TALK AMERICA HOLDINGS INC
Form 10-K/A
March 30, 2005

The following items were the subject of a Form 12b-25 and are included herein: Item 6, Item 7, Item 8, Item 9A, Item 15-Financial Statement Schedules and Exhibits 23, 31 and 32.

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, 2004
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. [X]

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

As of June 30, 2004, 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, 2004 of $7.73 per share as reported on the Nasdaq National Market, was approximately $206,312,664 (calculated by excluding solely for purposes of this form outstanding shares owned by directors and executive officers).

As of March 11, 2005, the registrant had issued and outstanding 27,078,605 shares of common stock, par value $.01 per share.

DOCUMENTS INCORPORATED BY REFERENCE

None.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES

INDEX TO FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2004

Unless the context otherwise requires, references to "us," "we," and "our" or to "Talk America" refer to Talk America Holdings, Inc. and its subsidiaries.

PART II

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 Strategies,” "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 subsequently 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.

ITEM 6. SELECTED 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. Please note that the selected financial data below, our Consolidated Financial Statements included elsewhere in this Form 10-K and the discussion in our "Management's Discussion and Analysis of Financial Condition and Results of Operations" reflect the restatement, discussed in Item 9A of Part II of this Form 10-K, of our consolidated financial statements for the four quarters and the year ended December 31, 2003 by our Amendment No. 2 on Form 10-K/A to our Annual Report on Form 10-K for the year ended December 31, 2003, which Amendment No. 2 was filed with the Securities and Exchange Commission on March 28, 2005.

	Year Ended December 31,				
	2004	**2003**	**2002**	**2001**	**2000**
	(In Thousands, Except For Per Share Amounts)				
Consolidated Statements of Operations Data:					
Revenue	$ 471,012	$ 383,693	$ 317,507	$ 488,158	$ 525,712
Costs and expenses:					
Network and line costs	225,244	173,349	146,911	218,964	272,208
General and administrative expenses	72,020	63,104	62,166	98,391	86,083
Provision for doubtful accounts	21,313	11,599	9,365	92,778	53,772
Sales and marketing expenses	70,202	51,008	27,148	73,973	152,028
Depreciation and amortization	22,904	18,345	17,318	34,390	19,257
Impairment and restructuring charges	--	--	--	170,571	--
Total costs and expenses	411,683	317,405	262,908	689,067	583,348
Operating income (loss)	59,329	66,288	54,599	(200,909)	(57,636)
Other income (expense):					
Interest income	290	388	802	1,220	4,859
Interest expense	(733)	(7,353)	(9,087)	(6,091)	(5,297)
Other income (expense), net	1,895	2,470	28,448	17,950	(3,822)
Income (loss) before provision (benefit) for income taxes	60,781	61,793	74,762	(187,830)	(61,896)
Provision (benefit) for income taxes	23,969	(20,024)	(22,300)	--	--
Income (loss) before cumulative effect of an accounting change	36,812	81,817	97,062	(187,830)	(61,896)
Cumulative effect of an accounting change	--	--	--	(36,837)	--
Net income (loss)	$ 36,812	$ 81,817	$ 97,062	$ (224,667)	$ (61,896)
Income (loss) per share - Basic:					
Income (loss) before cumulative effect of an accounting change per share	$ 1.37	$ 3.10	$ 3.56	$ (7.11)	$ (2.63)
Cumulative effect of an accounting change per share	--	--	--	(1.40)	--
Net income (loss) per share	$ 1.37	$ 3.10	$ 3.56	$ (8.51)	$ (2.63)

Weighted average common shares outstanding		26,847		26,376		27,253		26,414		23,509
Income (loss) per share - Diluted:										
Income (loss) before cumulative effect of an accounting change per share	$	1.32	$	2.94	$	3.15	$	(7.11)	$	(2.63)
Cumulative effect of an accounting change per share		--		--		--		(1.40)		--
Net income (loss) per share	$	1.32	$	2.94	$	3.15	$	(8.51)	$	(2.63)
Weighted average common and common equivalent shares outstanding		27,854		27,806		30,798		26,414		23,509

