

Edgar Filing: MEMBERWORKS INC - Form 10-Q

MEMBERWORKS INC  
Form 10-Q  
February 14, 2003

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

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of  
the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2002

Commission File No. 0-21527

MEMBERWORKS INCORPORATED

-----  
(Exact name of registrant as specified in its charter)

DELAWARE

06-1276882

-----  
(State of Incorporation)

-----  
(I.R.S. Employer  
Identification No.)

680 Washington Boulevard  
Stamford, Connecticut

06901

-----  
(Address of principal executive offices)

-----  
(Zip Code)

(203) 324-7635

-----  
(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, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate the number of shares outstanding of each of the registrant's class of common stock as of the latest practicable date:  
12,706,162 shares of Common Stock, \$0.01 par value as of January 30, 2003.  
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## MEMBERWORKS INCORPORATED

### CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands, except per share amounts)

|                 |                           | December<br>2002     |
|-----------------|---------------------------|----------------------|
|                 |                           | -----<br>(Unaudited) |
|                 | Assets                    |                      |
| Current assets: |                           |                      |
|                 | Cash and cash equivalents | \$ 82                |
|                 | Marketable securities     |                      |

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|   |        |
|---|--------|
| Accounts receivable   | 11     |
| Prepaid membership materials  | 3      |
| Prepaid expenses  | 3      |
| Membership solicitation and other deferred costs  | 108    |
|   | -----  |
| Total current assets  | 210    |
| Fixed assets, net   | 28     |
| Goodwill  | 42     |
| Intangible assets, net  | 7      |
| Other assets  | 2      |
|   | -----  |
| Total assets  | \$ 290 |
|   | =====  |
|   |        |
| Liabilities and Shareholders' Deficit   |        |
| Current liabilities:  |        |
| Current maturities of long-term obligations   | \$     |
| Accounts payable  | 33     |
| Accrued liabilities   | 64     |
| Deferred membership fees  | 196    |
|   | -----  |
| Total current liabilities   | 294    |
| Deferred income taxes   | 2      |
| Long-term liabilities   | 3      |
|   | -----  |
| Total liabilities   | 300    |
|   |        |
| Shareholders' deficit:  |        |
| Preferred stock, \$0.01 par value -- 1,000 shares<br>authorized; no shares issued                                       |        |
| Common stock, \$0.01 par value -- 40,000 shares<br>authorized; 17,703 shares issued (17,493 shares<br>at June 30, 2002) |        |
| Capital in excess of par value  | 111    |
| Accumulated deficit   | (19)   |
| Accumulated other comprehensive loss  |        |
|   | -----  |
| Total shareholders' equity before treasury stock  | 91     |
| Treasury stock, 5,008 shares at cost (4,139 shares at June 30, 2002)  | (102)  |
|   | -----  |
| Total shareholders' deficit   | (10)   |
|   | -----  |
| Total liabilities and shareholders' deficit   | \$ 290 |
|   | =====  |

The accompanying notes are an integral part of these consolidated financial statements.

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(In thousands, except per share data)

|  | Three months ended<br>December 31, |            |
|--|------------------------------------|------------|
|  | 2002                               | 2001       |
| Revenues   | \$ 114,045                         | \$ 102,684 |
| Expenses:  |                                    |            |
| Operating  | 19,178                             | 19,508     |
| Marketing  | 69,899                             | 57,444     |
| General and administrative   | 18,764                             | 18,570     |
| Restructuring and other charges  | -                                  | 6,893      |
| Amortization of intangible assets  | 346                                | 440        |
| Operating income (loss)  | 5,858                              | (171)      |
| Settlement of investment related litigation (Note 4)                           | -                                  | -          |
| (Loss) gain on sale of subsidiary (Note 3)                                     | -                                  | -          |
| Net loss on investment (Note 3)  | -                                  | (9,043)    |
| Other income (expense), net  | 221                                | 54         |
| Income (loss) before minority interest   | 6,079                              | (9,160)    |
| Minority interest  | -                                  | -          |
| Income (loss) before income taxes  | 6,079                              | (9,160)    |
| Provision for income taxes   | (729)                              | -          |
| Income (loss) before cumulative effect of accounting change                    | 5,350                              | (9,160)    |
| Cumulative effect of accounting change (Note 2)                                | -                                  | -          |
| Net income (loss)  | \$ 5,350                           | \$ (9,160) |
| Basic earnings (loss) per share:   |                                    |            |
| Income (loss) before cumulative effect of accounting change                    | \$ 0.42                            | \$ (0.62)  |
| Cumulative effect of accounting change   | -                                  | -          |
| Basic earnings (loss) per share  | \$ 0.42                            | \$ (0.62)  |
| Diluted earnings (loss) per share:   |                                    |            |
| Income (loss) before cumulative effect of accounting change                    | \$ 0.40                            | \$ (0.62)  |
| Cumulative effect of accounting change   | -                                  | -          |
| Diluted earnings (loss) per share  | \$ 0.40                            | \$ (0.62)  |
| Weighted average common shares used in earnings (loss) per share calculations: |                                    |            |
| Basic  | 12,735                             | 14,789     |
| Diluted  | 13,396                             | 14,789     |

The accompanying notes are an integral part of

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these consolidated financial statements.

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MEMBERWORKS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(In thousands)

|   | For the six<br>December  |
|---|--------------------------|
|   | -----<br>2002<br>-----   |
| Operating activities  |                          |
| Net income  | \$ 23,163                |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                          |
| Revenues before deferral  | 209,140                  |
| Marketing costs before deferral   | (114,673)                |
| Revenues recognized   | (219,049)                |
| Marketing costs expensed  | 135,448                  |
| Depreciation and amortization   | 6,169                    |
| Deferred income taxes   | 2,864                    |
| Gain on settlement  | (19,148)                 |
| Net loss (gain) on sale of subsidiary   | 959                      |
| Net loss on investment  | 206                      |
| Restructuring and other charges   | -                        |
| Minority interest   | -                        |
| Cumulative effect of accounting change  | -                        |
| Other   | 382                      |
| Change in assets and liabilities:   |                          |
| Accounts receivable   | (1,529)                  |
| Prepaid membership materials  | (1,169)                  |
| Prepaid expenses  | 334                      |
| Other assets  | (424)                    |
| Related party payables  | -                        |
| Accounts payable  | 1,044                    |
| Accrued liabilities   | 6,319                    |
| Net cash provided by (used in) operating activities   | -----<br>30,036<br>----- |
| Investing activities  |                          |
| Acquisition of fixed assets   | (2,762)                  |
| Settlement of investment related litigation   | 19,148                   |
| (Purchase price adjustments) proceeds from sale of subsidiary, net of cash sold             | (750)                    |
| Net cash provided by investing activities   | -----<br>15,636<br>----- |

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|  |    |          |
|--|----|----------|
| Financing activities   |    |          |
| Net proceeds from issuance of stock and warrants             |    | 1,851    |
| Treasury stock purchases                                     |    | (14,957) |
| Payments of long-term obligations                            |    | (927)    |
| Net cash used in financing activities                        |    | (14,033) |
| Effect of exchange rate changes on cash and cash equivalents |    | (32)     |
| Net increase in cash and cash equivalents                    |    | 31,607   |
| Cash and cash equivalents at beginning of period             |    | 51,185   |
| Cash and cash equivalents at end of period                   | \$ | 82,792   |

The accompanying notes are an integral part of these consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, such statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The preparation of these consolidated financial statements in conformity with generally accepted accounting principles requires management of the Company to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Operating results for the three and six months ended December 31, 2002 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2003. For further information, refer to the financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K with respect to the fiscal year ended June 30, 2002.

