates a claim for indemnification under the marketing agreement, to defend against the claim vigorously. We believe that the ultimate outcome of the foregoing actions will not result in liability that would have a material adverse effect on our financial condition or results of operations.

While we believe that we have access to new capital in the public or private markets to fund our ongoing cash requirements, there can be no assurance as to the timing, amounts, terms or conditions of any such new capital or whether it could be obtained on terms acceptable to us. We anticipate that our cash requirements will generally be met from our cash-on-hand and from cash generated from operations. Based on our current projections for operations, we believe that our cash-on-hand and our cash flow from operations will be sufficient to fund our currently contemplated capital expenditures, our debt service obligations, and the expenses of conducting our operations for at least the next twelve months. However, there can be no assurance that we will be able to realize our projected cash flows from operations, which is subject to the risks and uncertainties discussed above, or that we will not be required to consider capital expenditures in excess of those currently contemplated, as discussed above.

Our business involves risks and uncertainties and our actual results could differ materially from our expectations. In addition to those factors discussed elsewhere in this Form 10-K, important factors that could impact our business include, among others:

- changes in government policy, regulation and enforcement and/or adverse judicial or administrative interpretations and rulings relating to regulations and enforcement, including, but not limited to, those that affect the continued availability to us, on acceptable economic terms, of the unbundled network element platform of the local



exchange carriers network, on which our business, as now conducted, is substantially dependent;

- our ability successfully to implement our business strategy, including the development and deployment of our own local services networking platform and the migration of our customer base to the new platform, and our ability to finance the costs of such implementation;
- the success of such business strategy if and when implemented;
- increased price competition for long distance and local services;
- our ability to continue to manage the nonpayment of amounts due us from our customers from bundled and long distance services;
- attrition in the number of our customers;
- our ability to continue to manage our operations, including attracting and retaining qualified personnel;
- our ability to continue to expand our active offering of local bundled services to a greater number of states;
- our ability to continue to manage our collection management systems and credit controls for customers;
- interruptions in our network and information systems; and
- our ability to continue to provide adequate customer service.

## CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to bad debt, goodwill and intangible assets, income taxes, contingencies and litigation. We base our estimates and judgments on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

### Allowance for Doubtful Accounts

Allowances for doubtful accounts are maintained for estimated losses resulting from the failure of customers to make required payments on their accounts. We review accounts receivable aging trends, historical bad debt trends, and customer credit-worthiness through customer credit scores, current economic trends and changes in customer payment history when evaluating the adequacy of the allowance for doubtful accounts. In addition, we review the financial condition of the carriers that pay us access charges to assess their ability to make payments.

### Valuation of Long-Lived Assets and Intangible Assets with a Definite Life

We review the recoverability of the carrying value of long-lived assets, including intangibles with a definite life, for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. When such events occur, we compare the carrying amount of the assets to the undiscounted expected future cash flows from them. Factors we consider important that could trigger an impairment review include the following:

- Significant underperformance relative to historical or projected future operating results
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business
- Significant negative industry or economic trends
- Significant decline in our stock price for a sustained period and market capitalization relative to net book value

If this comparison indicates there is impairment, the amount of the impairment loss to be recorded is calculated by the excess of the net assets carrying value over its fair value and is typically calculated using discounted expected future cash flows.

#### Goodwill

Goodwill represents the cost in excess of net assets of acquired companies. Effective January 1, 2002, with the adoption of SFAS No. 142, goodwill (comprised of goodwill acquired in the Access One acquisition in August 2000) will not be amortized, but rather will be tested for impairment annually, and will be tested for impairment between annual tests if an event occurs or circumstances change that would indicate the carrying amount may be impaired. Prior to January 1, 2002, goodwill and intangibles were amortized on a straight-line basis over periods ranging from 5 years to 15 years. Impairment testing for goodwill is performed at a reporting unit level; we determined that we have one reporting unit under the guidance of SFAS No. 142. An impairment loss would generally be recognized when the carrying amount of the reporting unit's net assets exceeds the estimated fair value of the reporting unit. Prior to January 1, 2002, goodwill was tested for impairment in a manner consistent with long-lived assets and intangible assets with a definite life.

#### Income Taxes

Income taxes are accounted for under the asset and liability method. During 2003, we recorded income taxes at a rate equal to our combined federal and state effective rates. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled.

