TALK AMERICA HOLDINGS INC
Form 10-Q
May 14, 2003

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2003

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM ___ TO ___

COMMISSION FILE NUMBER 0 - 26728

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

DELAWARE	23-2827736
(State of incorporation)	(I.R.S. Employer Identification No.)

12020 SUNRISE VALLEY DRIVE, SUITE 250, RESTON, VIRGINIA	20191
(Address of principal executive offices)	(Zip Code)

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

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 whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes X No ___

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

26,177,651 shares of Common Stock, par value of $0.01 per share, were issued and outstanding as of May 9, 2003.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT FOR PER SHARE DATA)
(UNAUDITED)

	THREE MONTHS ENDED MARCH 31,	
	2003	2002

Sales	$ 87,843	$ 79,447
Costs and expenses:		
Network and line costs	43,884	40,219
General and administrative expenses	13,465	14,561
Provision for doubtful accounts	2,223	4,007
Sales and marketing expenses	8,785	5,895
Depreciation and amortization	4,307	4,443
Total costs and expenses	72,664	69,125
Operating income	15,179	10,322
Other income (expense):		
Interest income	110	89
Interest expense	(2,479)	(1,474)
Other income (expense), net	2,151	(807)
Income before provision for income taxes	14,961	8,130
Provision for income taxes	5,835	--
Net income	$ 9,126	$ 8,130
Income per share - Basic:		
Net income per share	$ 0.35	$ 0.30
Weighted average common shares outstanding	26,376	27,185
Income per share - Diluted:		
Net income per share	$ 0.32	$ 0.28
Weighted average common and common equivalent shares outstanding	29,940	29,460

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)
(UNAUDITED)

	MARCH 31, 2003
ASSETS	
Current assets:	

Cash and cash equivalents	$ 29,046
Accounts receivable, trade (net of allowance for uncollectible accounts of 7,349 and $7,821 at March 31, 2003 and December 31, 2002, respectively)	30,963
Deferred income taxes	16,765
Prepaid expenses and other current assets	1,810
Total current assets	78,584
Property and equipment, net	66,277
Goodwill	19,503
Intangibles, net	6,667
Deferred income taxes	--
Other assets	7,020
	$ 178,051
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$ 33,332
Sales, use and excise taxes	11,772
Deferred revenue	7,634
Current portion of long-term debt	62
Accrued compensation	3,358
Other current liabilities	6,464
Total current liabilities	62,622
Long-term debt:	
8% Secured convertible notes due 2006	26,552
12% Senior subordinated notes due 2007	56,620
8% Convertible senior subordinated notes due 2007 (includes future accrued interest of $1,151 and $1,216 at March 31, 2003 and December 31, 2002, respectively)	3,973
5% Convertible subordinated notes due 2004	670
Other long-term debt	11
Total long-term debt	87,826
Commitments and contingencies	
Stockholders' equity:	
Preferred stock - $.01 par value, 5,000,000 shares authorized; no shares outstanding	--
Common stock - $.01 par value, 100,000,000 shares authorized; 26,161,437 and 27,469,593 shares issued and outstanding at March 31, 2003 and December 31, 2002, respectively	275
Treasury stock - $.01 par value, 1,315,789 shares at March 31, 2003	(5,000
Additional paid-in capital	352,003
Accumulated deficit	(319,675
Total stockholders' equity	27,603
	$ 178,051

See accompanying notes to consolidated financial statements.

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TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(IN THOUSANDS)
(UNAUDITED)

	COMMON STOCK		ADDITIONAL PAID-IN	ACCUMULATED	TREASURY
	SHARES	AMOUNT	CAPITAL	DEFICIT	SHARES
Balance, December 31, 2002	27,470	$ 275	$ 351,992	$ (328,801)	--
Net income	--	--	--	9,126	--
Acquisition of treasury stock	--	--	--	--	1,316
Exercise of common stock options	7	--	11	--	--
Balance, March 31, 2003	27,477	$ 275	$ 352,003	$ (319,675)	1,316

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TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	THREE MONTHS ENDED MARCH 31,	
	2003	2002
Cash flows from operating activities:		
Net income	$ 9,126	$ 8,130
Reconciliation of net income to net cash provided by (used in) operating activities:		
Provision for doubtful accounts	2,223	4,007
Depreciation and amortization	4,307	4,443
Loss on sale and retirement of assets	--	205
Deferred income taxes	5,535	--
Other non-cash charges (benefits)	(2,219)	84
Changes in assets and liabilities:		
Accounts receivable, trade	(5,343)	(582)
Prepaid expenses and other current assets	435	192
Other assets	1,114	120
Accounts payable and accrued expenses	494	(10,349)
Deferred revenue	1,154	(1,655)
Sales, use and excise taxes	332	(710)
Other liabilities	(2,550)	682

Net cash provided by operating activities	14,608	4,567
Cash flows from investing activities:		
Capital expenditures	(2,691)	(167)
Capitalized software development costs	(663)	(570)
Acquisition of intangibles	--	(50)
Net cash used in investing activities	(3,354)	(787)
Cash flows from financing activities:		
Payments of borrowings	--	(1,336)
Acquisition of convertible debt and senior notes	(10,793)	(1,227)
Payment of capital lease obligations	(16)	(422)
Proceeds from exercise of stock options and warrants	12	--
Repurchase of common stock	(5,000)	--
Net cash used in financing activities	(15,797)	(2,985)
Net increase (decrease) in cash and cash equivalents	(4,543)	795
Cash and cash equivalents, beginning of period	33,589	22,100
Cash and cash equivalents, end of period	$ 29,046	$ 22,895

See accompanying notes to consolidated financial statements.

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

NOTE 1. ACCOUNTING POLICIES

(A) BASIS OF FINANCIAL STATEMENTS PRESENTATION

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

The consolidated financial statements and related notes thereto as of March 31, 2003 and for the three months ended March 31, 2003 and March 31, 2002 are presented as unaudited, but in the opinion of management include all adjustments necessary to present fairly the information set forth therein. The consolidated balance sheet information for December 31, 2002 was derived from the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002 filed March 31, 2003. These interim financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2002. The interim results are not necessarily indicative of the results for any future periods. Certain prior year amounts have been reclassified for comparative purposes.

