TALK AMERICA HOLDINGS INC
Form 10-K/A
March 28, 2006

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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 Exhbits 23, 31 and 32. In addition, the Part III items of this Report have been amended and are included herein.

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, 2005
Commission File No. 000-26728

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

Delaware	**23-2827736**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
6805 Route 202 **New Hope, PA**	**18938**
(Address of principal executive offices)	(zip code)

(215) 862-1500
(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 if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to section 13 or Section 15(d) of the Act.
Yes [ ] No [X]

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ]

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

As of June 30, 2005, 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, 2005 of $10.04 per share as reported on the Nasdaq National Market, was approximately $277,788,698 (calculated by excluding solely for purposes of this form outstanding shares owned by directors and executive officers).

As of March 1, 2006, the registrant had issued and outstanding 30,396,192 shares of common stock, par value $.01 per share.

DOCUMENTS INCORPORATED BY REFERENCE

None.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
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Unless the context otherwise requires, references to "us," "we," and "our" or to "Talk America" refer to Talk America Holdings, Inc. and its subsidiaries.
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PART II

ITEM 6. SELECTED FINANCIAL DATA.

The selected consolidated unaudited 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 Annual Report and our Form 10-K Annual Reports previously filed.

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(In Thousands, Except For Per Share Amounts)				
C Consolidated Statements of Operations Data:					
Revenue	$ 462,740	$ 471,012	$ 383,693	$ 317,507	$ 488,158
Costs and expenses:					
Network and line costs	243,925	225,244	173,349	146,911	218,964
General and administrative expenses	82,127	72,020	63,104	62,166	98,391
Provision for doubtful accounts	19,114	21,313	11,599	9,365	92,778
Sales and marketing expenses	29,863	70,202	51,008	27,148	73,973
Depreciation and amortization	44,937	22,904	18,345	17,318	34,390
Impairment and restructuring charges	--	--	--	--	170,571
Total costs and expenses	419,966	411,683	317,405	262,908	689,067
Operating income (loss)	42,774	59,329	66,288	54,599	(200,909)
Other income (expense):					
Interest income	1,007	290	388	802	1,220
Interest expense	(350)	(733)	(7,353)	(9,087)	(6,091)
Other income (expense), net	974	1,895	2,470	28,448	17,950
Income (loss) before provision (benefit) for income taxes	44,405	60,781	61,793	74,762	(187,830)
Provision (benefit) for income taxes	18,244	23,969	(20,024)	(22,300)	--
Income (loss) before cumulative effect of an accounting change	26,161	36,812	81,817	97,062	(187,830)
Cumulative effect of an accounting change	--	--	--	--	(36,837)
Net income (loss)	$ 26,161	$ 36,812	$ 81,817	$ 97,062	$ (224,667)
Income (loss) per share - Basic:					
Income (loss) before cumulative effect of an accounting change per share	$ 0.91	$ 1.37	$ 3.10	$ 3.56	$ (7.11)
Cumulative effect of an accounting change per share	--	--	--	--	(1.40)
Net income (loss) per share	$ 0.91	$ 1.37	$ 3.10	$ 3.56	$ (8.51)

Weighted average common shares outstanding		28,675		26,847		26,376		27,253		26,414
Income (loss) per share - Diluted:										
Income (loss) before cumulative effect of an accounting change per share	$	0.89	$	1.32	$	2.94	$	3.15	$	(7.11)
Cumulative effect of an accounting change per share		--		--		--		--		(1.40)
Net income (loss) per share	$	0.89	$	1.32	$	2.94	$	3.15	$	(8.51)
Weighted average common and common equivalent shares outstanding		29,296		27,854		27,806		30,798		26,414

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	At December 31,				
	2005	2004	2003	2002	2001
			(In Thousands)		
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 46,288	$ 47,492	$ 35,242	$ 33,588	$ 22,100
Total current assets	118,281	138,068	105,595	82,825	51,214
Goodwill and intangibles, net	41,413	14,979	17,769	26,882	29,672
Total assets	288,689	241,728	247,178	189,075	165,737
Current portion of long-term debt	3,988	2,529	16,806	61	14,454
Total current liabilities	88,739	84,584	93,235	64,754	87,789
Long-term debt	1,289	1,717	31,791	100,855	152,370
Stockholders' equity (deficit)	$ 191,787	$ 141,521	$ 103,143	$ 23,466	$ (74,422)

See “Management’s Discussion and Analysis of Financial Condition and Results of Operations” for a discussion of items affecting the results of 2003, 2004 and 2005.