We consider all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a net deferred tax asset. Judgment is used in considering the relative impact of negative and positive evidence. In arriving at these judgments, the weight given to the potential effect of negative and positive evidence is commensurate with the extent to which it can be objectively verified. We record a valuation allowance to reduce our deferred tax assets and review the amount of such allowance annually. When we determine certain deferred tax assets are more likely than not to be utilized, we will reduce our valuation allowance accordingly.

#### New Accounting Pronouncements

Effective January 1, 2002, we adopted Emerging Issues Task Force (EITF) 01-09, "Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Products." This issue presumes that consideration from a vendor to a customer or reseller of the vendor's products is a reduction of the selling prices of the vendor's products and, therefore, should be characterized as a reduction of revenue when recognized in the vendor's statement of operations and could lead to negative revenue under certain circumstances. Revenue reduction is required unless the consideration relates to a separate, identifiable benefit and the benefit's fair value can be established. The adoption of this issue resulted in a reclassification from sales and marketing expenses of \$7.3 million to a reduction of net sales for the year ended December 31, 2001 attributable to direct marketing promotion check campaigns. The adoption of EITF 01-09 did not have a material effect on our consolidated financial statements for the years ended December 31, 2003 and 2002, as we did not have any direct marketing promotion check campaigns during this period.

In May 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statements No. 13, and Technical Corrections as of April 2002." SFAS 145 eliminates the requirement to report gains and losses from extinguishment of debt as extraordinary items. Gains and losses from extinguishment of debt will now be classified as extraordinary items only if they meet the criteria of APB Opinion No. 30. We adopted SFAS 145 effective January 1, 2003. The adoption of SFAS 145 resulted in a reclassification from extraordinary gains (losses) from the extinguishment of debt of \$29.3 million and \$20.7 million, respectively, to other income (expense) for the years ended December 31, 2002 and 2001.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES  
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	FORM 10-K/A PAGE
Reports of Independent Auditors	15
Consolidated statements of operations for the years ended December 31, 2003, 2002 and 2001	16
Consolidated balance sheets as of December 31, 2003 and 2002	17
Consolidated statements of cash flows for the years ended December 31, 2003, 2002 and 2001	18
Consolidated statements of stockholders' equity (deficit) for the years ended December 31, 2003, 2002 and 2001	19
Notes to consolidated financial statements	20

Report of Independent Auditors

To the Board of Directors and  
Shareholders of Talk America Holdings, Inc.:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15 (a)(1) of this Annual Report on Form 10-K/A present fairly, in all material respects, the financial position of Talk America Holdings, Inc. and its subsidiaries at December 31, 2003 and December 31, 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15 (a)(2) accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall

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financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections as of April 2002, effective January 1, 2003 and Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, effective January 1, 2002.

As discussed in Note 16 to the consolidated financial statements, the December 31, 2003 balance sheet has been restated to properly reflect the current maturities of long term debt.

**PricewaterhouseCoopers LLP**

Philadelphia, Pennsylvania  
February 3, 2004, except for  
Note 14, as to which date is  
February 27, 2004, and Note  
16, as to which date is  
May 7, 2004

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TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(In thousands, except for per share data)

	Year Ended December 31,		
	2003	2002	2001
Revenue	\$ 382,663	\$ 317,507	\$ 488,158
Costs and expenses:			
Network and line costs	181,682	155,567	235,153
General and administrative expenses	57,503	53,510	82,202
Provision for doubtful accounts	11,599	9,365	92,778
Sales and marketing expenses	48,277	27,148	73,973
Depreciation and amortization	18,344	17,318	34,390
Impairment and restructuring charges	--	--	170,571
Total costs and expenses	317,405	262,908	689,067
Operating income (loss)	65,258	54,599	(200,909)
Other income (expense):			
Interest income	388	802	1,220
Interest expense	(7,353)	(9,087)	(6,091)
Other income (expense), net	2,470	28,448	17,950
Income (loss) before provision for income taxes	60,763	74,762	(187,830)

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Provision (benefit) for income taxes	(17,698)	(22,300)	--
Income (loss) before cumulative effect of an accounting change	78,461	97,062	(187,830)
Cumulative effect of an accounting change	--	--	(36,837)
Net income (loss)	\$ 78,461	\$ 97,062	\$ (224,667)
Income (loss) per share Basic:			
Income (loss) before cumulative effect of an accounting change per share	\$ 2.97	\$ 3.56	\$ (7.11)
Cumulative effect of an accounting change per share	--	--	(1.40)
Net income (loss) per share	\$ 2.97	\$ 3.56	\$ (8.51)
Weighted average common shares outstanding			
	26,376	27,253	26,414
Income (loss) per share Diluted:			
Income (loss) before cumulative effect of an accounting change per share	\$ 2.75	\$ 3.15	\$ (7.11)
Cumulative effect of an accounting change per share	--	--	(1.40)
Net income (loss) per share	\$ 2.75	\$ 3.15	\$ (8.51)
Weighted average common and common equivalent shares outstanding			
	28,514	30,798	26,414