2

	At December 31,				
	2004	2003	2002	2001	2000
			(In Thousands)		
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 47,492	$ 35,242	$ 33,588	$ 22,100	$ 40,604
Total current assets	138,068	105,595	82,825	51,214	97,203
Goodwill and intangibles, net	14,979	17,769	26,882	29,672	218,639
Total assets	241,728	247,178	189,075	165,737	407,749
Current portion of long-term debt	2,529	16,806	61	14,454	2,822
Total current liabilities	84,584	93,235	64,754	87,789	100,271
Long-term debt	1,717	31,791	100,855	152,370	103,695
Stockholders' equity (deficit)	141,521	103,143	23,466	(74,422)	82,700

See “Management’s Discussion and Analysis of Financial Condition and Results of Operations” for a discussion of items affecting the results of 2002, 2003 and 2004.

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 herein 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. 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 subsequently 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

We offer a bundle of local and long distance phone services to residential and small business customers in the United States. We have built a large, profitable base of bundled phone service customers using the wholesale operating platforms of the incumbent local exchange companies, such as the Regional Bell Operating Companies, and have begun and plan to migrate customers to our own networking platform in Detroit and Grand Rapids, Michigan, and further increase our revenues and profitability on those customers by offering new products and services.

In December 2004, the FCC issued final rules that effectively eliminated the requirement that incumbent local exchange companies provide us wholesale services using the unbundled network element platform and established a 12-month transition plan for implementation. Beginning on March 11, 2005, we are no longer able to use the unbundled network element platform to provide service to new customers and 12 months after that date the limitation will extend to all customers. In addition, during this 12-month period, the wholesale rates that we are charged will increase by $1 per line per month. At the end of the 12-month period, we will need to service customers that are not on our own networking platform through a resale or other wholesale agreement, both of which will have significantly higher costs than servicing customers through the unbundled network platform. As a result of (a) significant changes to the FCC rules that previously required the incumbent local exchange companies to provide on a wholesale basis the unbundled network elements to us and (b) price increases established by various state public utility commissions, the rates that we are to be charged by the incumbent local exchange companies to provide our services increased significantly in 2004 and will continue to increase over time. These cost increases have and will continue to lead us to increase our product pricing, which we believe inhibits our ability to add new customers and to retain existing customers. Therefore we have reduced our efforts to increase subscriber growth in the markets other than those areas where we currently have or plan to deploy network facilities (Detroit and Grand Rapids), which will significantly reduce our sales and marketing expenditures from past periods. In addition to the increases discussed above as a result of these regulatory actions, we plan to further increase our product pricing for our customers located in those areas where we do not currently have or plan to deploy network facilities. These cost increases will increase our revenue for such customers; however, it will likely adversely affect our ability to retain such customers on our service.

An integral element of our business strategy is to develop our own local networking capacity. Local networking would enhance our operating flexibility and provide us with an alternative to the wholesale operating platforms of the incumbent local exchange companies. Beginning in 2003, we deployed networking assets in Michigan and, as of December 31, 2004, we had approximately 25,000 bundled lines on our Michigan network. We are continuing the expansion of our network by collocating our networking equipment in the incumbent local exchange companies' end offices to provide service over our own network to a larger existing customer base in Detroit and Grand Rapids, Michigan. As a result of the significant changes in the regulatory environment, we have accelerated our networking initiatives and by December 31, 2005 we expect to have approximately 175,000 bundled lines on our network in Michigan, although some of the regulatory changes could also impede this deployment (discussed under "Regulation" above, and "Liquidity and Capital Resources, Other Matters," below). We have and continue to improve the automation of the business processes required to provide local network-based services. In addition, we are actively exploring next generation networking opportunities with a variety of vendors in order to decrease our cost of delivering service, reduce our reliance upon the incumbent local exchange companies and provide local telephone services through new, innovative methods of delivery. However, we have not previously developed, deployed or operated a local network of our own or of this scale and there can be no assurance that we shall be able successfully to do so and thereafter profitably provide local telephone services through such a network.

We will continue to add new services and enhance our existing service and product offerings, as available. We believe that the addition of these new services and of enhanced services will increase our revenues and gross margins on those customers while also meeting their needs and demands and reducing our customer turnover. We launched a new dial-up internet service in June 2004, and began testing digital subscriber line, or DSL, service in the third quarter 2004.