NOTE 2 - CUMULATIVE EFFECT OF ACCOUNTING CHANGE

Adoption of SFAS 142

Memberworks Incorporated ("the Company" or "MemberWorks") adopted Financial Accounting Standards Board Statement ("SFAS") No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), effective July 1, 2001. With the adoption of SFAS 142, the Company reassessed the estimated useful lives and residual values of all acquired intangible assets to make any necessary amortization period adjustments. Based on that assessment, only goodwill was determined to have an indefinite useful life and no adjustments were made to the amortization periods or residual values of other intangible assets. The Company determined that at

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July 1, 2001, there was an impairment of goodwill of \$5,907,000 at one of its reporting units due to the change in methodology of calculating impairment under SFAS 142 concurrent with downward trends in the operations of the reporting unit. This amount was recorded as a cumulative effect of accounting change in the statement of operations for the quarter ended September 30, 2001.

### NOTE 3 - GAIN ON SALE OF SUBSIDIARY/LOSS ON INVESTMENT

During the quarter ended September 30, 2001, the Company sold its investment in iPlace, Inc. for \$50,111,000 in cash and 1,601,000 shares of Homestore.com, Inc. stock. The Company reported a gain of \$65,608,000 on the sale. During the quarter ended September 30, 2002, the Company settled with Homestore.com, Inc. all issues pending related to amounts held in escrow in connection with the sale. The Company recorded a net loss of \$959,000 related to this purchase price adjustment in the quarter ended September 30, 2002.

During fiscal 2002, the investment in Homestore.com, Inc. declined in value and management determined that the decline was other than temporary. As a result, the Company wrote down its investment in Homestore.com, Inc. to its fair value and recognized a loss of \$22,296,000 in the quarter ended September 30, 2001 and a loss of \$9,043,000 in the quarter ended December 31, 2001.

In addition, the Company sold all of its Homestore.com, Inc. common stock during the quarter ended September 30, 2002. The Company recognized a loss of \$206,000 in connection with this sale.

### NOTE 4 - Settlement of investment related litigation

During the quarter ended September 30, 2002, MemberWorks, along with certain of the other former shareholders of iPlace, Inc., settled their lawsuit against Homestore.com, Inc. The total settlement amount in favor of the plaintiffs was \$23,000,000 of which MemberWorks received \$19,148,000.

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### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### NOTE 5 - INCOME TAX EXPENSE

Income tax expense as a percentage of pre-tax income was approximately 12% for the three and six months ended December 31, 2002. The effective tax rate varied from the U.S. statutory rate for the three and six months ended December 31, 2002 primarily due to the utilization of net operating loss carryforwards. During the quarter ended September 30, 2001, the Company recorded a provision for alternative minimum taxes of approximately \$742,000 in connection with the gain on the sale of iPlace, Inc. This provision for alternative minimum taxes was later reversed in the June 2002 quarter due to a change in the tax laws.

### NOTE 6 - EARNINGS PER SHARE

Basic and diluted earnings per share amounts are determined in accordance with the provisions of SFAS No. 128, "Earnings Per Share." The following table sets forth the reconciliation of the numerators and denominators in the computation of basic and diluted earnings per share (in thousands, except per share data):

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|   | Three Months Ended<br>December 31, |            |
|---|------------------------------------|------------|
|   | 2002                               | 2001       |
| -----   |                                    |            |
| Numerator for basic and diluted earnings (loss) per share:      |                                    |            |
| Net income (loss) before cumulative effect of accounting change | \$ 5,350                           | \$ (9,160) |
| Cumulative effect of accounting change                          | -                                  | -          |
|   | -----                              | -----      |
| Net income (loss)   | \$ 5,350                           | \$ (9,160) |
|   | =====                              | =====      |
| Denominator for basic earnings (loss) per share:                |                                    |            |
| Weighted average number of common shares outstanding - basic    | 12,735                             | 14,789     |
| Effect of dilutive securities:                                  |                                    |            |
| Options   | 661                                | -          |
|   | -----                              | -----      |
| Weighted average number of common shares outstanding - diluted  | 13,396                             | 14,789     |
|   | =====                              | =====      |
| Basic earnings (loss) per share                                 | \$ 0.42                            | \$ (0.62)  |
|   | =====                              | =====      |
| Diluted earnings (loss) per share                               | \$ 0.40                            | \$ (0.62)  |
|   | =====                              | =====      |

The diluted earnings (loss) per share calculation excludes the effect of potentially dilutive shares when their effect is antidilutive. For the three months ended December 31, 2002 and 2001, the Company had 3,041,000 and 4,553,000 shares, respectively, of potentially dilutive stock options outstanding that are not included in the calculation as they are antidilutive. For the six months ended December 31, 2002 and 2001, the Company had 3,112,000 and 3,479,000 shares, respectively, of potentially dilutive stock options that are not included in the calculations as they are antidilutive.

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MEMBERWORKS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 7 - COMPREHENSIVE INCOME

The components of comprehensive income are as follows (in thousands):

| Three months ended<br>December 31, | Si    |
|------------------------------------|-------|
| -----                              | ----- |



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|  | 2002     | 2001       | 2000     |
|--|----------|------------|----------|
|  | -----    | -----      | -----    |
| Net income (loss)                        | \$ 5,350 | \$ (9,160) | \$ 2,000 |
| Foreign currency translation gain (loss) | 5        | (87)       |          |
| Comprehensive income (loss)              | \$ 5,355 | \$ (9,247) | \$ 2,000 |
|  | =====    | =====      | =====    |

NOTE 8 - GOODWILL AND OTHER INTANGIBLE ASSETS

The gross carrying value and accumulated amortization of goodwill and other intangibles are as follows (in thousands):

|                                     | As of December 31, 2002  |                             | As of                   |
|-------------------------------------|--------------------------|-----------------------------|-------------------------|
|                                     | Gross Carrying<br>Amount | Accumulated<br>Amortization | Gross Carryin<br>Amount |
|                                     | -----                    | -----                       | -----                   |
| Amortized intangible assets:        |                          |                             |                         |
| Membership and Client Relationships | \$ 13,195                | \$ (6,141)                  | \$ 13,195               |
| Other                               | 950                      | (694)                       | 950                     |
| Total amortized intangible assets   | \$ 14,145                | \$ (6,835)                  | \$ 14,145               |
|                                     | =====                    | =====                       | =====                   |
| Unamortized intangible assets:      |                          |                             |                         |
| Goodwill                            | \$ 42,039                |                             | \$ 42,039               |

The future intangible amortization expense for the next five years is estimated to be as follows (in thousands):

|              |          |
|--------------|----------|
| Fiscal Year: |          |
| 2003         | \$ 1,393 |
| 2004         | 1,045    |
| 2005         | 840      |
| 2006         | 695      |
| 2007         | 554      |

Goodwill was tested for impairment during the quarter ended September 30, 2002 as required by SFAS 142. The Company has concluded that none of its goodwill is impaired. Fair value was estimated using discounted cash flow methodologies. In addition, the Company reassessed the estimated useful lives of its indefinite intangible assets and determined that the lives were appropriate. The Company will test the goodwill of each of its reporting units annually or more frequently if impairment indicators exist.