(B) 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:

- Failure or difficulties in managing the Company's operations, including attracting and retaining qualified personnel
- Dependence on the availability and functionality of RBOCs' networks as they relate to the unbundled network element platform
- Increased price competition in local and long distance services and overall competition within the telecommunications industry
- Interruption or failure of, or failure to manage, the Company's network and technology and information systems
- Changes in government policy, regulation and enforcement or adverse judicial or administrative interpretations and rulings or legislative action relating to regulations and enforcement, including, but not limited to, changes that affect the continued availability of the unbundled network element platform of the local exchange carriers network.
- Failure of the marketing of the Company's bundle of local and long distance services
- Inability to adapt to technological change
- Failure to manage the nonpayment of amounts due the Company from its customers from bundled and long distance services
- Attrition in the number of end users
- Failure of the Company to be able to expand its active offering of local bundled services in a greater number of states
- Adverse determinations in certain litigation matters
- Failure of the Company to provide adequate customer service

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

(C) NEW ACCOUNTING PRONOUNCEMENTS

In November 2002, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"), an interpretation of FASB Statement No. 5, "Accounting for Contingencies." This interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantees. This interpretation is effective on a prospective basis for guarantees issued or modified after December 31, 2002 and for financial statements of interim or annual periods ending after December 15, 2002. The Company historically has been, and currently is, party to various agreements that obligate the Company to indemnify other parties in certain situations, primarily for litigation or regulatory claims arising from activities conducted pursuant to the agreements. These agreements generally include, but are not limited to, agreements with other carriers, marketing agreements, licensing agreements, lease agreements, underwriting agreements and employment related agreements. The adoption of this standard did not have a material impact on the Company's consolidated financial statements for the three months ended March 31, 2003.

NOTE 2. DEBT

(A) 12% SENIOR SUBORDINATED NOTES DUE 2007 AND 8% CONVERTIBLE SENIOR SUBORDINATED NOTES DUE 2007

Effective April 4, 2002, the Company completed the exchange of $57.9 million of the $61.8 million outstanding principal balance of its 4-1/2% Convertible Subordinated Notes due September 15, 2002 ("4-1/2% Convertible Subordinated Notes") into $53.2 million of new 12% Senior Subordinated PIK Notes due August 2007 ("12% Senior Subordinated Notes") and $2.8 million of new 8% Convertible Senior Subordinated Notes due August 2007 ("8% Convertible Senior Subordinated Notes") and cash paid of $0.5 million. In addition, the Company exchanged $17.4 million of the $18.1 million outstanding principal balance of its 5% Convertible Subordinated Notes ("5% Convertible Subordinated Notes") that mature on December 15, 2004 into $17.4 million of the new 12% Senior Subordinated Notes.

The new 12% Senior Subordinated Notes accrue interest at a rate of 12% per year on the principal amount, payable semiannually on February 15 and August 15, beginning on August 15, 2002. Interest is payable in cash, except that the Company may, at its option, pay up to one-third of the interest due on any interest payment date through and including the August 15, 2004 interest payment date in additional 12% Senior Subordinated Notes. The new 8% Convertible Senior Subordinated Notes accrue interest at a rate of 8% per year on the principal amount, also payable semiannually on February 15 and August 15, and are convertible, at the option of the holder, into common stock at $15.00 per share. The 12% Senior Subordinated Notes and 8% Convertible Senior Subordinated Notes are redeemable at any time at the option of the Company at par value plus accrued interest to the redemption date. The AOL Restructuring Agreement discussed below obligates the Company to redeem 8% Secured Convertible Notes upon the redemption of subordinated debt. As of March 31, 2003, the Company had $56.6 and $2.8 million principal amount outstanding of the 12% Senior Subordinated Notes and 8% Convertible Senior Subordinated Notes, respectively. As of March 31, 2002, prior to the exchange, $61.8 million principal amount of the 4-1/2% Notes and $18.1 million principal amount of the 5% Notes remained outstanding.

In accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," the exchange of the 4-1/2% Convertible Subordinated Notes into $53.2 million of the 12% Senior Subordinated Notes and $2.8 million of the 8% Convertible Senior Subordinated Notes was accounted for as a troubled debt restructuring. Since the total liability of $57.4 million ($57.9 million of principal as of the exchange date, less cash payments of $0.5 million) is less than the future cash flows to holders of 8% Convertible Senior Subordinated Notes and 12% Senior Subordinated Notes of $91.5 million (representing the $56.0 million of principal and $35.5 million of future interest expense), the liability remained on the balance sheet at $57.4 million as long-term debt. The difference of $1.4 million between principal and the carrying amount is being recognized as a reduction of interest expense over the life of the new notes.

The Company reacquired $9.4 million of 12% Senior Subordinated Notes during the three months ended March 31, 2003 at a $2.2 million discount from face amount. This amount, in accordance with Statement of Financial Accounting Standards ("SFAS") No. 145, "Rescission of FASB Statements No. 4, 44, and 64,

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Amendment of FASB Statements No. 13, and Technical Corrections as of April 2002," is reported as other income in the consolidated statement of operations. There was no such item in the comparable period. In the second quarter of 2003 through May 14, the Company has reacquired an additional $4.1 million of 12% Senior Subordinated Notes at a $0.2 million discount from face amount.

(B) 5% CONVERTIBLE SUBORDINATED NOTES DUE 2004

As of March 31, 2003, the Company had $0.7 million principal amount outstanding of its 5% Convertible Subordinated Notes that mature on December 15, 2004. Interest on these notes is due and payable semiannually on June 15 and December 15. The notes are convertible, at the option of the holder, at a conversion price of $76.14 per share. The 5% Convertible Subordinated Notes are redeemable, in whole or in part at the Company's option, at 101.43% of par prior to December 14, 2003 and 100.71% of par thereafter.