Our future business strategy is to serve medium sized businesses in those areas where we plan to deploy network facilities. Expansion into this business market will increase our addressable market in such an area and will permit us to leverage our investment in our network facilities due to the complementary telecommunication traffic or usage patterns of these business customers and our residential and small business customers. We will consider and pursue the acquisition of customers or networking assets to enter the business market, complement existing networking plans or to supplement customer density where there is a potential for deployment of network facilities. As a consequence of the FCC's rules regarding access to the incumbent local exchange companies' networks after March 11, 2005, our acquisition of customers from other companies who provide service using the unbundled network elements platform must be consummated in a manner where the transfer of the acquired customer is directly provisioned to our own network facilities, which, due to the limitations on the number of phone lines the incumbent local exchange company is required to "hot cut" over to our network per day, may limit or minimize the potential advantages of any such acquisition. However, we have not recently made any such acquisitions of customers, networking assets or businesses and there can be no assurances that we will be able to do so successfully.

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,		
	2004	**2003**	**2002**
Revenue	100.0%	100.0%	100.0%
Costs and expenses:			
Network and line costs	47.8	45.2	46.3
General and administrative expenses	15.3	16.4	19.5
Provision for doubtful accounts	4.5	3.0	2.9
Sales and marketing expenses	14.9	13.3	8.6
Depreciation and amortization	4.9	4.8	5.5
Total costs and expenses	87.4	82.7	82.8
Operating income	12.6	17.3	17.2
Other income (expense):			
Interest income	0.1	0.1	0.3
Interest expense	(0.2)	(1.9)	(2.9)
Other, net	0.4	0.6	9.0
Income before income taxes	12.9	16.1	23.6
Provision (benefit) for income taxes	5.1	(5.2)	(7.0)
Net income	7.8%	21.3%	30.6%

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,	
	2004	**2003**
Revenue	22.8%	20.8%
Costs and expenses:		
Network and line costs	29.9%	18.0%
General and administrative expenses	14.1%	1.5%
Provision for doubtful accounts	83.7%	23.9%
Sales and marketing expenses	37.6%	87.9%
Depreciation and amortization	24.9%	5.9%
Total costs and expenses	29.7%	(20.7%)
Operating income	(10.5%)	21.4%
Other income (expense):		
Interest income	(25.3%)	(51.6%)
Interest expense	(90.0%)	(19.1%)
Other, net	(23.3%)	(91.3%)
Income before income taxes	(1.6%)	(17.3%)
Provision for income taxes	219.7%	(10.2%)
Net income	(55.0%)	(15.7%)

Revenue. The increase in revenue in 2004 from 2003 and in 2003 from 2002 was due to an increase in bundled revenue offset by a decline in long distance revenue. 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 adversely affected customer turnover. Additional increases in fees and rates related to our long distance and bundled products will adversely affect customer turnover.

Bundled revenue increased to $407.7 million for 2004 from $282.3 million for 2003 due primarily to higher average bundled lines in 2004 as compared to 2003. We ended 2004 with 671,000 billed bundled lines, compared to 557,000 at the end of 2003. Approximately 48.0% of the bundled lines in December 2004 were in Michigan, compared to 58.6% in December 2003, reflecting our continued efforts to market into other states. We expect the actions we will take, as a result of the recent regulatory changes, to focus customer growth on areas where we have our own local network and increase prices on our services where we do not have or plan to deploy network facilities will cause the number of bundled lines and revenues to decline in the future and will significantly increase the percentage of our bundled lines in Michigan.

The increase in bundled revenue to $282.3 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 compared to 333,000 at the end of 2002.

Our long distance revenue decreased in 2004 to $63.3 million from $101.4 million in 2003, and from $146.3 million in 2002. 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 included non-cash amortization of deferred revenue of $6.2 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.

Network and Line Costs. The increase of network and line costs in 2004 from 2003 was primarily due to the increase in bundled customers, partially offset by the decrease in long distance customers. Network and line costs as a percentage of revenue increased slightly in 2004 from 2003 and decreased slightly in 2003 from 2002. To date, we have been able to increase our prices to offset per line increases in network and line cost, but these increases may, over time, cause customer attrition. Network and line costs in 2004 exclude depreciation of $6.2 million for 2004 and $3.4 million for 2003.