NOTE 9 - ALLOWANCE FOR MEMBERSHIP CANCELLATIONS

Accrued liabilities set forth in the accompanying condensed consolidated balance sheets as of December 31, 2002 and June 30, 2002 include an allowance for membership cancellations of \$26,328,000 and \$23,753,000, respectively.

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## MEMBERWORKS INCORPORATED

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### NOTE 10 - RESTRUCTURING CHARGES

On October 11, 2001, the Company announced the implementation of several cost saving initiatives due to a slowdown in consumer response rates and increased economic uncertainty in both the U.S. and abroad. This restructuring program included a workforce reduction, the closing of the Company's United Kingdom operations and the downsizing of the operational infrastructure throughout the Company. As a result of the restructuring program, the Company recorded restructuring charges of \$6,893,000 during the quarter ended December 31, 2001.

The major components of the restructuring charges and the remaining accrual balances as of December 31, 2002 are as follows (in thousands):

|                     | Total<br>Charges | Non-cash<br>Charges to date | Cash Charges<br>to date |
|---------------------|------------------|-----------------------------|-------------------------|
| Workforce reduction | \$ 2,214         | \$ -                        | \$ 2,053                |
| Lease obligations   | 3,094            | -                           | 1,343                   |
| Asset disposals     | 1,585            | 1,585                       | -                       |
|                     | -----            | -----                       | -----                   |
| Total               | \$ 6,893         | \$ 1,585                    | \$ 3,396                |
|                     | =====            | =====                       | =====                   |

#### NOTE 11 - LEGAL PROCEEDINGS

Except as set forth below, in management's opinion, there are no significant legal proceedings to which the Company or any of its subsidiaries is a party or to which any of their properties are subject. The Company is involved in other lawsuits and claims generally incidental to its business including, but not limited to, various suits, including previously disclosed suits in the 2002 Annual Report filed on Form 10-K, brought against the Company by individual consumers seeking monetary and/or injunctive relief relating to the marketing of the Company's programs. In addition, from time to time, and in the regular course of its business, the Company receives inquiries from various federal and/or state regulatory authorities. Management does not believe that there will be any material effect on the results of operations as a result of its outstanding litigation proceedings.

In March 2002, the Company and other plaintiffs filed suit against Homestore.com, Inc. in United States District Court for the District of Connecticut. The action was transferred to the United States District Court for the Central District of California. The suit, which sought injunctive and other relief, alleged securities fraud, negligent misrepresentation, breach of contract and other grounds in connection with the Company's sale of its interest in iPlace, Inc. In response to plaintiffs' preliminary motions, the court ordered Homestore.com, Inc. to place \$58,000,000 in a constructive trust pending resolution of the lawsuit or further order of the court. During the quarter ended September 30, 2002, MemberWorks, along with certain of the other former shareholders of iPlace, Inc., settled their lawsuit against Homestore.com, Inc. The total settlement amount in favor of the plaintiffs was \$23,000,000, of which

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MemberWorks received \$19,148,000.

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### MEMBERWORKS INCORPORATED

#### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

On January 24, 2003, the Company filed a motion with the Superior Court for the Judicial District of Hartford, Connecticut to vacate and oppose the confirmation of an arbitration award issued in December 2002. The arbitration, filed against the Company by MedValUSA Health Programs, Inc. ("MedVal") in September 2000, involved claims of breach of contract, breach of the duty of good faith and fair dealing, and violation of the Connecticut Unfair Trade Practices Act ("CUTPA"). Even though the arbitrators found that MemberWorks was not liable to MedVal for any compensatory damages, they awarded \$5,495,000 in punitive damages and costs against MemberWorks solely under CUTPA. MemberWorks believes that this arbitration award is unjustified and not based on any existing legal precedent. Specifically, the Company is challenging the award on a number of grounds, including that it violates a well defined public policy against excessive punitive damage awards, raises constitutional issues and disregards certain legal requirements for a valid award under CUTPA. The hearing on the Company's motion was held on February 10, 2003. However, the date that the judge will rule on the motion is unknown. While the Company intends to vigorously seek to vacate this award, as well as to take action to prevent the enforcement of the award by, among other things, seeking to prevent the confirmation of the award, there can be no assurance that MemberWorks will be successful in its efforts. The Company has made no provision in its financial statements for this contingency because it believes that a loss is not probable.

#### NOTE 12 - NEW ACCOUNTING PRONOUNCEMENTS

In June 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 146"), which is effective for exit or disposal activities that are initiated after December 31, 2002. SFAS 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs in a Restructuring)." MemberWorks does not believe that the adoption of SFAS 146 will have a material impact on the Company's financial statements.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 requires a guarantor to include disclosure of certain obligations, and if applicable, at the inception of the guarantee, recognize a liability for the fair value of other certain obligations undertaken in issuing a guarantee. The recognition requirement is effective for guarantees issued or modified after December 31, 2002. MemberWorks does not believe that the adoption of FIN 45 will have a material impact on the Company's financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an Amendment of FASB Statement No. 123." This Statement amends FASB Statement No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for an entity that

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voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of that Statement to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. Finally, this Statement amends APB Opinion No. 28, "Interim Financial Reporting," to require disclosure about those effects in interim financial information. The transition provisions of this statement shall be effective for financial statements with fiscal years ending after December 15, 2002. The disclosure provisions of this statement shall be effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. The Company has not yet completed its analysis of the effects of adopting this statement on its consolidated financial positions or results of operations.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). FIN 46 clarifies the application of Accounting Research Bulletin No. 51 and applies immediately to any variable interest entities created after January 31, 2003 and to variable interest entities in which an interest is obtained after that date. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. While it will continue to evaluate the requirements of FIN 46, MemberWorks does not believe that the adoption of FIN 46 will have a material impact on the Company's financial statements.