(C) 8% SECURED CONVERTIBLE NOTES DUE 2006

In September 2001, the Company restructured its financial obligations with America Online, Inc. ("AOL") that arose under the Investment Agreement entered into on January 5, 1999 and, effective September 30, 2001, also ended its marketing relationship with AOL (collectively the "AOL Restructuring"). In connection with the AOL Restructuring, the Company and AOL entered into a Restructuring Agreement pursuant to which the Company issued to AOL $54.0 million principal amount of its 8% Secured Convertible Notes. The 8% Secured Convertible Notes were issued in exchange for a release of the Company's reimbursement obligations under the Investment Agreement. AOL, in lieu of any other payment for the early discontinuance of the marketing relationship, paid the Company, at the time of the AOL Restructuring, $20.0 million by surrender and cancellation of $20.0 million principal amount of the 8% Secured Convertible Notes delivered to AOL, thereby reducing the outstanding principal amount of the 8% Secured Convertible Notes to $34.0 million.

The 8% Secured Convertible Notes are convertible into shares of the Company's common stock at the rate of $15.00 per share and may be redeemed by the Company at any time without premium. The 8% Secured Convertible Notes accrue interest at the rate of 8% per year on the principal amount, payable semiannually on January 1 and July 1. The 8% Secured Convertible Notes are guaranteed by the Company's principal operating subsidiaries and are secured by a pledge of the Company's and the subsidiaries' assets. In addition, AOL, as the holder of the 8% Secured Convertible Notes, entered into an intercreditor agreement with the lender under the Company's existing secured credit facility, which survives the early retirement of debt under the Company's Senior Credit Facility.

On December 23, 2002, by letter agreement, the Company and AOL amended certain provisions of the Restructuring Agreement between them (the "Amendment"). Pursuant to the Amendment, the maturity date for the 8% Secured Convertible Notes issued under the Restructuring Agreement was advanced to September 19, 2006 (four days later than the first date of mandatory redemption at the option of the holder) from 2011, and the Company's right to elect to pay a portion (50%) of the interest on the 8% Secured Convertible Notes in kind rather than in cash was eliminated.

In addition, the Amendment provided that certain limitations on the Company's purchase of its outstanding subordinated indebtedness ("Sub Debt") and common stock were amended, to permit the Company, through September 30, 2003, to: (i) repurchase outstanding Sub Debt provided it does not pay more than 80% of the face amount and, for every dollar used to repurchase Sub Debt, it repurchases $0.50 of principal amount of 8% Secured Convertible Notes from AOL; and (ii) purchase shares of its common stock, provided it purchases the shares at or below market value and it concurrently purchases an equal number of shares of common stock from AOL. The aggregate amount that the Company may utilize with respect to both the repurchase of Sub Debt and of common stock cannot exceed $10 million.

As a consequence of the Amendment and the repurchase of $4.1 million of the 8% Secured Convertible Notes in the fourth quarter of 2002, the Company recorded an extraordinary non-cash gain of $28.9 million from the decrease in the future accrued interest relating to the 8% Secured Convertible Notes which was reflected as a $28.9 million reduction in long-term debt. As a further consequence, the Company began recording the interest expense associated with the 8% Secured Convertible Notes in its consolidated statement of operations.

In the quarter ended March 31, 2003, the Company repurchased $3.6 million of the 8% Secured Convertible Notes. In addition, the Company purchased 1,315,789 of its common shares from AOL at a per share price of $3.80, the average closing price for the five days ended January 15, 2003. As of March 31, 2003, the aggregate amount remaining that the Company may utilize with respect to the repurchase of both Sub Debt and common stock under the terms of the Amendment was $1.4 million.

In the second quarter of 2003, through May 14, in connection with its acquisition of $4.1 million principal amount of 12% Senior Subordinated Notes, as discussed above, the Company has reacquired an additional $4.1 million of 8% Secured Convertible Notes at par, leaving outstanding $22.5 million principal amount of the 8% Secured Convertible Notes.

NOTE 3. LEGAL PROCEEDINGS

The Company is party to a number of legal actions and proceedings, including purported class actions, arising from the Company's provision and marketing of telecommunications services, as well as certain legal actions and regulatory investigations and enforcement proceedings arising in the ordinary course of business. Recently, the Company has been made aware that AOL has agreed to settle a class action case for approximately $10 million; the claims in the case allegedly relate to marketing activities conducted pursuant to the Telecommunications Marketing Agreement, by and between the Company, Talk America Inc. and AOL, dated as of February 22, 1997, as amended (the "Marketing Agreement"). AOL has asserted that the Company is required to indemnify AOL in this matter under the terms of the Marketing Agreement and advised that it will seek such indemnification from the Company. The Company believes that it does not have an obligation to indemnify AOL in this matter and that any claim by AOL for this indemnification would be without merit. The Company intends, if AOL pursues a claim for indemnification under the Marketing Agreement, to defend the claim vigorously. The Company believes that the ultimate outcome of the foregoing actions will not result in liability that would have a material adverse effect on the Company's financial condition or results of operations.

NOTE 4. STOCK-BASED COMPENSATION

The following disclosure complies with the adoption of SFAS No. 123, amended by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123," and includes pro forma net loss as if the fair value based method of accounting had been applied:

	Three Months Ended March 31,	
	2003	2002
Net income as reported	$9,126	$8,130
Stock-based employee compensation expense included in reported net income	--	--
Total stock-based employee compensation expense determined under fair value based method for all options	206	1,246

Pro forma net income	$8,920	$6,884

	Three Months Ended March 31,	
	2003	2002
BASIC EARNINGS PER SHARE:		
As reported	$0.35	$0.30
Pro forma	$0.34	$0.25
DILUTED EARNINGS PER SHARE:		
As reported	$0.32	$0.28
Pro forma	$0.31	$0.23

For purposes of pro forma disclosures under SFAS 123, the estimated fair value of the options is assumed to be amortized to expense over the options' vesting period. The fair value of the options granted has been estimated at the

various dates of the grants using the Black-Scholes option-pricing model with the following assumptions:

- Fair market value based on the Company's closing common stock price on the date the option is granted;
- Risk-free interest rate based on the weighted averaged 5 year U.S. treasury note strip rates;
- Volatility based on the historical stock price over the expected term (5 years);
- No expected dividend yield based on future dividend payment plans.