We accrue expenses for network costs that we believe we have incurred pursuant to our interconnection agreements with a particular supplier or tariffs but for which we have not yet been billed. This primarily occurs due to errors and omissions in billing on the part of our principal suppliers, the Regional Bell Operating Companies. Accrued expenses are eliminated upon the earlier of actual billing (including billing for charges appropriately recorded in prior periods but not invoiced, or “backbilling”) by the Regional Bell Operating Companies or the expiration of the time period for which we are liable for the charges. In addition, we accrue for network expense not yet billed in a jurisdiction if we believe there is a prospect that regulatory or other legal changes in the jurisdiction will retroactively increase the rates we have charged. For example, in Georgia an appeals court overturned a recent rate reduction by the state public utility commission and ordered the commission to re-calculate our rates. This issue is currently being considered by the state commission or remand from the court and we expect that the issue will be resolved during 2005. We believe that these rates will be in excess of those previously allowed and have accrued accordingly.

We seek to 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. In addition, 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:

6

- As a result of significant changes to the FCC rules that required the incumbent local exchange companies, such as the Regional Bell Operating Companies that are our principal suppliers, to provide us the unbundled network elements of their operating platforms on a wholesale basis, the wholesale operating platforms of the incumbent local exchange companies is effectively not available to us for our new customers after March 11, 2005 or for all our customers after March 11, 2006. This determination and others 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, will require us either to provide services in these areas through other means, including total service resale agreements or commercial agreements with incumbent local exchange companies, purchase of special access services or network elements purchased from the Regional Bell Operating Companies at "just and reasonable" rates under Section 271 of the Act, in all cases at significantly increased costs, or to provide services over our own switching facilities, if we are able to deploy them (see Item 1 "Regulation," above and "Liquidity and Capital Resources, Other Matters," below);

- Adverse changes to the current pricing methodology, TELRIC, mandated by the FCC for use in establishing the prices charged to us by incumbent local exchange companies for the use of their unbundled network elements for so long as we are permitted to continue to use them, and for the use of transport and other services in connection with our local network. 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 exchange 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. The TELRIC methodology still governs our pricing for loops purchased from the incumbent local exchange companies in connection with our local network. We cannot predict if the FCC will order new TELRIC pricing or if Congress will amend the 1996 Act, affecting such pricing or availability. These changes could result in material increases in prices charged to us for unbundled network elements, including those used in our own local network; and

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

We expect the actions we will take, as a result of the recent regulatory changes, to focus customer growth in areas where we have our own local network, currently Michigan, and increase prices on our services, will cause the number of bundled lines to decline in the future and reduce network and line costs, although the amount of the reduction may be offset in part by the increased costs we may be required to pay. 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 2004 from 2003 and in 2003 from 2002. In 2004, the increase was attributable to a new operating lease for information technology equipment. 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 increases were primarily due to the year-to-year increases in the number of employees for customer service and information technology to support our expanding base of bundled customers and our deployment of our local facilities. General and administrative expense as a percentage of revenue decreased from 2003 to 2004 and from 2002 to 2003. This decrease resulted from the efficiencies of a growing base of revenues relative to certain fixed operating expenses. We expect that as revenues decline in the future, as we anticipate, general and administrative expense as a percentage of revenues will increase.

Provision for Doubtful Accounts. The provision for doubtful accounts increased in 2004 from 2003. The increase was due to an increase in the number of customers and revenue as well an increase in bad debt expense as a percentage of revenues. The increase in bad debt as a percentage of revenue in 2004 was primarily due to:

· Reduced employee collection hours as a result of several hurricanes near our Florida customer service centers. As a result of the closures and employee attendance disruption, our collections personnel were unable to pursue payments from delinquent customers. We were unable to make up the lost employee time and, as a result, the collection time decreased and aging on the accounts deteriorated, therefore, the provision for doubtful accounts increased.

· An increase in market share outside of Michigan into states where we have experienced generally higher levels of bad debt. Our experience is that bad debt varies by state. The greater relative proportion of customers in states other than Michigan resulted in increased overall bad debt.