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### MEMBERWORKS INCORPORATED

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

##### OVERVIEW

MemberWorks addresses the needs of organizations seeking to leverage the expertise of an outside provider in offering membership service programs. Membership service programs offer selected products and services from a variety of vendors for an annual fee or a monthly fee. Membership service programs intend to enhance existing relationships between businesses and consumers. MemberWorks derives its revenues principally from annually renewable membership fees. The Company generally receives full payment of annual fees at or near the beginning of the membership period, but recognizes revenue as the member's refund privilege expires. Similarly, the costs associated with soliciting each new member, as well as the cost of royalties paid to clients, are recognized as the related revenue is recognized. Profitability and cash flow generated from renewal memberships exceed that of new memberships due to the absence of solicitation costs associated with new member procurement.

##### CRITICAL ACCOUNTING POLICIES

Critical accounting policies are those policies that are important to the Company's financial condition and results and involve subjective or complex judgments on the part of management, often as a result of the need to make estimates. The following areas all require the use of judgments and estimates: membership cancellation rates, deferred marketing costs, valuation of intangible assets, estimation of remaining useful lives of intangible assets, estimation of the effective tax rate and valuation of deferred tax assets. Estimates in each

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of these areas are based on historical experience and various assumptions that MemberWorks believes are appropriate. Actual results may differ from these estimates. MemberWorks believes the following represent the critical accounting policies of the Company as contemplated by Financial Reporting Release No. 60, "Cautionary Advice Regarding Disclosure about Critical Accounting Policies." For a summary of all of the Company's significant accounting policies, see Note 2 of the Notes to the consolidated financial statements of the Company's 2002 Annual Report filed on Form 10-K.

### Revenue recognition

Membership fees are billed through clients of the Company primarily through credit cards. During an initial annual membership term or renewal term, a member may cancel his or her membership in the program, either for a complete refund of the membership fee for that period or a prorata refund based on the remaining portion of the membership period depending upon the terms of the membership program. Deferred membership fees are recorded, net of estimated cancellations, after the trial period has expired, and are amortized as revenues from membership fees upon the expiration of membership refund privileges. Revenue from members who are charged on a monthly payment program is recognized, net of estimated cancellations, as the membership fees are billed. An allowance for cancellations is established based on management's estimates and is updated regularly. In determining the estimate of allowance for cancellations, management analyzes historical cancellation experience, current economic trends and changes in customer demand for the Company's products. Actual membership cancellations are charged against the allowance for cancellations on a current basis. If actual cancellations differ from the estimate, the results of operations would be impacted. Accrued liabilities set forth in the accompanying consolidated balance sheets as of December 31, 2002 and June 30, 2002 include an allowance for membership cancellations of \$26.3 million and \$23.8 million, respectively.

### Membership solicitation and other deferred costs

Membership solicitation costs include marketing and direct mail costs related directly to membership solicitation (i.e., direct response advertising costs). In accordance with the American Institute of Certified Public Accountants Statement of Position 93-7, "Reporting on Advertising Costs," direct response advertising costs are deferred and charged to operations over the membership period. Other deferred costs consist of royalties paid to clients, which relate to the same revenue streams as the direct response advertising costs and are also charged to income over the membership period. Total membership solicitation costs incurred to obtain a new member generally are less than the estimated total membership fees. However, if total membership solicitation costs were to exceed total estimated membership fees, an adjustment would be made to the extent of any impairment.

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## MEMBERWORKS INCORPORATED

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

### Valuation of goodwill and other intangibles

MemberWorks reviews the carrying value of its goodwill and other intangible assets, and assesses the remaining estimated useful lives of its intangible assets, in accordance with Financial Accounting Standards Board ("FASB")

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Statement No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). The Company reviews the carrying value of its goodwill and other intangible assets by comparing such amounts to their fair values. MemberWorks is required to perform this comparison at least annually or more frequently if circumstances indicate possible impairment. When determining fair value, the Company utilizes various assumptions, including projections of future cash flows. A change in these underlying assumptions will cause a change in the results of the tests and, as such, could cause fair value to be less than the carrying amounts. In such an event, MemberWorks would then be required to record a corresponding charge, which would negatively impact earnings. Goodwill at July 1, 2002 and 2001, was tested for impairment during the quarters ended September 30, 2002 and 2001, respectively. The Company concluded that none of its goodwill was impaired as of July 1, 2002. As of July 1, 2001, the Company determined that there was an impairment of goodwill of \$5.9 million at one of its reporting units due to the change in methodology of calculating impairment under SFAS 142 concurrent with downward trends in the operations of the reporting unit (see Note 2 to the Condensed Consolidated Financial Statements). This amount was recorded as a cumulative effect of accounting change in the statement of operations in the fiscal quarter ended September 30, 2001.

### Income tax provision

MemberWorks estimates current tax provisions or benefits based on a projected effective tax rate for the fiscal year ended June 30, 2003 using the most currently available information and forecasts. The projected effective tax rate is updated for actual results and estimates when they become known. In addition, MemberWorks assesses the realization of deferred tax assets considering various assumptions, including estimates of future taxable income and ongoing tax strategies. A change in these underlying assumptions would impact the results of operations.

### THREE MONTHS ENDED DECEMBER 31, 2002 VS. THREE MONTHS ENDED DECEMBER 31, 2001

REVENUES. Revenues increased 11% to \$114.0 million for the quarter ended December 31, 2002 from \$102.7 million for the quarter ended December 31, 2001. The increase in revenues is due to the Company's strategic initiative to migrate its members that participate in a full-money-back refund policy program to a prorata refund policy program, in addition to an increase in the average program price point. As of December 31, 2002, virtually all of the Company's membership base is enrolled in a prorata refund policy program. As a result of the Company's strategic initiative to move its members to a prorata refund policy program, revenues which would have been recognized at the end of a membership year are now recognized ratably during the membership year as the refund privileges expire in accordance with Staff Accounting Bulletin 101, "Revenue Recognition in the Financial Statements" ("SAB 101"). As a percentage of total revenues, annual renewal revenues were 50% in 2002 and 50% in 2001. Revenue from members who are charged on a monthly payment program increased to \$17.4 million for the quarter ended December 31, 2002 from \$7.8 million for the quarter ended December 31, 2001 due to an increase in members enrolled in a monthly payment plan.

MEMBERWORKS INCORPORATED

MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

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REVENUES BEFORE DEFERRAL. Revenues before deferral, which are revenues before the application of SAB 101, are an important measure of the Company's performance during the reporting period because they represent the actual membership fees billed during the current reporting period less an allowance for cancellations. The Company's management utilizes revenues before deferral to measure the Company's current performance. In contrast, revenue, as recognized under SAB 101, represents the membership fees billed in prior periods less an allowance for cancellations that have been amortized and recognized as the refund privileges expire. Revenues before deferral increased 10% to \$111.0 million for the quarter ended December 31, 2002 from \$101.2 million for the quarter ended December 31, 2001. Revenues before deferral increased compared to the prior year primarily due to an increase in the average program price point. The Company's membership base decreased to approximately 6.3 million members at December 31, 2002 from 6.5 million members at December 31, 2001 due to the controlled marketing slow down implemented in the beginning of fiscal 2002. This controlled marketing slow down was due to decreased response rates in certain distribution channels. As a percentage of total revenues before deferral, annual renewal revenues were 49% in 2002 and 50% in 2001. Members who are billed on a monthly payment plan are billed each month until the member cancels and the revenues from these members are excluded from the calculation of annual renewal revenues. Revenue from members who are charged on a monthly payment program increased to \$17.4 million for the quarter ended December 31, 2002 from \$7.8 million for the quarter ended December 31, 2001 due to an increase in members enrolled in a monthly payment plan.