NOTE 5. PER SHARE DATA

Basic earnings per common share for a fiscal period is calculated by dividing net income by the weighted average number of common share outstanding during the fiscal period. Diluted earnings per common share is calculated by adjusting the weighted average number of common shares outstanding and the net income during the fiscal period for the assumed conversion of all potentially dilutive stock options, warrants and convertible bonds (and assuming that the proceeds hypothetically received from the exercise of dilutive stock options are used to repurchase shares at the Company's average share price during the fiscal period). For the diluted earnings calculation, the net income is adjusted by the interest expense on the convertible bonds assumed to be converted. Earnings per share are computed as follows (in thousands except per share data):

	THREE MONTHS ENDED,	
	2003	2002
Net income used to compute basic earnings per share	$ 9,126	$ 8,130
Interest expense on convertible bonds, net of tax affect	319	--
Net income used to compute diluted earnings per share	$ 9,445	$ 8,130

Average shares of common stock outstanding used to compute basic earnings per share	26,376	27,185
Additional common shares to be issued assuming exercise of stock options and warrants (net of shares assumed reacquired) and conversion of convertible bonds *	3,564	2,275
Average shares of common and common equivalent stock outstanding used to compute diluted earnings per share	29,940	29,460
Income per share - Basic:		
Net income per share	$ 0.35	$ 0.30
Weighted average common shares	26,376	27,185
Income per share - Diluted:		
Net income per share	$ 0.32	$ 0.28
Weighted average common and common equivalent shares outstanding	29,940	29,460

* The diluted share basis for the three months ended March 31, 2003 and 2002 excludes 9 and 1,078 shares, respectively, associated with the convertible bonds and 2,184 and 2,933 shares, respectively, associated with the options and warrants due to their antidilutive effect.

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ITEM 2. 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-Q and in the Company's Annual Report on Form 10-K filed March 31, 2003 and any subsequent filings. Certain of the statements contained herein may be considered forward-looking statements. Such statements are identified by the use of forward-looking words or phrases, including, but not limited to, "estimates," "expects," "expected," "anticipates," and "anticipated." These forward-looking statements are based on the Company's current expectations. Although the Company believes 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.

Forward-looking statements involve risks and uncertainties and the Company's actual results could differ materially from the Company's expectations. In addition to those factors discussed in the Company's Annual Report on Form 10-K filed March 31, 2003, the Company's other filings with the Securities and Exchange Commission and below in the following discussion, important factors that could cause such actual results to differ materially are discussed in Note 1 of the Notes to Consolidated Financial Statements, above.

OVERVIEW

The Company provides local and long distance telecommunication services to residential and small business customers in the United States. The Company has developed integrated order processing, provisioning, billing, payment, collection, customer service and information systems. These proprietary systems, along with attractive wholesale pricing, enable the Company to offer savings through competitively priced service plans, high-quality service and simplicity through consolidated billing and responsive customer care.

The Company offers both local and long distance telecommunication services, primarily a bundled offering of local and long distance voice services, which are billed to customers in one combined invoice. Local phone services include local dial tone, various local calling plans that include free member-to-member calling, and a variety of features such as caller identification, call waiting and three-way calling. Long distance phone services include traditional 1+ long distance, international and calling cards. The Company uses the unbundled network element platform ("UNE-P") of the regional bell operating companies ("RBOCs") network to provide local services and the Company's nationwide network to provide long distance services. The Federal Communications Commission ("FCC") has recently concluded its triennial review of local phone competition. Although the text of the order is not yet available, the decision appears to preserve the Company's ability to use UNE-P for the provision of bundled telecommunications services pending further market-by-market analyses by the respective state commissions.

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RESULTS OF OPERATIONS

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

	THREE MONTHS ENDED MARCH 31, 2003	THREE MONTHS ENDED MARCH 31, 2002
Sales	100.0%	100.0%
Costs and expenses:		
Network and line costs	50.0	50.6
General and administrative expenses	15.3	18.3
Provision for doubtful accounts	2.5	5.1
Sales and marketing expenses	10.0	7.4
Depreciation and amortization	4.9	5.6
Total costs and expenses	82.7	87.0
Operating income	17.3	13.0
Other income (expense):		
Interest income	0.1	0.1
Interest expense	(2.8)	(1.9)
Other, net	2.4	(1.0)
Income before income taxes	17.0	10.2
Provision for income taxes	6.6	--
Net income	10.4%	10.2%

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QUARTER ENDED MARCH 31, 2003 COMPARED TO QUARTER ENDED MARCH 31, 2002

Sales. Sales increased by 10.6% to $87.8 million for the quarter ended March 31, 2003 from $79.4 million for the quarter ended March 31, 2002. The increase in sales is due to higher bundled sales offset by lower long distance sales resulting from the Company's continued focus, begun in 2000, on its efforts in the local telecommunication services market by offering local telecommunication services bundled with long distance services and significantly reduced sales and marketing related to the long distance product.

The Company's bundled sales for the quarter ended March 31, 2003 were $60.2 million as compared to $35.5 million for the quarter ended March 31, 2002. The increase in sales was due to higher average bundled lines in 2003 as compared to 2002, partially offset by lower average monthly revenue per customer. The overall increase resulted from the Company's ongoing strategy to market lower priced products to be more competitive with incumbent and other competitive local exchange carriers. The quarter ended March 31, 2003 also reflected both growth in bundled lines and reductions in customer turnover. The Company had approximately 402,300 bundled lines as of March 31, 2003 as compared to approximately 193,700 bundled lines at March 31, 2002. Approximately 269,000 of the bundled lines at March 31, 2003 were in Michigan. Long term growth in revenues will depend upon the Company's ability to develop and scale various marketing programs in additional states or areas, maintain the current level of customer turnover and maintain operating efficiencies.