· In an effort to expand our addressable market during 2004, we experimented with a new credit screening vendor and methodology to supplement our existing credit screening process. The change was meant to provide a credit score for potential customers for whom no score was available under our primary scoring methodology. Management believed that, in building the parameters for this new method, the bad debt would have been consistent with that of our primary method. In actuality, however, customers accepted through this new methodology had higher bad debt than customers accepted through our primary credit screening method. Thus, the influx of customers through the new methodology during the third quarter resulted in increased bad debt for the third and fourth quarters. Based on these actual results, we ceased utilizing this supplemental screening methodology.

The provision for doubtful accounts increased in 2003 from 2002. The increase was due to an increase in the number of customers and revenue. In addition, 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.

Sales and Marketing Expenses. Sales and marketing expense increased in 2004 from 2003 and in 2003 from 2002. The increases are primarily attributable to the increase of sales and marketing activity for continued growth of our bundled sales. Sales and marketing expense as a percentage of revenue also increased over the prior year during these periods, as the cost of acquiring a customer increased. Currently, substantially all of our sales and marketing expenses relate to the bundled product. Included in sales and marketing expenses are advertising expenses of $9.8 million for 2004, $6.8 million for 2003, and $1.5 million for 2002. We expect sales and marketing expenses to decrease in 2005 as we significantly reduce our efforts to increase subscriber growth and focus only on markets with potential for networking.

Interest Expense. The decreases in interest expense for 2004 from 2003 and for 2003 from 2002 are primarily attributable to the decreases in, and the retirement in 2004 of the balance of, the outstanding debt balances.

Depreciation and Amortization. Depreciation and amortization increased in 2004 from 2003 and in 2003 from 2002 primarily due to depreciation on costs incurred in 2003 and 2004 related to our deployment of networking assets (our local switch and collocation equipment) in Michigan and amortization of capitalized software projects completed during 2003 and 2004 primarily related to the development of customer relations management software. In December 2004, in connection with a review of our fixed assets, the estimated remaining useful life of our five long distance switches was shortened from an average of 8 years to 1.6 years. This change had the effect of increasing depreciation for 2004 by $1.4 million. In addition, we expect that depreciation expense will increase by approximately $18 million in 2005 from 2004.

Other Income, Net. Other income for 2004 consists of income recorded as a result of the statutory expiration of the liability for certain sales and use taxes reserves. 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.

Provision for Income Taxes. In 2003, management evaluated the deferred tax asset valuation allowance and determined that a portion of the allowance should be reversed. The evaluation considered the profitability of our 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 would more likely than not be utilized, and reversed deferred tax asset valuation allowances of $50.6 million for 2003, recognized a non-cash deferred income tax benefit of $44.1 million and reduced the amount of goodwill related to the August, 2000 acquisition of Access One Communications, Inc. by $6.5 million. In 2003, the tax benefit was partially offset by an income tax expense of $24.1 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, 2004, we had approximately $114.7 million of federal NOLs, which are available to offset future taxable income. A valuation allowance has been maintained for a $23 million tax deduction, which was taken in our 1996 federal income tax return and for which we are currently involved in an administrative proceeding before the Internal Revenue Service. A valuation allowance has also been maintained for certain state NOLs, which we believe 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 federal NOLs will be substantially utilized by 2007 with the exception of $2.3 million in NOLs generated by Access One Communications, Inc. and its subsidiaries, which will be substantially utilized by 2018.

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. For 2004 and 2003, our operating activities provided net cash flow of $74.6 million and $73.2 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, 2004, we had $47.5 million in cash and cash equivalents and long-term debt and capital lease obligations (including current maturities) of $4.2 million, compared to $35.2 million and $48.6 million, respectively, at December 31, 2003.