OPERATING EXPENSES. Operating expenses consist of member service call center costs, membership benefit costs and membership program fulfillment costs. Operating expenses decreased 2% to \$19.2 million for the quarter ended December 31, 2002 from \$19.5 million for the quarter ended December 31, 2001. As a percentage of revenues, operating expenses decreased to 16.8% for the quarter ended December 31, 2002 from 19.0% for the quarter ended December 31, 2001 due to cost control measures and operating expense leverage gained from increased revenues.

MARKETING EXPENSES. Marketing expenses consist of direct solicitation costs incurred to obtain new members and royalties paid to clients, which are generally amortized in the same manner as the related revenue. Marketing expenses increased 22% to \$69.9 million for the quarter ended December 31, 2002 from \$57.4 million for the quarter ended December 31, 2001 due to an increased mix of non-deferred marketing costs expensed in 2002. As a percentage of revenue, marketing expenses increased to 61.3% in 2002 from 55.9% in 2001.

MARKETING COSTS BEFORE DEFERRAL. Marketing costs before deferral, which are marketing costs before the application of SAB 101, are an important measure of the Company's performance during the reporting period because they represent the actual marketing costs incurred during the current reporting period. The Company's management utilizes marketing costs before deferral to measure the Company's current performance. In contrast, marketing expenses, as recognized under SAB 101, represent the marketing costs incurred in prior periods that have been amortized and recognized in the same manner as the related revenues. Marketing costs before deferral increased 9% to \$59.8 million for the quarter ended December 31, 2002 from \$55.1 million for the quarter ended December 31, 2001 primarily due to the 10% increase in revenue before deferral. As a percentage of revenues before deferral, marketing costs before deferral decreased to 53.8% in 2002 from 54.4% in 2001 primarily due to an improvement in new member marketing efficiencies.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses primarily include personnel-related costs, occupancy costs and other overhead costs. General and administrative expenses increased 1% to \$18.8 million for the quarter ended December 31, 2002 from \$18.6 million for the quarter ended

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December 31, 2001. As a percentage of revenues, general and administrative expenses decreased to 16.5% in 2002 from 18.1% in 2001 primarily due to leverage gained from increased revenues.

AMORTIZATION OF OTHER INTANGIBLES. Intangible amortization decreased to \$0.3 million during the quarter ended December 31, 2002 from \$0.4 million for the quarter ended December 31, 2001.

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### MEMBERWORKS INCORPORATED

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

OTHER INCOME, NET. Other income, net is primarily composed of interest income from cash and cash equivalents and interest expense on the Company's borrowings under its line of credit during the period. Other income was \$0.2 million for the quarter ended December 31, 2002 versus \$0.1 million for the quarter ended December 31, 2001. The increase in other income is due to an increased cash balance during the December 31, 2002 quarter.

PROVISION FOR INCOME TAXES. During the quarter ended December 31, 2002, the Company recorded a tax provision of \$0.7 million based on an effective tax rate of approximately 12%. The effective tax rate varied from the U.S. statutory rate for the quarter ended December 31, 2002 primarily due to the utilization of net operating loss carryforwards. The Company was not required to record a provision for income taxes for the quarter ended December 31, 2001 due to a tax loss realized in that period.

#### SIX MONTHS ENDED DECEMBER 31, 2002 VS. SIX MONTHS ENDED DECEMBER 31, 2001

REVENUES. Revenues decreased 1% to \$219.0 million for the six months ended December 31, 2002 from \$221.6 million for the six months ended December 31, 2001. The decrease in revenues is due to the sale of iPlace, Inc. and the closing of the United Kingdom operations. Excluding iPlace, Inc. from the prior year, revenues were \$219.0 million and \$212.3 million during the six months ended December 31, 2002 and 2001, respectively. The increase in revenues is due to the Company's strategic initiative to migrate its members that participate in a full-money-back refund policy program to a prorata refund policy program, in addition to an increase in the average program price point. As of December 31, 2002, virtually all of the Company's membership base is enrolled in a prorata refund policy program. As a result of the Company's strategic initiative to move its members to a prorata refund policy program, revenues which were recognized at the end of a membership year are now recognized ratably during the membership year as the refund privileges expire in accordance with SAB 101. As a percentage of total revenues, annual renewal revenues were 48% in 2002 and 49% in 2001. Members who are billed on a monthly payment plan are billed each month until the member cancels and the revenues from these members are excluded from the calculation of annual renewal revenues. The decrease in annual renewal revenues as a percentage of total revenues is due to the increase in revenue from monthly members. Revenue from members who are charged on a monthly payment program increased to \$33.8 million during the six months ended December 31, 2002 from \$15.5 million during the six months ended December 31, 2001 due to an increase in members enrolled in a monthly payment plan.

REVENUES BEFORE DEFERRAL. Revenues before deferral increased 1% to \$209.1



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million for the six months ended December 31, 2002 from \$206.7 million for the six months ended December 31, 2001. Excluding revenue from iPlace, Inc. and the United Kingdom from the prior year, revenue before deferral increased 8%. Revenues before deferral increased compared to the prior year due to an increase in the average program price points as more members move to the premium products. The Company's membership base decreased to approximately 6.3 million members at December 31, 2002 from 6.5 million members at December 31, 2001 due to the controlled marketing slow down implemented in the beginning of fiscal 2002. As a percentage of total revenues before deferral, annual renewal revenues were 49% in 2002 and 49% in 2001. Revenue from members who are charged on a monthly payment program increased to \$33.8 million during the six months ended December 31, 2002 from \$15.5 million during the six months ended December 31, 2001 due to an increase in members enrolled in a monthly payment plan.

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### MEMBERWORKS INCORPORATED

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

**OPERATING EXPENSES.** Operating expenses decreased 8% to \$37.3 million for the six months ended December 31, 2002 from \$40.6 million for the six months ended December 31, 2001 primarily due to sale of iPlace, Inc. As a percentage of revenues, operating expenses decreased to 17.0% for the six months ended December 31, 2002 from 18.3% for the six months ended December 31, 2001 primarily due to the sale of iPlace, Inc. which had higher operating costs as a percentage of revenue, the cost savings initiatives implemented in the beginning of the December 2001 quarter and operating expense leverage gained from increased revenues.

**MARKETING EXPENSES.** Marketing expenses increased 1% to \$135.4 million for the six months ended December 31, 2002 from \$134.2 million for the six months ended December 31, 2001. As a percentage of revenue, marketing expenses increased to 61.8% in 2002 from 60.6% in 2001. These increases are primarily due to a higher level of non-deferrable marketing expenses in six months ended December 31, 2002.