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 Annual Report.

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 Annual 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

Talk America Holdings, Inc., through its subsidiaries, is a leading competitive communications services provider offering voice and data services to commercial (primarily small and medium-sized business) and residential customers. We are focused on markets where we have our own networking assets, which we began deploying in Michigan in late 2003. Today, we are collocated in 313 end offices in Michigan, Ohio, Kentucky, Tennessee, North

Carolina, Louisiana, Mississippi, Alabama, Florida and Georgia. As of December 31, 2005, we had approximately 595,000 local voice and data equivalent lines, of which approximately 341,000 were on our own network. Voice equivalent lines include individual telephone lines and T-1 equivalent lines based on circuit bandwidth. Data equivalent lines include DSL, dial-up and T-1 equivalent lines based on circuit bandwidth.

We expanded into the commercial business market with the acquisition in July 2005 of LDMI Telecommunications, Inc. (“LDMI”), a privately held facilities-based competitive local exchange provider serving business and residential customers primarily in Michigan and Ohio. Our results include the results of LDMI since the date of acquisition. In addition, we have significantly expanded our network and commercial business through the acquisition in January 2006 of Network Telephone Corporation (“NTC”), a privately held facilities-based competitive local exchange provider serving commercial customers in the Southeast. As of December 31, 2005, NTC had approximately 150,000 local voice and data equivalent lines, of which approximately 125,000 were on their network. During 2005, we also completed the construction of our network in Michigan, integrated this network with LDMI’s network assets and migrated over 200,000 lines from the incumbent local exchange company wholesale platform to our network. Our off-network customers represent a large, profitable base of bundled phone service customers utilizing the wholesale operating platforms of the incumbent local exchange companies.

Our business strategy is to continue to expand our network and grow our on-net customer and revenue base through (i) organic growth in our core markets serving both commercial and residential customers; (ii) additional acquisitions that either supplement our existing markets or offer expansion into new markets; and (iii) enhancement of our product portfolio. Growth in our on-net business, both commercial and residential, will permit us to leverage our investment in our network facilities due to the complementary telecommunication traffic or usage patterns of these customer bases.

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,		
	2005	**2004**	**2003**
Revenue	100.0%	100.0%	100.0%
Costs and expenses:			
Network and line costs	52.7	47.8	45.2
General and administrative expenses	17.7	15.3	16.4
Provision for doubtful accounts	4.1	4.5	3.0
Sales and marketing expenses	6.5	14.9	13.3
Depreciation and amortization	9.7	4.9	4.8
Total costs and expenses	90.8	87.4	82.7
Operating income	9.2	12.6	17.3
Other income (expense):			
Interest income	0.2	0.1	0.1
Interest expense	(0.1)	(0.2)	(1.9)
Other, net	0.2	0.4	0.6
Income before income taxes	9.6	12.9	16.1
Provision (benefit) for income taxes	3.9	5.1	(5.2)
Net income	5.7%	7.8%	21.3%

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,	
	2005	**2004**
Revenue	(1.8%)	22.8%
Costs and expenses:		
Network and line costs	8.3%	29.9%
General and administrative expenses	14.0%	14.1%
Provision for doubtful accounts	(10.3%)	83.7%
Sales and marketing expenses	(57.5%)	37.6%
Depreciation and amortization	96.2%	24.9%
Total costs and expenses	2.0%	29.7%
Operating income	(27.9%)	(10.5%)
Other income (expense):		
Interest income	247.2%	(25.3%)
Interest expense	(52.3%)	(90.0%)
Other, net	(48.6%)	(23.3%)
Income before income taxes	(26.9%)	(1.6%)
Provision for income taxes	(23.9%)	219.7%

Net income	(28.9%)	(55.0%)

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Revenue. Total revenue decreased in 2005 from 2004. As a result of significant changes to FCC rules, beginning in March 2005, we were no longer able to provide service to new customers using the incumbent local exchange companies' unbundled network platform. In addition, the cost of providing service under replacement wholesale agreements has increased substantially. These cost increases have and will continue to lead us to increase our product pricing, which limits our ability to add new customers and to retain existing customers. Therefore, beginning in March 2005, we ceased our efforts to increase subscriber growth in markets other than those areas where we currently have or plan to deploy network facilities. We began deploying our own networking assets in Michigan in late 2003. These actions have caused a significant decrease in the number of customer lines and revenue during 2005. This decline in customer lines and revenue was partially mitigated by the acquisition of LDMI in the third quarter 2005 and the inclusion of its results from that date. The increase in revenue in 2004 from 2003 was due to an increase in local customer revenue, partially offset by a decline in long distance revenue. During 2004 and 2005, we increased certain fees and rates related to our long distance and local products and such changes in rates have adversely impacted customer turnover. Additional increases in fees and rates related to our long distance and local products will adversely affect customer turnover.