Our contractual obligations as of December 31, 2004 are summarized by years to maturity as follows (in thousands):

Contractual Obligations	Total	1 year or less	2 - 3 Years	4 - 5 Years	Thereafter
Talk America Inc. and other subsidiaries:					
Vendor financing agreement (1)	$ 2,057	$ 1,397	$ 660	$ --	$ --
Capital lease obligations	2,189	1,132	1,057	--	--
Vendor financed maintenance (1)	1,122	561	561	--	--
Operating leases	6,003	2,922	2,447	278	356
Purchase commitments (2)	4,400	4,400	--	--	--
Invoice printing commitment (3)	4,913	1,183	2,456	1,274	--
Carrier commitments (4)	97,000	33,000	64,000	--	--
Total Contractual Obligations	$ 117,684	$ 44,595	$ 71,181	$ 1,552	$ 356

(1) In May 2004, in connection with the purchase of software, we entered into a loan agreement with the software supplier for $3.1 million payable over 36 months at a 2.9% annual interest rate. The agreement includes $2.5 million of software and an annual maintenance contract of $0.6 million. In addition, we agreed to renew the maintenance agreement for an additional two years at the cost of $1.1 million, which is funded on the anniversary dates. As of December 31, 2004, there was approximately $2.1 million outstanding under this loan.

(2) At December 31, 2004, we had outstanding purchase orders for capital expenditures related to the build out of our Michigan networking facilities with two vendors in the aggregate amount of $4.4 million.

(3) We have a contract with our invoice printing company that establishes pricing and provides for annual minimum payments.

(4) In December 2003, we entered into a 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. Our AT&T agreement establishes pricing and provides for annual minimum revenue commitments based upon usage as follows: 2005 - $32 million, 2006 - $32 million and 2007 - $32 million and obligates us to pay 65 percent of the revenue shortfall, if any. Despite the anticipated reduction in our local bundled customer base, we anticipate that we will not be required to make any shortfall payments under this contract as a result of the restructuring of the obligations or the growth in network minutes as a result of acquisitions, there can be no assurances that we will be successful in our efforts. To the extent

that we are unable to meet these minimum commitments, our costs of purchasing the services under the agreement will correspondingly increase. In addition to the AT&T commitment, the carrier commitments include a commitment with one separate carrier of approximate $1.0 million in 2005.

9

Cash provided by (used for):

				Percent Change	
	2002	2003	2004	2003 vs. 2002	2004 vs. 2003
Operating activities	$ 51,898	$ 73,171	$ 74,595	41.0%	1.9%
Investing activities	(7,332)	(14,715)	(16,497)	(100.7%)	(12.1%)
Financing activities	(33,078)	(56,802)	(45,848)	(71.7%)	19.3%

Cash Provided By Operating Activities. Cash generated by operations increased by $1.4 million from 2003 to 2004. The increase was driven primarily by higher cash flow before changes in working capital. In the aggregate, the changes in working capital were similar in 2004 and 2003. Net accounts receivable increased by $8.6 million in 2004 down from an increase of $12.5 million in 2003. The increase in net accounts receivable in both 2003 and 2004 was due to an increase in revenues during the same periods. As revenues are expected to decline in 2005, net accounts receivable should also be expected to decline. Accounts payable increased by $8.1 million in 2004 up from an increase of $3.1 million in 2003. The increase in accounts payable in both 2003 and 2004 was due to an increase in operating expenses during the same periods. As operating expenses are expected to decline in 2005, accounts payable should also be expected to decline. These items that favorably affected cash from operations were offset by an increase in other current assets and other current liabilities. The application of NOL carryforwards has limited our current payment of income taxes to cash taxes for alternative minimum taxes and certain state income taxes. We expect that our NOLs will be substantially utilized during 2007.

Cash generated by operations increased by $21.3 million from 2002 to 2003. The increase was driven by both higher cash flow before working capital changes of $11.7 million and a reduction in working capital. In the aggregate, changes in working capital used $1.3 million in 2003 down from a use of $10.3 million in 2002. Accounts payable were reduced significantly in 2002 as we improved payment terms with our vendors. Deferred revenue and net accounts receivable increased substantially in 2003 as compared to 2002 as our bundled business grew.