The Company's long distance sales decreased to $27.7 million for the quarter ended March 31, 2003 from $43.9 million for the quarter ended March 31, 2002. The Company's decision to focus on the bundled product, together with customer turnover, contributed to the decline in long distance customers and revenues. This decline in long distance customers and revenues is expected to continue so long as the Company continues to focus its marketing efforts on the bundled product. Long distance revenues for the quarter ended March 31, 2002 included non-cash amortization of deferred revenue of $1.9 million 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.

During the quarter ended March 31, 2003 the Company selectively increased certain fees and rates related to its long distance and bundled products and such changes in rates and bill presentation may adversely impact customer turnover. The Federal Trade Commission and the Federal Communications

Commission have proposed rules and regulations governing the creation and enforcement of national "do not call" databases that could affect the Company's ability to outbound telemarket, which is currently an important sales channel for the Company.

Network and Line Costs. Network and line costs increased by 9.1% to $43.9 million for the quarter ended March 31, 2003 from $40.2 million for the quarter ended March 31, 2002. The increase in costs was primarily due to an increase in bundled customers, partially offset by a decrease in long distance customers and favorable resolution of disputes with vendors. As a percentage of sales, network and line costs decreased to 50.0% for the quarter ended March 31, 2003, as compared to 50.6% for the quarter ended March 31, 2002. The lower total network and line costs as a percentage of sales were due primarily to a decrease in the bundled network and line costs as a percentage of sales for the bundled product.

This decrease was partially offset by a shift in the Company's sales to the higher cost bundled product. Bundled network and line costs as a percentage of sales decreased to 53.4% for the quarter ended March 31, 2003, as compared to 63.8% for the quarter ended March 31, 2002. Long distance network and line costs as a percentage of sales increased to 42.6% for the quarter ended March 31, 2003, as compared to 39.9% for quarter ended March 31, 2002. Network and line costs for the quarter ended March 31, 2003 included carrier billing credits for disputed amounts of approximately $0.8 million for bundled and $0.3 million for long distance network and line costs as compared to approximately $0.6 and $0.2 million, respectively, for the quarter ended March 31, 2002. There are several factors that could cause network and line costs as a percentage of sales to increase in the future, including (i) adverse changes to the current rules and regulations or adverse judicial or administrative interpretations and rulings or legislative action relating to (a) the FCC's recently concluded triennial review of local phone competition and the pending market-by-market analyses by the respective state commissions, or (b) prices the Company pays for UNEs and UNE-P, (ii) greater absorption of fixed network costs as the Company's long distance customer base declines, and (iii) certain minimum network service commitments relating to the Company's long distance network. Changes in the pricing of the Company's service plans could also cause network and line costs as a percentage of sales to change in the future. See "Liquidity and Capital Resources, Other Matters."

General and Administrative Expenses. General and administrative expenses decreased by 7.5% to $13.5 million, or 15.3% of sales, for the quarter ended March 31, 2003 from $14.6 million, or 18.3% of sales, for the quarter ended March 31, 2002. The overall decrease in general and administrative expenses was due primarily to a reduction in costs associated with collection of delinquent customer accounts. Due to improved credit screening procedures and internal collection efforts, the Company has substantially reduced its delinquent customer account balances and therefore its expenses associated with collection of these accounts. The decrease was also due to significant workforce reductions and other cost cutting efforts by the Company as it pursued improvements in operating efficiencies of the Company's bundled business model. While the Company expects general and administrative expense as a percentage of sales 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 the Company will be able to realize these efficiencies.

Provision for Doubtful Accounts. Provision for doubtful accounts decreased by 44.5% to $2.2 million for the quarter ended March 31, 2003 from $4.0 million for the same quarter last year, and, as a percentage of sales, decreased to 2.5% as compared to 5.1% for the quarter ended March 31, 2002. The provision for doubtful accounts for the quarter ended March 31, 2002 reflected a benefit from the reversal of the reserve for doubtful accounts of $1.0 million due to better than expected collections experience on outstanding accounts receivable at year-end 2001. The Company continues to experience improved collections results due to several steps during the third and fourth quarters of 2001 to reduce bad debt expense, improve the overall credit quality of its customer base and increase its collections of past due amounts. The benefits of the Company's actions to reduce bad debt expense and improve the overall credit quality of its customer base are reflected in the lower bad debt expense for the quarter ended March 31, 2003. In general, the Company believes that bad debt expense as a percentage of sales of the Company's long distance customers is lower than that of its bundled customers because of the relatively greater maturity of the long distance customer base.

Sales and Marketing Expenses. During the quarter ended March 31, 2003, the Company incurred $8.8 million of sales and marketing expenses as compared to $5.9 million for the same quarter last year, a 49.1% increase, and, as a percentage of sales, an increase to 10% as compared to 7.4% for the quarter ended March 31, 2002. The increase in expense is primarily attributable to increased levels of sales and marketing activity to continue the Company's bundled sales growth. Currently, substantially all of the sales and marketing expenses relate to the bundled product. Sales and marketing expenses are expected to increase in 2003 as the Company continues to target growth in the bundled product and invest in the development of its marketing programs.

Depreciation and Amortization. Depreciation and amortization for the quarter ended March 31, 2003 was $4.3 million, a decrease of $0.1 million compared to $4.4 million for quarter ended March 31, 2002, and, as a percentage of sales, decreased to 4.9% as compared to 5.6% for the quarter ended March 31, 2002.

Interest Income. Interest income was $0.1 million for each of the quarter ended March 31, 2003 and the quarter ended March 31, 2002.

Interest Expense. Interest expense was $2.5 million for the quarter ended March 31, 2003 as compared to $1.5 million for the quarter ended March 31, 2002. The increase is due to higher interest expense associated with the issuance of the Company's 12% Senior Subordinated Notes and 8% Convertible Senior Subordinated Notes issued in connection with the exchange offer completed on April 4, 2002 (see Note 2 of Notes to Consolidated Financial Statements). In addition, as a result of the restructuring agreement with AOL on December 23, 2002, the Company began recording the interest expense associated with the 8% Secured Convertible Notes on its consolidated statement of operations during the first quarter ended March 31, 2003. There was no interest expense recorded with respect to the 8% Secured Convertible Notes in the quarter ended March 31, 2002, as the notes were accounted for as a troubled debt restructuring. The increase was partially offset by the retirement on October 4, 2002 by the principal operating subsidiaries of the Company, prior to maturity, of all the debt outstanding under the Senior Credit Facility Agreement between the subsidiaries and MCG Finance Corporation ("MCG") and by the repurchase of 12% Senior Subordinated Notes and 8% Convertible Senior Subordinated Notes.