The increase in revenue from customers that are served by our own networking facilities, or on-net, to $75.2 million for 2005 from $3.4 million for 2004 was due to greater average lines in 2005 as compared to 2004 primarily as a result of the migration of customer lines to our own network and, to a lesser degree, the acquisition of LDMI. As of December 31, 2005, our voice and data equivalent lines on-net had increased to 341,000 from 25,000 as of December 31, 2004 and zero as of December 31, 2003.

The decrease in revenue from customers that are not served by our own networking facilities, or off-net, to $331.2 million for 2005 from $404.3 million for 2004 was due to fewer average lines in 2005 as compared to 2004, partially offset by an increase in average monthly revenue per customer. Our off-net voice and data equivalent lines declined during this period due both to the migration of off-net lines to our own network and, in areas where we were not building network, the attrition of customers leaving our services for those of other carriers. This decline was partially offset by increased off net lines as a result of the acquisition of LDMI. As of December 31, 2005, our off-net voice and data equivalent lines had decreased to 254,000 from 668,000 as of December 31, 2004. A significant increase in the costs we pay for network services from the incumbent local telephone carriers has caused us to cease marketing to new customers in markets where we do not currently have network facilities and, as a result of this, together with continued migrations to our network, we expect the decline in off-net revenues to continue in the future. The increase in off-net revenue to $404.3 million in 2004 from $282.3 million in 2003 was due to higher average bundled lines in 2004 as compared to 2003.

Long distance only and other revenue decreased for 2005 to $56.3 million from $63.3 million for 2004 and from $101.4 million in 2003. The acquisition of LDMI partially offset a decline in revenues from our existing long distance base in 2005. 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 long distance customers and revenues to decline in the future.

Network and Line Costs. Network and line costs as a percentage of revenue increased in 2005 from 2004 due to the advanced build out of our Michigan network facilities, the under-utilization of our Ohio network facilities, line migration costs, additional network personnel costs, and increased unbundled network element platform costs. These cost increases more than offset the impact that fewer average bundled lines and long distance customers had on network and line costs and, together with the acquisition of LDMI, resulted in an increase in network and line costs for 2005 from 2004. To date, we have been able to increase our prices to offset per line increases in network and line cost, but these price increases will increase customer turnover. 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. Network and line costs exclude depreciation and amortization of $26.8 million for 2005, $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 or commercial 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 incumbent local exchange 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 incumbent local exchange companies or the expiration of the time period for which we are liable for the charges. In addition, we accrue for network expense in a jurisdiction if there is expected to be regulatory or other legal changes in the jurisdiction that would retroactively increase the rates we have been charged. In Georgia, an appeals court overturned a rate reduction by the state public utility commission and ordered the commission to recalculate the rates charged to us. This issue is currently being considered by the state commission on remand from the court. The state commission has issued an order that will result in increased rates charged to us. We believe that the rates ultimately charged to us will be in excess of those previously allowed by the commission 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 (see "Liquidity and Capital Resources - Other Matters," below).

General and Administrative Expenses. General and administrative expenses increased in 2005 from 2004. This increase was primarily attributable to the LDMI acquisition and to an increase in the number of information technology and network employees needed to support our local networking initiatives, partially offset by a reduction in the number of employees that support our base of off-net customers. As a result, general and administrative expense as a percentage of revenue increased in 2005 from 2004. General and administrative expenses also increased in 2004 from 2003. 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. In addition, in 2004, the increase was partially attributable to a new operating lease for information technology equipment. General and administrative expense as a percentage of revenue decreased in 2004 from 2003. This decrease resulted from the efficiencies of a growing base of revenues relative to certain fixed operating expenses. Beginning in the first quarter of 2006, general and administrative expense will include expenses associated with the issuance of stock options pursuant to SFAS 123 R (see “Critical Accounting Estimates - New Accounting Pronouncements,” below).