Net Cash Used in Investing Activities. Capital expenditures increased by $1.1 million during 2004 as compared to 2003 and capitalized software increased by $0.8 million. In 2004, approximately 37% of our $13.0 million in capital expenditures consisted of costs related to our deployment of networking assets (local switch and collocation equipment) in Michigan, up from 66% of our $5.5 million in 2003. Also in 2003, to support our customer growth, we opened a new customer service call center. The remaining 2003 capital expenditures consisted primarily of upgrades to our information technology capabilities to support our customer growth. In addition, during 2004 we entered into a capital lease valued at $2.5 million for new database software and during 2003, we entered into a capital lease valued at $3.4 million for upgrades to our customer data storage equipment.

We expect to spend between $43 and $47 million in capital expenditures and capitalized software in 2005, primarily for the build out of the Michigan networking facilities. We have not, however, previously developed and deployed a local network of our own or of this scale and there can be no assurance that we will not encounter unanticipated costs in acquiring the assets necessary for such networking capability and its operation or in deploying the new network. In addition, to the extent we identify other markets to deploy networking facilities, our capital expenditures will increase accordingly.

Capitalized software development costs consist of direct development costs associated with internal-use computer software, including payroll costs for employees devoting time to the software projects. In 2004, capitalized software development costs totaled $3.5 million and were primarily related to the development of software related to the deployment of our networking facilities. We expect software development costs in 2005 to be consistent with 2004 as we continue to develop the integrated information systems required to provide local switch-based service.

To the extent that we are successful in identifying and completing an acquisition of either customers, networking assets or a business, net cash used in investing activities may increase.

Net Cash Used in Financing Activities. Net cash used in financing activities during 2004 and 2003 was $45.8 million and $56.8 million, respectively, primarily attributable to debt repayments of $46.5 million and $53.0 million in 2004 and 2003, respectively. In addition, during 2003, pursuant to our former share buyback program announced in January 2003, we purchased 1,315,789 shares for a purchase price of $5.0 million. On June 1, 2004, we announced that our Board of Directors had authorized a share buyback program for us to purchase up to $50 million of our outstanding shares. The shares may be purchased from time to time, in the open market and/or private transactions. Through December 31, 2004, we had not purchased any shares under this program.

During 2004, we redeemed $40.7 million of our 12% Senior Subordinated Notes, $2.8 million of our 8% Convertible Senior Subordinated Notes and $0.7 million of our 5% Convertible Subordinated Notes, representing the respective entire principal amounts outstanding as of December 31, 2003.

Net cash used in financing activities during 2002 was primarily attributable to debt repayment and purchases of $32.7 million. 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.

While we believe that we may have access to new capital in the public or private markets to fund our ongoing cash requirements (including any acquisitions), 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 in this report, or that we will not be required to consider capital expenditures in excess of those currently contemplated, as discussed in this report.

Other Matters

Our provision of telecommunications services is subject to government regulation. To date, our local telecommunications services have been provided almost exclusively through the use of unbundled network elements purchased from incumbent local exchange companies that were made available to us pursuant to FCC rules. It has been primarily the availability of these unbundled network elements from the incumbent local exchange companies' facilities at substantially lower prices than those available for resale through total service resale agreements that has enabled us to price our local telecommunications services competitively. As a result of the FCC’s final rules, since March 11, 2005, the unbundled network element platform is no longer available to us for adding new customers. Further, as of March 11, 2005 there is a $1 increase in the cost per line, per month for us to continue providing service to our existing customers that are on the unbundled network element platform. In addition, for both local loops and dedicated transport, the FCC adopted a twelve-month transition plan for competitive local exchange companies, such as us, to transition away from the use of DS1 and DS3 loops and dedicated transport where there is no impairment, as defined in the FCC’s final rules, and an eighteen-month transition plan to transition away from dark fiber. The transition plans apply only to the customer base as it exists on March 11, 2005, and do not permit competitive local exchange companies to add new dedicated transport unbundled network elements in the absence of impairment.