**MARKETING COSTS BEFORE DEFERRAL.** Marketing costs before deferral decreased 9% to \$114.7 million for the six months ended December 31, 2002 from \$125.4 million for the six months ended December 31, 2001. As a percentage of revenues before deferral, marketing costs before deferral decreased to 54.8% in 2002 from 60.7% in 2001. These decreases were primarily due to an improvement in new member marketing efficiencies and the sale of iPlace, Inc.

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses decreased 10% to \$37.6 million for the six months ended December 31, 2002 from \$41.6 million for the six months ended December 31, 2001. As a percentage of revenues, general and administrative expenses decreased to 17.2% in 2002 and 18.8% in 2001. These decreases were primarily due to the sale of iPlace, Inc., the closing of the United Kingdom operations and cost savings initiatives implemented in the beginning of the quarter ended December 31, 2001.

**AMORTIZATION OF OTHER INTANGIBLES.** Intangible amortization decreased to \$0.7 million during the six months ended December 31, 2002 from \$1.1 million for the six months ended December 31, 2001 due to the effect of the sale of iPlace, Inc.

**SETTLEMENT OF INVESTMENT RELATED LITIGATION.** During the quarter ended September

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30, 2002, MemberWorks, along with certain of the other former shareholders of iPlace, Inc., settled their lawsuit against Homestore.com, Inc. The total settlement amount in favor of the plaintiffs was \$23.0 million of which MemberWorks received \$19.1 million.

**GAIN ON SALE OF SUBSIDIARY.** During the quarter ended September 30, 2001, the Company sold its investment in iPlace, Inc. for \$50.1 million in cash and 1.6 million shares of Homestore.com, Inc. stock. The Company reported a gain of \$65.6 million on the sale. During the quarter ended September 30, 2002, the Company settled with Homestore.com, Inc. all issues pending related to amounts held in escrow in connection with the sale. The Company recorded a net loss of \$1.0 million related to this purchase price adjustment in the quarter ended September 30, 2002.

**NET LOSS ON INVESTMENT.** During the quarter ended September 30, 2001, the Company reported a loss of \$22.3 million reflecting the write-down of the Company's investment in Homestore.com, Inc. common stock to its fair market value. During the quarter ended September 30, 2002, the Company sold all of its Homestore.com, Inc. common stock and recognized a loss of \$0.2 million.

**OTHER INCOME/EXPENSE, NET.** Other income/expense, net is primarily composed of interest income from cash and cash equivalents and interest expense on the Company's borrowings under its line of credit. Other income increased to \$0.3 million in 2002 from expense of less than \$0.1 million in 2001 due to the increase in the Company's cash balance.

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### MEMBERWORKS INCORPORATED

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

**PROVISION FOR INCOME TAXES.** During the six months ended December 31, 2002, the Company recorded a tax provision of \$3.1 million based on an effective tax rate of approximately 12%. The effective tax rate varied from the U.S. statutory rate for the six months ended December 31, 2002 primarily due to the utilization of net operating loss carryforwards. During the quarter ended September 30, 2001, the Company recorded a provision for alternative minimum taxes of approximately \$0.7 million in connection with the gain on the sale of iPlace, Inc. this provision for alternative minimum taxes was later reversed in the June 2002 quarter due to a change in the tax laws.

#### LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operating activities was \$30.0 million for the six months ended December 31, 2002 versus cash used in operating activities of \$3.4 million for the six months ended December 31, 2001. Net cash provided by operating activities is comprised of operating cash flow before changes in assets and liabilities and changes in assets and liabilities.

Operating cash flow before changes in assets and liabilities was positive \$25.5 million for the six months ended December 31, 2002 compared to negative \$0.7 million for the six months ended December 31, 2001. The increase in operating cash flow before changes in assets and liabilities was due to a decrease in marketing costs before deferral as a percentage of revenue before deferral, cost savings as a result of the restructuring plan and the actual costs incurred in

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December 2001 related to the restructuring plan. Revenues before deferral were \$209.1 million for the six months ended December 31, 2002 versus \$206.7 million for the six months ended December 31, 2001. Marketing expenses before deferral were \$114.7 million for the six months ended December 31, 2002 versus \$125.4 million for the six months ended December 31, 2001. As a percent of revenues before deferral, marketing expenses before deferral were 54.8% in 2002 and 60.7% in 2001. These decreases were primarily due to an improvement in new member marketing efficiencies and the sale of iPlace, Inc. Revenues before deferral increased 8% excluding revenue from iPlace, Inc., which was sold in August 2001, and the United Kingdom operating subsidiary, which was closed in October 2001, from the prior year. Excluding marketing expenses from iPlace, Inc., marketing expenses before deferral decreased 4%.

Changes in assets and liabilities increased cash from operating activities by \$4.6 million in 2002 versus a decrease of \$2.6 million in 2001. The positive effect of changes in assets and liabilities during the six months ended December 31, 2002 was primarily due to an increase in the cancellation liability related to the increase in revenue before deferral and the timing of the payment of certain expenses which the Company expects will reverse in the March 2003 quarter.

Net cash provided by investing activities was \$15.6 million in 2002 versus \$43.0 million in 2001. During the six months ended December 31, 2002, MemberWorks, along with certain of the other former shareholders of iPlace, Inc., settled their lawsuit against Homestore.com, Inc. The total settlement amount in favor of the plaintiffs was \$23.0 million of which MemberWorks received \$19.1 million. In addition, during the six months ended December 31, 2002, the Company settled with Homestore.com, Inc. all issues pending related to amounts held in escrow in connection with the sale. The Company paid \$0.8 million from the escrow account related to the settlement. The net cash provided by investing activities during the six months ended December 31, 2001 includes the receipt of \$46.0 million in net proceeds from the sale of iPlace, Inc. in 2001. Capital expenditures were \$2.8 million during the six months ended December 31, 2002 and \$3.0 million during the six months ended December 31, 2001.

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### MEMBERWORKS INCORPORATED

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Net cash used in financing activities was \$14.0 million for the six months ended December 31, 2002 versus \$14.8 million for the six months ended December 31, 2001 primarily due to the repurchase of treasury stock. The Company purchased 873,000 shares of treasury stock in 2002 for \$15.0 million, an average price of \$17.13, and 1,142,000 shares in 2001 for \$15.7 million, an average price of \$13.72. During the quarter ended September 30, 2002, the Board of Directors authorized an additional 2.5 million shares to be repurchased under the buyback program. As of December 31, 2002, the Company had 2.1 million shares available for repurchase under its buyback program.

As of December 31, 2002, the Company had cash and cash equivalents of \$82.8 million. In addition, the Company has an \$18 million bank credit facility which bears interest at the higher of the base commercial lending rate for the bank or the Federal Funds Rate plus 0.5% per annum. As of December 31, 2002, the effective interest rate for borrowings was 6.16%. There were no borrowings outstanding under this bank credit facility as of December 31, 2002. The bank

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credit facility has certain financial covenants, including a maximum debt coverage ratio, a minimum fixed charges coverage ratio, potential restrictions on additional borrowings and potential restrictions on additional stock repurchases. The Company believes that existing cash balances, cash generated from its operations and its available bank credit facility, will be sufficient to meet its funding requirements for at least the next twelve months.