Provision for Doubtful Accounts. The provision for doubtful accounts decreased in 2005 from 2004. The decrease was primarily due to a decrease in the average number of customers and a decrease in bad debt expense as a percentage of revenues. 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, an increase in market share outside of Michigan into states where we have experienced generally higher levels of bad debt and the consequences of our experiment, in an effort to expand our addressable market during 2004, 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 2004 resulted in increased bad debt for the third and fourth quarters 2004. Based on these actual results, we ceased utilizing this supplemental screening methodology.

Sales and Marketing Expenses. Sales and marketing expenses decreased significantly in 2005 from 2004. The decreases are attributable to the decrease of sales and marketing activity related to our bundled product, including decreased headcount and reduced direct mail and media expenses due to our reduced efforts to increase subscriber growth in markets where we do not have, or plan to deploy network facilities. Included in sales and marketing expenses are advertising expenses of $3.8 million for 2005, $10.5 million for 2004 and $7.5 million for 2003. We expect sales and marketing expenses to increase in 2006 as we expand our marketing efforts commensurate with the growth of our networking footprint. Sales and marketing expense increased in 2004 from 2003 primarily due to our increased efforts to attract new bundled customers during 2004.

Interest Expense. The decreases in interest expense for 2005 from 2004 and for 2004 from 2003 are primarily attributable to the decreases in outstanding debt balances.

Depreciation and Amortization. Depreciation and amortization increased in 2005 from 2004 primarily due to increased depreciation related to the reduction in the remaining useful lives of our long distance switches and capital expenditures incurred in 2004 and 2005 related to our deployment of networking assets (our local switching and collocation equipment) in Michigan and depreciation and amortization related to the LDMI acquisition. In December 2004, in connection with a review of our fixed assets, the estimated remaining useful lives of our five long distance switches were shortened from an average of 8 years to 1.6 years. This change had the effect of increasing depreciation in 2005 and 2004 by $15.1 million and $1.4 million, respectively. Depreciation increased in 2004 over 2003 due to the increased depreciation related to the reduction in the remaining useful lives of our long distance switches.

Other Income, Net. Other income for 2005 and 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.

LIQUIDITY AND CAPITAL RESOURCES

We assess our liquidity in terms of our ability to generate cash to fund our operations, our capital expenditures and our debt service obligations. For 2005 and 2004, our operating activities provided net cash flow of $72.0 million and $74.6 million, respectively. In 2005, all of the net cash flow from operating activities was used to fund capital expenditures and capitalized software development costs and the acquisition of LDMI. In 2004, the net cash flow from operating activities was used primarily to reduce our outstanding debt obligations. As of December 31, 2005, we had $46.3 million in cash and cash equivalents and long-term debt and capital lease obligations (including current maturities) of $5.3 million, compared to $47.5 million and $4.2 million, respectively, at December 31, 2004.

Our contractual obligations as of December 31, 2005 are summarized by years to maturity as follows (in thousands):

Contractual Obligations	Total	Less than 1 year	1 - 3 Years	3 - 5 Years	More than 5 Years
Vendor financing agreement (1)	$ 1,220	$ 1,220	$ --	$ --	$ --
Capital lease obligations	4,057	2,768	1,289	--	--
Vendor financed maintenance (1)	561	561	--	--	--
Operating leases (2)	21,509	5,175	5,813	4,777	5,744
Purchase commitments (3)	588	588	--	--	--
Invoice printing commitment (4)	3,730	1,213	2,517	--	--
Carrier commitments (5)	73,296	37,637	35,586	48	25
Total Contractual Obligations	$ 104,961	$ 49,162	$ 45,205	$ 4,825	$ 5,769

(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 $0.6 million per year, which is funded on the anniversary dates. As of December 31, 2005, there was approximately $1.2 million outstanding under this loan. In addition, capital lease obligations also have associated interest expense of $0.4 million.

(2) As of December 31, 2005, our contractual obligations under operating leases are primarily for leased facility space.

(3) At December 31, 2005, we had outstanding purchase orders for capital expenditures of $0.6 million.

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

(5) 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 commitments based upon usage as follows: 2006 - $32 million and 2007 - $32 million and obligates us to pay 65 percent of the revenue shortfall, if any. In February 2006, we amended the AT&T agreement to provide that certain services that we purchase or may purchase from AT&T (and its affiliates) will now count toward the minimum commitment. With this amendment we anticipate that we will not be required to make any shortfall payments under this contract. In addition to the AT&T commitment, we have other commitments with various other vendors for telecommunication services.