See accompanying notes to consolidated financial statements.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(In thousands, except for share and per share data)

December 31, 2003	December 31, 2002
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	(as restated, see Note 16)	
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 35,242	\$ 33,588
Accounts receivable, trade (net of allowance for uncollectible accounts of \$9,414 and \$7,821 at December 31, 2003 and 2002, respectively)	40,321	27,843
Deferred income taxes	24,605	17,500
Prepaid expenses and other current assets	5,427	3,894
<b>Total current assets</b>	<b>105,595</b>	<b>82,825</b>
Property and equipment, net	68,069	66,915
Goodwill	19,503	19,503
Intangibles, net	4,666	7,379
Deferred income taxes	40,543	4,800
Other assets	7,547	7,653
	<b>\$ 245,923</b>	<b>\$ 189,075</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 35,296	\$ 32,152
Sales, use and excise taxes	14,551	11,439
Deferred revenue	10,873	6,480
Current portion of long-term debt	16,806	61
Accrued compensation	9,888	5,609
Other current liabilities	7,027	9,013
<b>Total current liabilities</b>	<b>94,441</b>	<b>64,754</b>
Long-term debt	31,791	100,855
Deferred income taxes	19,904	--
<b>Commitments and contingencies</b>		
<b>Stockholders' equity:</b>		
Preferred stock - \$.01 par value, 5,000,000 shares authorized; no shares outstanding	--	--
Common stock - \$.01 par value, 100,000,000 shares authorized; 26,662,952 and 27,469,593 shares issued and outstanding at December 31, 2003 and 2002, respectively	280	275
Additional paid-in capital	354,847	351,992

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Accumulated deficit	(250,340)	(328,801)
Treasury stock - \$.01 par value, 1,315,789 shares at December 31, 2003	(5,000)	--
Total stockholders' equity	99,787	23,466
	\$ 245,923	\$ 189,075

See accompanying notes to consolidated financial statements.

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TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands)

	Year Ended December 31,		
	2003	2002	2001
Cash flows from operating activities:			
Net income (loss)	\$ 78,461	\$ 97,062	\$ (224,667)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Provision for doubtful accounts	11,599	9,365	92,778
Depreciation and amortization	18,344	17,318	34,390
Non-cash compensation	--	194	--
Non-cash interest and amortization of accrued interest liabilities	(260)	832	--
Provision for uncollectible note	--	--	77
Loss on sale and retirement of assets	23	205	116
Impairment of goodwill and intangibles	--	--	168,684
Cumulative effect of accounting change of contingent redemptions	--	--	36,837
Gain from restructuring of convertible debt	--	(28,909)	--
Gain from restructuring of contingent redemptions	--	--	(16,867)
Gain from extinguishment of debt	(2,475)	(431)	(3,781)
Unrealized loss on increase in fair value of contingent redemptions	--	--	2,372
Deferred income taxes	(19,740)	(22,300)	--
Gain on legal settlement	--	(1,681)	--
Changes in assets and liabilities:			
Accounts receivable, trade	(24,078)	(10,560)	(65,788)
Prepaid expenses and other current assets	(1,605)	(1,902)	(527)
Other assets	1,475	2,211	1,142

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Accounts payable	3,144	(11,462)	(27,181)
Deferred revenue	4,393	(3,713)	(9,004)
Sales, use and excise taxes	3,112	3,101	404
Other current liabilities and accrued compensation	773	2,568	5,418
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided by (used in) operating activities	73,166	51,898	(5,597)
	<u>          </u>	<u>          </u>	<u>          </u>
Cash flows from investing activities:			
Acquisition of intangibles	(133)	(50)	(154)
Capital expenditures	(11,842)	(4,781)	(2,949)
Capitalized software development costs	(2,739)	(2,501)	(1,406)
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash used in investing activities	(14,714)	(7,332)	(4,509)
	<u>          </u>	<u>          </u>	<u>          </u>
Cash flows from financing activities:			
Payments of borrowings	(52,914)	(17,983)	(2,624)
Payments of capital lease obligations	(61)	(1,036)	(1,022)
Acquisition of convertible debt and senior notes	--	(14,691)	(1,227)
Proceeds from exercise of options and warrants	1,177	632	--
Payments in connection with restructuring contingent redemptions	--	--	(3,525)
Purchase of treasury stock	(5,000)	--	--
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash used in financing activities	(56,798)	(33,078)	(8,398)
	<u>          </u>	<u>          </u>	<u>          </u>
Net increase (decrease) in cash and cash equivalents	1,654	11,488	(18,504)
Cash and cash equivalents, beginning of year	33,588	22,100	40,604
	<u>          </u>	<u>          </u>	<u>          </u>
Cash and cash equivalents, end of year	\$ 35,242	\$ 33,588	\$ 22,100
	<u>          </u>	<u>          </u>	<u>          </u>