The Company did not have any material commitments for capital expenditures as of December 31, 2002. The Company intends to utilize cash generated from operations to fulfill any capital expenditure requirements for the remainder of fiscal 2003.

### COMMITMENTS

The Company is not aware of any factors that are reasonably likely to adversely affect liquidity trends, other than the risk factors presented in the Forward Looking Statements in this Form 10-Q filing. The Company does not have off-balance sheet arrangements, non-exchange traded contracts or material related party transactions.

Future minimum payments of contractual obligations as of December 31, 2002 are as follows (amounts in thousands):

|                             | Payments Due by Period |                     |                  |                 |
|-----------------------------|------------------------|---------------------|------------------|-----------------|
|                             | Total                  | Less than<br>1 year | 1-3 years        | 4-5 years       |
| Operating leases            | \$ 27,645              | \$ 6,424            | \$ 11,135        | \$ 5,340        |
| Capital leases              | 33                     | 33                  | -                | -               |
| Notes payable               | -                      | -                   | -                | -               |
| Other long-term obligations | 262                    | 235                 | 27               | -               |
| <b>Total payments due</b>   | <b>\$ 27,940</b>       | <b>\$ 6,692</b>     | <b>\$ 11,162</b> | <b>\$ 5,340</b> |

The Company operates in leased facilities. Management expects that leases currently in effect will be renewed or replaced by other leases of a similar nature and term.

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### MEMBERWORKS INCORPORATED

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

#### NEW ACCOUNTING PRONOUNCEMENTS

In June 2002, the FASB issued Statement No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 146"), which is effective

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for exit or disposal activities that are initiated after December 31, 2002. SFAS 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs in a Restructuring)." MemberWorks does not believe that the adoption of SFAS 146 will have a material impact on the Company's financial statements.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 requires a guarantor to include disclosure of certain obligations, and if applicable, at the inception of the guarantee, recognize a liability for the fair value of other certain obligations undertaken in issuing a guarantee. The recognition requirement is effective for guarantees issued or modified after December 31, 2002. MemberWorks does not believe that the adoption of FIN 45 will have a material impact on the Company's financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an Amendment of FASB Statement No. 123." This Statement amends FASB Statement No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of that Statement to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. Finally, this Statement amends APB Opinion No. 28, "Interim Financial Reporting," to require disclosure about those effects in interim financial information. The transition provisions of this statement shall be effective for financial statements with fiscal years ending after December 15, 2002. The disclosure provisions of this statement shall be effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. The Company has not yet completed its analysis of the effects of adopting this statement on its consolidated financial positions or results of operations.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). FIN 46 clarifies the application of Accounting Research Bulletin No. 51 and applies immediately to any variable interest entities created after January 31, 2003 and to variable interest entities in which an interest is obtained after that date. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. While it will continue to evaluate the requirements of FIN 46, MemberWorks does not believe that the adoption of FIN 46 will have a material impact on the Company's financial statements.

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MANAGEMENT'S DISCUSSION AND ANALYSIS  
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FORWARD LOOKING STATEMENTS

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This Quarterly Report on Form 10-Q contains forward-looking statements that are based on current expectations, estimates, forecasts and projections about the industry in which MemberWorks operates and the Company's management's beliefs and assumptions. These forward-looking statements include statements that do not relate solely to historical or current facts and can be identified by the use of words such as "believe," "expect," "estimate," "project," "continue" or "anticipate." These forward-looking statements are made pursuant to safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements are not guarantees of future performance and are based on a number of assumptions and estimates that are inherently subject to significant risks and uncertainties, many of which are beyond our control, cannot be foreseen and reflect future business decisions that are subject to change. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Among the many factors that could cause actual results to differ materially from the forward-looking statements are:

- Higher than expected membership cancellations;
- Lower than expected membership renewal rates;
- Changes in the marketing techniques of credit card issuers;
- Increases in the level of commission rates and other compensation required by marketing partners to actively market with MemberWorks;
- Potential reserve requirements by business partners such as the Company's payment processors;
- Unanticipated cancellation or termination of marketing agreements and the extent to which MemberWorks can continue successful development and marketing of new products and services;
- Unanticipated changes in or termination of the Company's ability to process membership fees through third parties, including clients, payment processors and bank card associations;
- The Company's ability to introduce new programs on a timely basis;
- The Company's ability to develop and implement operational and financial systems to manage growing operations;
- The Company's ability to recover from a complete or partial system failure or impairment, other hardware or software related malfunctions or programming errors;
- The Company's ability to obtain financing on acceptable terms to finance the Company's growth strategy and to operate within the limitations imposed by financing arrangements;
- The Company's ability to integrate acquired businesses into the Company's management and operations and operate successfully;
- Further changes in the already competitive environment for the Company's products or competitors' responses to the Company's strategies;
- Changes in the growth rate of the overall U.S. economy, or the international economy where MemberWorks does business, such that credit availability, interest rates, consumer spending and related consumer debt are impacted;
- Additional government regulations and changes to existing government regulations of the Company's industry; and
- New accounting pronouncements

Many of these factors are beyond MemberWorks' control, and, therefore, its ability to generate predictable revenue and income growth may be adversely affected by these factors.

MemberWorks cautions that such factors are not exclusive. All of the forward-looking statements made in this Quarterly Report on Form 10-Q are qualified by these cautionary statements and readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. Except as required by law,

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MemberWorks does not have any intention or obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

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### MEMBERWORKS INCORPORATED

#### Item 3. Quantitative and Qualitative Disclosures about Market Risk

##### Interest Rate

The Company has an \$18.0 million bank credit facility which bears interest at the higher of the base commercial lending rate for the bank or the Federal Funds Rate plus 0.5% per annum. There were no borrowings outstanding under this bank credit facility as of December 31, 2002. Management believes that an increase in the commercial lending rate or the Federal Funds rate would not be material to the Company's financial position or its results of operations. If the Company is not able to renew its existing credit facility agreement, which matures on April 1, 2003, it is possible that any replacement lending facility obtained by the Company may be more sensitive to interest rate changes. The Company does not currently hedge interest rates.

##### Foreign Currency

The Company has international sales and facilities in Canada and therefore, is subject to foreign currency rate exposure. Canadian sales have been denominated in the Canadian dollar and its functional currency is the local currency. Assets and liabilities of the Canadian subsidiary are translated into U.S. dollars at the exchange rate in effect as of the balance sheet date. Income and expense items are translated at the average exchange rate for the period. Accumulated net translation adjustments are recorded in shareholders' equity. Foreign exchange transaction gains and losses are included in the results of operations, and were not material for all periods presented. As a result, the Company's financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic condition. To the extent the Company incurs expenses that are based on locally denominated sales volume paid in local currency, the exposure to foreign exchange risk is reduced. The Company has determined that the impact of a near-term 10% appreciation or depreciation of the U.S. dollar would have an insignificant effect on its financial position, results of operations and cash flows. The Company does not maintain any derivative instruments to mitigate the exposure to translation and transaction risk. However, this does not preclude the Company's adoption of specific hedging strategies in the future. MemberWorks will assess the need to utilize financial instruments to hedge currency exposures on an ongoing basis.