Cash provided by (used for):

	2005	2004	2003	Percent Change 2005 vs. 2004	Percent Change 2004 vs. 2003
Operating activities	$ 72,012	$ 74,595	$ 73,171	(3.5%)	1.9%
Investing activities	(76,003)	(16,497)	(14,715)	(360.7%)	(12.1%)
Financing activities	2,787	(45,848)	(56,802)	106.1%	19.3%

Cash Provided By Operating Activities. Cash generated by operations decreased by $2.6 million in 2005 from 2004 and increased by $1.4 million in 2004 from 2003. Although cash generated from operations has been relatively flat for 2005, 2004 and 2003, the composition of the cash flow has changed considerably. During 2005, we experienced significantly lower sales and marketing expense, which offset decreased revenue and increased network cost and general and administrative expense. We expect that our cash flow from operations will decline in 2006 as we experience higher sales and marketing expense as a result of our efforts to expand growth in areas where we have networking assets. The application of net operating loss carryforwards, or NOLs, in 2005, 2004 and 2003 has limited our current payment of income taxes to cash taxes for alternative minimum taxes and certain state income taxes, but we expect that Talk America's NOLs will be substantially utilized during 2006. The use of NOLs acquired in the LDMI acquisition will be limited, with the benefit spread through 2018.

Net Cash Used in Investing Activities. Capital expenditures increased by $32.3 million during 2005 as compared to 2004 and capitalized software development costs increased by $0.5 million. In 2005, approximately $40.0 million of our $45.2 million in capital expenditures consisted of costs related to our deployment of networking assets (local switch and collocation equipment) in Michigan. 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 vendor financing agreement for new database software valued at $2.5 million 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 $25.0 and $30.0 million in capital expenditures and capitalized software in 2006, primarily for the build out of the Atlanta networking facilities and expansion of our Michigan network facilities.

The acquisition of LDMI on July 13, 2005, required the payment of $21.3 million in cash ($24.0 million less cash acquired of $2.7 million) and the issuance of 1.8 million shares of our common stock for the purchase of all of the equity of LDMI and the repayment of $4.7 million in debt. The acquisition of NTC on January 3, 2006, required the payment of $18.0 million in cash for the purchase of all of the equity of NTC. To the extent that we are successful in identifying and completing additional acquisitions of customers, networking assets or businesses, net cash used in investing activities may increase.

Net Cash Used in Financing Activities. Net cash provided by financing activities during 2005 was $2.8 million, primarily attributable to proceeds from the exercise of stock options and warrants. Net cash used in financing activities during 2004 was $45.8 million, primarily attributable to the repayment of outstanding debt. 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. 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, 2005, we had not purchased any shares under this program.

In recent years we have been meeting our ongoing cash requirements (including for the conduct of our operations, acquisitions and capital expenditures) from our cash on-hand and from cash generated from operations. However, our continued growth, including additional acquisitions, may require that we seek alternative sources of funding. While we believe that we would have access to new capital in the public or private markets, 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. 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 Form 10-K Annual Report.

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 incumbent local exchange companies. In addition, we accrue for network expense in a jurisdiction if there is expected to be regulatory or other legal changes in the jurisdiction which would retroactively increase the rates we have been 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 by the middle of 2006. 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 incumbent local exchange 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 state. As the expiration of the statute of limitations occurred, 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 2005 and 2004, 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. If we determine deferred tax assets will more likely than not be utilized, we will reduce our valuation allowance accordingly.

New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R). SFAS 123R requires that compensation cost related to share-based payment transactions, including the issuance of stock options, be recognized in the financial statements. Currently, we account for our share-based payment transactions under the provisions of APB 25, which does not necessarily require the recognition of compensation cost in the consolidated statement of income in the financial statements.

In response to the accounting standard referenced above, the Compensation Committee of our Board of Directors, which consists entirely of independent directors, as well as the full Board of Directors, unanimously approved accelerating on December 28, 2005, the vesting of certain out-of-the-money, unvested stock options held by current employees, including our executive officers and directors. The acceleration applied only to those options with an exercise price of $10.49 per share, and granted on December 22, 2003. The closing market price of our common stock on December 27, 2005 was $9.02 per share. The following table summarizes the options subject to acceleration:

	Aggregate Number of Common Stock Shares Issuable Under Accelerated Stock Options	Weighted Average Exercise Price Per Share
Total Non-Employee Directors	11,666	$10.49
Total Named Executive Officers (1)	159,998	$10.49
Total Directors and Named Executive Officers	171,664	$10.49
Total All Other Employees	176,185	$10.49
Total (2)	347,849	$10.49

(1) Named executive officers consist of the officers listed in The Summary Compensation Table in Part III, Item 11. Executive Compensation of this Form 10-K Annual Report.
(2) The accelerated options represent approximately 7.0% of total outstanding options.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK.