Other Income and Expense, Net. Net other income was $2.2 million for the quarter ended March 31, 2003 compared to net other expense of $0.8 million for the quarter ended March 31, 2002. The amount for the quarter ended March 31, 2003 consists of gains from the repurchase of a portion of the Company's 12% Senior Subordinated Notes at a discount to par. The amount for the quarter ended March 31, 2002 primarily consisted of cost in connection with the Company's restructuring of its convertible subordinated notes (see Note 2 of Notes to Consolidated Financial Statements).

Provision for Income Taxes. For the quarter ended March 31, 2003, the Company recorded income tax expense of $5.8 million, an effective tax rate of 39%, but as a result of the application of net operating loss carryforwards, the Company need only pay accrued alternative minimum taxes and state income taxes of $0.4 million for income earned in the quarter ended March 31, 2003. At March 31, 2002, since the amounts and extent of the Company's future earnings were not determinable with a sufficient degree of probability to recognize the deferred tax assets in accordance with the requirements of Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes", the Company recorded a full valuation allowance on the net deferred tax assets and, as a result, no provision for income taxes was reflected on the statement of operations. Management will review the valuation allowance during 2003 to determine whether the remaining valuation allowance should be reversed or portion thereof. There can be no assurances that the Company will realize the full benefit of the net operating loss carryforwards on future taxable income generated by the Company due to the "change of ownership" provisions of the

Internal Revenue Code Section 382 (see "Liquidity and Capital Resources, Other Matters").

LIQUIDITY AND CAPITAL RESOURCES

The Company's cash requirements arise primarily from its subsidiaries' operational needs, its subsidiaries' capital expenditures and the debt service obligations of the Company. Since Talk America Holdings, Inc. conducts all of its operations through its subsidiaries, primarily Talk America Inc., it relies on dividends, distributions and other payments from its subsidiaries to fund its obligations.

Contractual obligations of the Company as of March 31, 2003 are summarized by years to maturity as follows (in thousands):

Contractual Obligations (1)	Total	1 year or less	2 - 3 Years	4 - 5 Years	Thereafter
Talk America Holdings, Inc.:					
8% Secured Convertible Notes due 2006	$ 26,552	$ --	$ --	$ 26,552	$ --
12% Senior Subordinated Notes due 2007	56,620	--	--	56,620	--
8% Convertible Senior Subordinated Notes due 2007 (2)	3,973	--	--	3,973	--
5% Convertible Subordinated Notes due 2004	670	--	670	--	--
Talk America Inc. and other subsidiaries:					
Capital lease obligations	73	62	11	--	--
	$ 87,888	$ 62	$ 681	$ 87,145	$ --
Operating leases	4,744	1,626	2,352	619	147
Total Contractual Obligations	$ 92,632	$1,688	$3,033	$ 87,764	$ 147

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(1) Excluded from these contractual obligations are various network service agreements for long distance services that contain certain minimum usage commitments. The largest contract establishes pricing and provides for revenue commitments based upon usage of $52 million for the 18 months ended February 2004 and $40 million for the 9 months ended December 2004. This contract obligates the Company to pay 65 percent of the shortfall, if any. A separate contract with a different vendor establishes pricing and provides for annual minimum payments for the years ended December 31, as follows: 2003 - $6.0 million and 2004 - $3.0 million. While the Company anticipates that it will not be required to make any shortfall payments under these contracts as a result of (1) growth in network minutes, (2) the management of traffic flows on its network, (3) the restructuring of these obligations, and/or (4) the sale of

additional minutes of usage from the wholesale or other long distance markets, there can be no assurances that the Company will be successful in its efforts. In addition, these actions will likely cause the Company to experience an increase in per minute network costs.

(2) The 8% Convertible Senior Subordinated Notes include $2.8 million of principal and $1.2 million of future accrued interest (see Note 2 of the Notes to Consolidated Financial Statements).

The Company relies on internally generated funds and cash and cash equivalents on hand to fund its capital and financing requirements. The Company had $29.0 million of cash and cash equivalents as of March 31, 2003, and $22.9 million as of March 31, 2002.

Net cash provided by operating activities was $14.6 million for the quarter ended March 31, 2003 as compared to $4.6 million for the quarter ended March 31, 2002. For the quarter ended March 31, 2003, the major contributors to the net cash provided by operating activities were net income of $9.1 million and

non-cash charges of $10.1 million, primarily consisting of depreciation and amortization of $4.3 million and deferred income taxes of $5.5 million. Net cash provided by operating activities also consisted of decreases in prepaid expenses of $0.4 million, other assets of $1.1 million, primarily from repayment of a related party loan, and an increase in deferred revenue of $1.1 million for advance customer billings. These amounts were offset by an increase in accounts receivable of $5.3 million, a decrease in other liabilities of $2.6 million, primarily consisting of a reduction of interest payable, and increases in prepaid expenses and other current and non-current assets of $1.5 million. For the quarter ended March 31, 2002, the major contributors to the net cash provided by operating activities were net income of $8.1 million and non-cash charges of $8.7 million, primarily consisting of provision for doubtful accounts of $4.0 million, and depreciation and amortization of $4.4 million. These 2002 amounts were offset by an increase in accounts receivable of $0.6 million and a decrease in accounts payable of $10.3 million.

Net cash used in investing activities was $3.4 million during the quarter ended March 31, 2003, consisting of capitalized software development costs of $0.7 million and capital expenditures primarily for the purchase of equipment of $2.7 million. Net cash used in investing activities of $0.8 million during the quarter ended March 31, 2002 consisted primarily of capitalized software development costs of $0.6 million. The remaining balance related to purchase of property, equipment and intangibles. The Company expects to incur capital expenditures of between $10 and $12 million and capitalized software development costs of between $2 and $3 million in 2003.