##### Fair Value

The Company does not have material exposure to market risk with respect to investments, as the Company does not hold any marketable securities as of December 31, 2002. MemberWorks does not use derivative financial instruments for speculative or trading purposes. However, this does not preclude the Company's adoption of specific hedging strategies in the future.

#### Item 4. Controls and Procedures

##### Evaluation of disclosure controls and procedures.

The chief executive officer and chief financial officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in

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the Securities Exchange Act of 1934 Rules 13a-14(c) and 15-d-14(c)) as of a date within 90 days of the filing of this quarterly report (the "Evaluation Date") and have concluded that as of the Evaluation Date, the Company's disclosure controls and procedures were effective. The Company's disclosure controls and procedures are designed to ensure that material information relating to MemberWorks and its consolidated subsidiaries that are required to be disclosed in its reports under the Exchange Act is accumulated and communicated to the chief executive officer and chief financial officer.

Changes in internal controls.

There were no significant changes in the Company's internal controls or in other factors that could significantly affect our controls subsequent to the Evaluation Date.

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MEMBERWORKS INCORPORATED

### PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

Except as set forth below, in management's opinion, there are no significant legal proceedings to which the Company or any of its subsidiaries is a party or to which any of their properties are subject. The Company is involved in other lawsuits and claims generally incidental to its business including, but not limited to, various suits, including suits previously disclosed in the 2002 Annual Report filed on Form 10-K, brought against the Company by individual consumers seeking monetary and/or injunctive relief relating to the marketing of the Company's programs. In addition, from time to time, and in the regular course of its business, the Company receives inquiries from various federal and/or state regulatory authorities. Management does not believe that there will be any material effect on the results of operations as a result of its outstanding litigation proceedings.

In March 2002, the Company and other plaintiffs filed suit against Homestore.com, Inc. in United States District Court for the District of Connecticut. The action was transferred to the United States District Court for the Central District of California. The suit, which sought injunctive and other relief, alleged securities fraud, negligent misrepresentation, breach of contract and other grounds in connection with the Company's sale of its interest in iPlace, Inc. In response to plaintiffs' preliminary motions, the court ordered Homestore.com, Inc. to place \$58.0 million in a constructive trust pending resolution of the lawsuit or further order of the court. During the quarter ended September 30, 2002, MemberWorks, along with certain of the other former shareholders of iPlace, Inc., settled their lawsuit against Homestore.com, Inc. The total settlement amount in favor of the plaintiffs was \$23.0 million, of which MemberWorks received \$19.1 million.

On January 24, 2003, the Company filed a motion with the Superior Court for the Judicial District of Hartford, Connecticut to vacate and oppose the confirmation of an arbitration award issued in December 2002. The arbitration, filed against the Company by MedValUSA Health Programs, Inc. ("MedVal") in September 2000, involved claims of breach of contract, breach of the duty of good faith and fair dealing, and violation of the Connecticut Unfair Trade Practices Act ("CUTPA"). Even though the arbitrators found that MemberWorks was not liable to MedVal for any compensatory damages, they awarded \$5.5 million in punitive damages and



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costs against MemberWorks solely under CUTPA. MemberWorks believes that this arbitration award is unjustified and not based on any existing legal precedent. Specifically, the Company is challenging the award on a number of grounds, including that it violates a well defined public policy against excessive punitive damage awards, raises constitutional issues and disregards certain legal requirements for a valid award under CUTPA. The hearing on the Company's motion was held on February 10, 2003. However, the date that the judge will rule on the motion is unknown. While the Company intends to vigorously seek to vacate this award, as well as to take action to prevent the enforcement of the award by, among other things, seeking to prevent the confirmation of the award, there can be no assurance that MemberWorks will be successful in its efforts. The Company has made no provision in its financial statements for this contingency because it believes that a loss is not probable.

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### MEMBERWORKS INCORPORATED

#### PART II. OTHER INFORMATION

##### Item 4. Submission of Matters to a Vote of Security Holders

a) MemberWorks Incorporated's 2002 Annual Meeting of Stockholders was held on November 21, 2002.

b) At the annual meeting the following Class III Directors were elected to the Board of Directors as follows:

|                    |            |            |
|--------------------|------------|------------|
| Gary A. Johnson:   | For -      | 10,187,494 |
|                    | Against -  | 1,537,987  |
|                    | Abstain -  | 0          |
|                    | Nonvotes - | 0          |
| Robert Kamerschen: | For -      | 11,415,592 |
|                    | Against -  | 309,889    |
|                    | Abstain -  | 0          |
|                    | Nonvotes - | 0          |

Class I Directors, Alec L. Ellison and Marc S. Tesler, and Class II Directors, Scott N. Flanders, Michael T. McClorey and Edward M. Stern, continue to serve as Directors of the Company.

c) The ratification of PricewaterhouseCoopers LLP as the Company's independent auditors was also approved at the annual meeting as follows:

|            |            |
|------------|------------|
| For -      | 11,288,501 |
| Against -  | 435,870    |
| Abstain -  | 1,110      |
| Nonvotes - | 0          |

##### Item 6. Exhibits and Reports on Form 8-K

a) Exhibits

None.

b) Reports on Form 8-K

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On December 23, 2002, the Company filed on Form 8-K under Item 5 "Other Events" and Item 7 "Financial Statements and Exhibits" a Press Release announcing the completion of a marketing agreement with America Online, Inc.

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MEMBERWORKS INCORPORATED

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.

MEMBERWORKS INCORPORATED  
(Registrant)

Date: February 14, 2003

By: /s/ Gary A. Johnson

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Gary A. Johnson, President, Chief  
Executive Officer and Director

February 14, 2003

By: /s/ James B. Duffy

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James B. Duffy, Executive Vice President and  
Chief Financial Officer (Principal Financial  
and Accounting Officer)

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CERTIFICATIONS

I, Gary A. Johnson, certify that:

1. I have reviewed this quarterly report on Form 10-Q of MemberWorks Incorporated,
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;

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4. The registrant's other certifying officer 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 officer 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 officer 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.

Dated: February 14, 2003

By: /s/ Gary A. Johnson  
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Gary A. Johnson, President, Chief  
Executive Officer and Director

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### CERTIFICATIONS (CONTINUED)

I, James B. Duffy, certify that:

1. I have reviewed this quarterly report on Form 10-Q of MemberWorks Incorporated,

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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 officer 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 "EvaluationDate"); 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 officer 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 officer 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.

Dated: February 14, 2003 By: /s/ James B. Duffy

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James B. Duffy, Executive Vice President and  
Chief Financial Officer (Principal Financial  
and Accounting Officer)