See accompanying notes to consolidated financial statements.

18

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(In thousands)

Common Stock	Treasury Stock	
<u>          </u>	<u>          </u>	<u>          </u>
Additional		



**Paid-In  
Accumulated**

**Shares  
Amount  
Capital  
Deficit  
Shares  
Amount  
Total**

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Balance, December 31, 2000

		26,148
\$		261
\$		287,486
\$		(201,196)
)		(91)
)		(3,851)
\$		82,700

Net (loss)

	--
	--
	--
)	(224,667)
	--
	--
)	(224,667)
Issuance of common stock for compensation	
	--
	--
)	(2,451)
	--
	68
	2,858
	407
Cumulative effect of an accounting change	
	--
	--
	65,617
	--
	--
	--
	65,617
Issuance of common stock in connection with AOL restructuring	

	1,003
	11
	440
	--
	24
	993
	1,444
Acquisition of treasury stock	--
	--
	--
	--
)	(1
	--
	--
Issuance of warrants for services	--
	--
	77
	--
	--
	--
	77

Balance, December 31, 2001

	27,151
	272
	351,169
)	(425,863
	--
	--
)	(74,422

Net income

--  
--  
--

	97,062
	--
	--
	97,062
Issuance of common stock for services	
	67
	1
	82
	--
	--
	--
	83
Exercise of common stock options	
	252
	2
	741
	--
	--
	--
	743
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Balance, December 31, 2002	
	27,470
	275
	29

	351,992
)	(328,801
	--
	--
	23,466
<hr/>	
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Net income

--  
--  
--  
78,461  
--  
--  
78,461

Acquisition of treasury stock

	--
	--
	--
	--
	1,316
)	(5,000)

)	(5,000)
Exercise of common stock options	

	509
	5
	1,172
	--
	--
	--
	1,177

Income tax benefit related to exercise of common stock options

	--
	--
	1,683
	--
	--
	--
	1,683

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Balance, December 31, 2003	27,979
\$	280
\$	354,847
\$	(250,340)
)	1,316
)	(5,000)
\$	99,787

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See accompanying notes to consolidated financial statements.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF ACCOUNTING POLICIES

(a) Business

Talk America Holdings, Inc., through its subsidiaries, offers a bundle of local and long distance phone services to residential and small business customers in the United States. We operate our own nationwide long distance network



and deliver local services through wholesale operating agreements with the incumbent local exchange companies. We have developed integrated order processing, provisioning, billing, payment, collection, customer service and information systems that enable us to offer and deliver high-quality service, savings through competitively priced telecommunication products, and simplicity through consolidated billing and responsive customer service. We operate our own sales and customer service centers. We manage our business as one reportable operating segment.

(b) Basis of Financial Statements Presentation

The consolidated financial statements include the accounts of Talk America Holdings, Inc. and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated.

(c) Use of Estimates

In preparing financial statements in conformity with generally accepted accounting principles in the United States, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

(d) Reclassifications

Certain amounts for 2002 and 2001 have been reclassified to conform to the current year presentation.

(e) Risks and Uncertainties

Future results of operations involve a number of risks and uncertainties. Factors that could affect future operating results and cash flows and cause actual results to vary materially from historical results include, but are not limited to:

- Changes in government policy, regulation and enforcement or adverse judicial or administrative interpretations and rulings or legislative action relating to regulations, enforcement and pricing, including, but not limited to, changes that affect the continued availability of the unbundled network element platform of the local exchange carriers network and the costs associated therewith
- Dependence on the availability and functionality of the networks of the incumbent local exchange carriers as they relate to the unbundled network element platform
- Increased price competition in local and long distance services, including bundled services, and overall competition within the telecommunications industry, including, but not limited to, in the State of Michigan
- Adverse determinations in certain litigation matters

Negative developments in these areas could have a material effect on our business, financial condition and results of operations.