The FCC has recently concluded its triennial review of local phone competition. Although the text of the order is not yet available, the decision appears to preserve the Company's ability to use UNE-P for the provision of bundled telecommunications services pending further market-by-market analyses by the respective state commissions. Changes to the current rules and regulations or adverse judicial or administrative interpretations and rulings or legislative action relating thereto that result in any curtailment in the availability of or the prices for the local switching UNE could require the Company to significantly increase its capital expenditures. (See "Liquidity and Capital Resources, Other Matters").

Net cash used in financing activities for the quarter ended March 31, 2003 was primarily attributable to repurchases of $9.4 million of the Company's 12% Senior Subordinated Notes and $3.6 million of the Company's 8% Secured

Convertible Notes, respectively, for a total of $10.8 million. The discount from face amount is reported as other income in the consolidated statement of operations for the quarter ended March 31, 2003. In connection with the share buyback program of $10 million or 2,500,000 shares announced in January 2003, cash used in financing activities also consisted of the repurchase of 1,315,789 shares of its common shares from AOL at a per share price of $3.80 (the average closing price for the five days ended January 15, 2003). The aggregate purchase price was approximately $5.0 million. For the quarter ended March 31, 2002, the net cash used in financing activities was primarily attributable to payment of borrowings under the Company's credit facility of $1.3 million, payments under 2011 Convertible Notes of $1.2 million and payments under capital lease obligations.

The Company generally does not have a significant concentration of credit risk with respect to net trade accounts receivable, due to the large number of end-users comprising the Company's customer base.

OTHER MATTERS

The Company's provision of telecommunication services is subject to government regulation. Changes in existing regulations could have a material adverse effect on the Company. The Company's local telecommunication services are provided almost exclusively through the use of RBOC Unbundled Network Elements ("UNE"), and it is primarily the availability of cost-based UNE rates that enables the Company to price its local telecommunications services competitively. On December 12, 2001, the FCC initiated its so-called UNE Triennial Review rulemaking in which it was to review all UNEs and determine whether RBOCs should continue to be required to provide them to competitors. The FCC has recently concluded its Triennial Review of local phone competition. Although the text of the order is not yet available, the decision appears to preserve the Company's ability to use UNE-P for the provision of bundled telecommunications services pending further market-by-market analyses by the respective state commissions. Changes to the current rules and regulations or adverse judicial or administrative interpretations and rulings or legislative action relating thereto that result in any curtailment in the availability of the local switching UNE or increase in costs that RBOCs may charge for such elements would materially impair the Company's ability to provide local telecommunications services. Such changes could eliminate the Company's capability to provide local telecommunications services entirely unless the Company is able to utilize another technology, which may not be available or

available on economically feasible terms, or the Company purchases, builds and implements its own local switching network, which would require significant additional capital expenditures by the Company.

At December 31, 2002, the Company had net operating loss ("NOL") carryforwards for federal income tax purposes of approximately $262 million. Due to the "change of ownership" provisions of the Internal Revenue Code Section 382, the availability of the Company's net operating loss and credit carryforwards may be subject to an annual limitation against taxable income in future periods if a change of ownership of more than 50% of the value of the Company's stock should occur within a three-year testing period. Many of the changes that affect these percentage change determinations, such as changes in the Company's stock ownership, are outside the Company's control. A more-than-50% cumulative change in ownership for purposes of the Section 382 limitation occurred on August 31, 1998 and October 26, 1999. As a result of such changes, certain of the Company's carryforwards are limited. As of December 31, 2002, approximately $15 million of NOL carryforwards were limited to offset future income. In addition, based on information currently available to the

Company, the Company believes that the change of ownership percentage was approximately 38% for the currently applicable three-year testing period. If, during the current three-year testing period, the Company experiences an additional more-than-50% ownership change under Section 382, the amount of the NOL carryforward available to offset future taxable income may be further and substantially reduced. To the extent the Company's ability to use these net operating loss carryforwards against any future income is limited, its cash flow available for operations and debt service would be reduced. There can be no assurance that the Company will realize the full benefit of the carryforwards.

The Company is party to a number of legal actions and proceedings, including purported class actions, arising from the Company's provision and marketing of telecommunications services, as well as certain legal actions and regulatory investigations and enforcement proceedings arising in the ordinary course of business. Recently, the Company has been made aware that AOL has agreed to settle a class action case for approximately $10 million; the claims in the case allegedly relate to marketing activities conducted pursuant to the Marketing Agreement. AOL has asserted that the Company is required to indemnify AOL in this matter under the terms of the Marketing Agreement and advised that it will seek such indemnification from the Company. The Company believes that it does not have an obligation to indemnify AOL in this matter and that any claim by AOL for this indemnification would be without merit. The Company intends, if AOL pursues a claim for indemnification under the Marketing Agreement, to defend the claim vigorously. The Company believes that the ultimate outcome of the foregoing actions will not result in liability that would have a material adverse effect on the Company's financial condition or results of operations.

While the Company believes that it has access, albeit limited, to new capital in the public or private markets to fund its 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 the Company. Accordingly, the Company anticipates that its cash requirements generally must be met from the Company's cash-on-hand and from cash generated from operations. Based on its current projections for operations, the Company believes that its cash-on-hand and its cash flow from operations will be sufficient to fund its currently contemplated capital expenditures, its debt service obligations, including the increased interest expense of its outstanding indebtedness, and the expenses of conducting its operations for at least the next twelve months. However, there can be no assurance that the Company will be able to realize its projected cash flows from operations, which is subject to the risks and uncertainties discussed above, or that the Company will not be required to consider capital expenditures in excess of those currently contemplated, as discussed above.

CRITICAL ACCOUNTING POLICIES

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's 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 the Company 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, the Company evaluates its estimates, including those related to bad debt, goodwill and intangible assets, income taxes, contingencies and litigation. The Company bases its 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.

RECOGNITION OF REVENUE

The Company derives its revenues from local and long distance phone services, primarily local services bundled with long distance services, long distance services, inbound toll-free service and dedicated private line services for data transmission. The Company recognizes revenue from voice, data and other telecommunications related services in the period in which subscriber uses the related service.