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

Our available cash balances are invested on a short-term basis (generally overnight) and, accordingly, are not subject to significant risks associated with changes in interest rates. Substantially all of our cash flows are derived from our operations within the United States and we are not subject to market risk associated with changes in foreign exchange rates.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
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Report of Independent Registered Public Accounting Firm

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

We have completed integrated audits of Talk America Holdings, Inc.'s 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Talk America Holdings, Inc. and its subsidiaries (the "Company") at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15 (a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statements schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of 2005 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Management’s Report on Internal Control over Financial Reporting, management has excluded LDMI Telecommunications, Inc. ("LDMI") from its assessment of internal control over financial reporting as of December 31, 2005 because it was acquired by the Company in a purchase business combination during 2005. LDMI is a wholly-owned subsidiary of the Company that represented approximately 24% and 10% of the Company's total assets and total revenue, respectively, as of and for the year ended December 31, 2005.

PricewaterhouseCoopers LLP
Philadelphia, Pennsylvania
March 27, 2006

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

	Year Ended December 31, 2005	2004	2003
Revenue	$ 462,740	$ 471,012	$ 383,693
Costs and expenses:			
Network and line costs (excluding depreciation shown below)	243,925	225,244	173,349
General and administrative expenses	82,127	72,020	63,104
Provision for doubtful accounts	19,114	21,313	11,599
Sales and marketing expenses	29,863	70,202	51,008
Depreciation and amortization	44,937	22,904	18,345
Total costs and expenses	419,966	411,683	317,405
Operating income	42,774	59,329	66,288
Other income (expense):			
Interest income	1,007	290	388
Interest expense	(350)	(733)	(7,353)
Other income, net	974	1,895	2,470
Income before provision (benefit) for income taxes	44,405	60,781	61,793
Provision (benefit) for income taxes	18,244	23,969	(20,024)
Net income	$ 26,161	$ 36,812	$ 81,817
Income per share - Basic:			
Net income per share	$ 0.91	$ 1.37	$ 3.10
Weighted average common shares outstanding	28,675	26,847	26,376
Income per share - Diluted:			
Net income per share	$ 0.89	$ 1.32	$ 2.94
Weighted average common and common equivalent shares outstanding	29,296	27,854	27,806

See accompanying notes to consolidated financial statements.

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

	December 31, 2005	December 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 46,288	$ 47,492
Accounts receivable, trade (net of allowance for uncollectible accounts of $13,838 and $17,508 at December 31, 2005 and 2004, respectively)	43,600	48,873
Deferred income taxes	18,096	34,815
Prepaid expenses and other current assets	10,297	6,888
Total current assets	118,281	138,068
Property and equipment, net	98,492	65,823
Goodwill	36,479	13,013
Intangible assets, net	4,934	1,966
Deferred income taxes	21,033	14,291
Capitalized software cost and other assets	9,470	8,567
	$ 288,689	$ 241,728
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 40,025	$ 38,843
Sales, use and excise taxes	7,316	11,179
Deferred revenue	13,824	15,321
Current portion of long-term debt and capitalized lease obligations	3,988	2,529
Accrued compensation	9,405	6,690
Other current liabilities	14,181	10,022
Total current liabilities	$ 88,739	$ 84,584
Long-term debt and capitalized lease obligations	1,289	1,717
Deferred income taxes	4,853	13,906
Asset retirement obligation	2,021	--
Commitments and contingencies		
Stockholders' equity:		
Preferred stock - $.01 par value, 5,000,000 shares authorized; no shares outstanding	--	--
Common stock - $.01 par value, 100,000,000 shares authorized; 30,368,267 and 27,037,096 shares issued and outstanding at December 31, 2005 and 2004, respectively	317	284
Additional paid-in capital	380,481	356,409
Accumulated deficit	(184,011)	(210,172)
Treasury stock - at cost, 1,315,789 shares at December 31, 2005 and 2004	(5,000)	(5,000)