As a result of the FCC’s final rules, we will be forced by March 11, 2006, to transition our customers from the unbundled network element platform to our own network facilities or to service our local customers through resale agreements or through elements purchased through commercial agreements that we may enter into with the incumbent local exchange companies. In 2003, we began deploying networking assets in Michigan and, as of December 31, 2004, we had approximately 25,000 bundled lines on our Michigan network. We are continuing the expansion of our network by collocating our networking equipment in the incumbent local exchange companies' end offices to provide service over our own network to a larger existing customer base in geographic regions where we have a high density of customers. We are also considering other ways of expanding our network capacity and customer base, including by acquisition of capacity and customers from other companies, both directly and by acquisition of such companies. By December 31, 2005 we expect to have 175,000 bundled lines on our network in Michigan, and we are actively exploring network opportunities in areas outside of Michigan. However, should cost-based transport unbundled network elements become effectively unavailable to us, our plans to deploy our own network facilities could be substantially impeded, and we could be forced to use other means to effect this deployment, including the use of facilities purchased at higher special access rates or transport services purchased from other facilities-based competitive local telephone carriers. In either event, our cost of service could rise dramatically and our plans for a service roll-out for use of our own network facilities could be delayed substantially or derailed entirely. This would have a material adverse effect on our business, prospects, operating margins, results of operations, cash flows and financial condition.

CRITICAL ACCOUNTING ESTIMATES

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.

Network and Line Costs

We accrue expenses for network costs that we believe we have incurred pursuant to our interconnection agreements with a particular supplier or tariffs but for which we have not yet been billed. This primarily occurs due to errors and omissions in billing on the part of our principal suppliers, the Regional Bell Operating Companies. In addition, we accrue for network expense not yet billed in a jurisdiction if we believe there is a prospect that regulators or other legal changes in the jurisdiction will retroactively increase the rates we have charged. For example, in Georgia an appeals court overturned a recent rate reduction by the state public utility commission and ordered the commission to re-calculate our rates. This issue is currently being considered by the state commission and we expect that the issue will be resolved during 2005. We believe that these rates will be in excess of those previously allowed and have accrued accordingly.

Accrued expenses are eliminated upon the earlier of actual billing (including billing for charges appropriately recorded in prior periods but not invoiced, or “backbilling”) by the Regional Bell Operating Companies or the expiration of the time period for which we are liable for the charges. The time period is governed by interconnection agreements or, in the absence of a specific agreement, by the statute of limitations operative in a given jurisdiction. As the expiration of the statute of limitations occurred, which began in 2004, we have reduced, and will reduce in the future, our liability for this exposure as there is no further legal recourse the supplier can take in collecting these amounts.

Allowance for Uncollectible 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 expected useful lives of the assets or the strategy for our overall business

- Significant negative regulatory, industry or economic trends
- Significant decline in our stock price for a sustained period and market capitalization relative to net book value

Long-lived assets are grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Since we provide integrated telecommunications services with our asset groups not being independent of each other, our assets are viewed as being of a single asset group and impairment testing is conducted at the entity level. Estimates of future cash flows used to test recoverability are made for the remaining useful life of the primary asset of the asset group. Cash flows are estimated using management's current view of the operating and financial prospects of the asset group. 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 and Intangible Assets with Indeterminate Lives

Goodwill represents the cost in excess of the fair value of the 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. 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. Fair value for the reporting unit is based on a discounted cash flow analysis and consideration of the current market value of our common stock. Cash flows are estimated using management's current view of the operating and financial prospects of the business. A discount rate of 18% was used in the discounted cash flow analysis.

Income Taxes

Income taxes are accounted for under the asset and liability method. During 2004 and 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

In December 2004, the FASB revised Statement of Financial Accounting Standards No. 123 ("SFAS No. 123 (R)"), requiring public companies to recognize the cost resulting from all share-based payment transactions in their financial statements. SFAS No. 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees" and amends SFAS No. 95, "Statement of Cash Flows." Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. The new standard will be effective for us in the first interim or annual reporting period beginning after June 15, 2005. We are currently assessing the implications of the transition methods allowed and have not determined whether the adoption of FAS 123(R) will result in amounts similar to current pro-forma disclosures under FAS 123. We expect the adoption to have an adverse impact on future consolidated statements of operations.

In December 2004, the FASB issued SFAS No. 153 Exchange of Nonmonetary Assets, an amendment of APB Opinion No. 29 ("SFAS 153"). SFAS 153 amends prior guidance to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of SFAS 153 are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 and shall be applied prospectively. SFAS 153 is not expected to have a material impact on our consolidated financial statements at the date of adoption.

13

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

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