Deferred revenue represents the unearned portion of local telecommunication services and features that are billed one month in advance. In addition, deferred revenue at March 31, 2002 included a non-refundable prepayment received in 1997 in connection with an amended telecommunications services agreement with Shared Technologies Fairchild, Inc. The payment was amortized over the five-year term of the agreement, which expired in October 2002. The amount included in revenue was $1.9 million in the quarter ended March 31, 2002.

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. The Company reviews 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. If the financial condition of the Company's carriers that pay access charges were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. The Company's accounts receivable balance was $31.0 million, net of allowance for doubtful accounts of $7.3 million, as of March 31, 2003.

VALUATION OF LONG-LIVED ASSETS AND INTANGIBLE ASSETS WITH A DEFINITE LIFE

The Company reviews 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, the Company compares the carrying amount of the assets to the undiscounted expected future cash flows from them. Factors the Company considers 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 the Company's use of the acquired assets or the strategy for the Company's overall business
- Significant negative industry or economic trends
- Significant decline in the Company's 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; the Company determined that it has 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.

SOFTWARE DEVELOPMENT COSTS

Direct development costs associated with internal-use computer software are accounted for under Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," and are capitalized including external direct costs of material and services and payroll costs for employees devoting time to the software projects. Costs incurred during the preliminary project stage, as well as for maintenance and training, are expensed as incurred. Amortization is provided on a straight-line basis over the shorter of 3 years or the estimated useful life of the software.

INCOME TAXES

Income taxes are accounted for under the asset and liability method. During the quarter ended March 31, 2003, the Company recorded income taxes at a rate equal to the Company's combined federal and state effective rates. However, to the extent of available net operating loss carryforwards, the Company is shielded from paying cash income taxes for several years, other than alternative minimum taxes and some state taxes.

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.

The Company recorded a valuation allowance to reduce its deferred tax assets in an amount that is more likely than not to be realized. The Company provided a valuation allowance of $66.7 million for the net deferred tax assets for the estimated future tax effects attributable to temporary differences between the basis of assets and liabilities for financial and tax reporting purposes as of March 31, 2003. In the event the Company were to determine that it would be able to realize all deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made. In 2002, as part of the Company's 2003 budgeting process, management evaluated the deferred tax valuation allowance and determined that a portion of this valuation allowance should be reversed, resulting in a non-cash deferred income tax benefit of $22.3 million. Management will evaluate the deferred tax valuation allowance again in 2003 to determine whether the remaining valuation allowance or portion thereof should be reversed.

LEGAL PROCEEDINGS

The Company is a party to a number of legal actions and proceedings arising from the Company's provision and marketing of telecommunications services, as well as certain legal actions and regulatory investigations and enforcement proceedings arising in the ordinary course of business. Management's current estimated range of liability related to some of the pending litigation is based on claims for which management can estimate the amount and range of loss. The Company recorded the minimum estimated liability related to those claims, where there is a range of loss. Because of the uncertainties related to both the amount and range of loss on the remaining pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, the Company will assess the potential liability related to the Company's pending litigation and revise its estimates. Such revisions in the Company's estimates of the potential liability could materially affect its results of operations and financial position.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

In the normal course of business, the financial position of the Company is subject to a variety of risks, such as the collectibility of its accounts receivable and the receivability of the carrying values of its long-term assets. The Company's long-term obligations consist primarily of long term debt with fixed interest rates. The Company does not presently enter into any transactions involving derivative financial instruments for risk management or other purposes.

The Company's available cash balances are invested on a short-term basis (generally overnight) and, accordingly, are not subject to significant risks associated with changes in interest rates. Substantially all of the Company's

cash flows are derived from its operations within the United States and the Company is not subject to market risk associated with changes in foreign exchange rates.

ITEM 4. CONTROLS AND PROCEDURES

Within the 90-day period prior to the filing of this report, an evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the Company's disclosure controls and procedures. Based on that evaluation, the CEO and CFO have concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Subsequent to the date of their evaluation, there were no significant changes in the Company's internal controls or in other factors that could significantly affect the disclosure controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART II - OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.1 Employment Agreement between the Company and Helen Manich dated April 14, 2003 (filed herewith).*

10.2 Indemnification Agreement between the Company and Helen Manich dated April 14, 2003 (filed herewith).*

10.3 Amendment to Employment Agreement for Kevin Griffo dated April 10, 2003 (filed herewith).*

10.4 Amendment to Employment Agreement for Warren Brasselle dated May 14, 2002 (filed herewith).*

99.1 Certification of Gabriel Battista Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished to the Commission herewith).

99.2 Certification of David G. Zahka Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished to the Commission herewith).

* Management contract or compensatory plan or arrangement.

(b) Reports on Form 8-K

The following Current Reports on Form 8-K were filed by the Company during the three months ended March 31, 2003

1. Current Report on Form 8-K dated January 20, 2003, reporting authorization of a share buyback program and the waiver of certain provisions of the Company's Restructuring Agreement with America Online, Inc.

2. Current Report on Form 8-K dated February 6, 2003, furnishing the Company's earnings press release for the quarter and year ended December 31, 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TALK AMERICA HOLDINGS, INC.

Date: May 14, 2003

By: /s/ Gabriel Battista

Gabriel Battista
Chairman of the Board of Directors,
Chief Executive Officer and Director

Date: May 14, 2003

By: /s/ David G. Zahka

David G. Zahka
Chief Financial Officer
(Principal Financial Officer)

Date: May 14, 2003

By: /s/ Thomas M. Walsh

Thomas M. Walsh
Senior Vice President - Finance
(Principal Accounting Officer)

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CERTIFICATIONS

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Gabriel Battista, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Talk America Holdings, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

May 14, 2003

/s/ Gabriel Battista

Gabriel Battista
Chief Executive Officer

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CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, David G. Zahka, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Talk America Holdings, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

May 14, 2003

/s/ David G. Zahka

David G. Zahka
Chief Financial Officer