Total stockholders' equity		191,787		141,521
	$	288,689	$	241,728

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2005	**2004**	**2003**
Cash flows from operating activities:			
Net income	$ 26,161	$ 36,812	$ 81,817
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for doubtful accounts	19,114	21,313	11,599
Depreciation and amortization	44,937	22,904	18,345
Other non-cash charges	378	13	22
Non-cash interest	96	(956)	(260)
Gain from extinguishment of debt	--	--	(2,476)
Deferred income taxes	14,928	19,588	(23,411)
Changes in assets and liabilities:			
Accounts receivable, trade	(2,490)	(29,865)	(24,077)
Prepaid expenses and other current assets	3,405	(900)	(1,533)
Other assets	(15)	60	1,410
Accounts payable	(19,937)	5,189	3,799
Deferred revenue	(4,626)	4,448	4,393
Sales, use and excise taxes	(8,414)	(2,342)	2,082
Accrued compensation	(274)	(3,198)	4,279
Other current liabilities	(1,251)	1,529	(2,818)
Net cash provided by operating activities	72,012	74,595	73,171
Cash flows from investing activities:			
Proceeds from sale of fixed assets	70	--	--
Acquisition of LDMI, net of cash acquired	(26,850)	--	--
Acquisition of intangibles	--	--	(133)
Capital expenditures	(45,234)	(12,963)	(11,844)
Capitalized software development costs	(3,989)	(3,534)	(2,738)
Net cash used in investing activities	(76,003)	(16,497)	(14,715)
Cash flows from financing activities:			
Payments on borrowings	--	(45,273)	(52,918)
Payments of capital lease obligations	(2,230)	(1,228)	(61)
Proceeds from exercise of options and warrants	5,017	653	1,177
Purchase of treasury stock	--	--	(5,000)
Net cash provided by (used in) financing activities	2,787	(45,848)	(56,802)
Net increase (decrease) in cash and cash equivalents	(1,204)	12,250	1,654
Cash and cash equivalents, beginning of year	47,492	35,242	33,588
Cash and cash equivalents, end of year	$ 46,288	$ 47,492	$ 35,242

See accompanying notes to consolidated financial statements.

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

	Common Stock		Additional Paid In	Accumulated	Treasury Stock		
	Shares	Amount	Capital	Deficit	Shares	Amount	Total
Balance, December 31, 2002	27,470	$ 275	$ 351,992	$ (328,801)	--	$ --	$ 23,466
Net income	--	--	--	81,817	--	--	81,817
Acquisition of treasury stock	--	--	--	--	1,316	(5,000)	(5,000)
Exercise of common stock options	509	5	1,172	--	--	--	1,177
Income tax benefit related to exercise of common stock options	--	--	1,683	--	--	--	1,683
Balance, December 31, 2003	27,979	280	354,847	(246,984)	1,316	(5,000)	103,143
Net income	--	--	--	36,812	--	--	36,812
Exercise of common stock options	374	4	658	--	--	--	662
Income tax benefit related to exercise of common stock options	--	--	904	--	--	--	904
Balance, December 31, 2004	28,353	284	356,409	(210,172)	1,316	(5,000)	141,521
Net income	--	--	--	26,161	--	--	26,161
Exercise of common stock options	1,531	15	5,002	--	--	--	5,017
Income tax benefit related to exercise of common stock options	--	--	3,126	--	--	--	3,126
Common stock issued in connection with acquisition of LDMI	1,800	18	15,944	--	--	--	15,962
Balance, December 31, 2005	31,684	$ 317	$ 380,481	$ (184,011)	1,316	$ (5,000)	$ 191,787

See accompanying notes to consolidated financial statements.

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

NOTE 1. SUMMARY OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

(a) Business

Talk America Holdings, Inc., through its subsidiaries, offers voice and data services to residential and small business customers in the United States. We offer these services to customers in our markets by one of the following methods: through the use of our own network facilities and the unbundled network element loops or T-1 circuits of the incumbent local exchange carriers or through wholesale agreements with other carriers. We have developed integrated order processing, provisioning, billing, payment, collection, customer service and information systems that enable us to offer and deliver high-quality service, savings through competitively priced telecommunication products, and simplicity through consolidated billing and responsive customer service. We operate our own sales and customer service centers. We manage our business as one reportable operating segment.

(b) Basis of Financial Statements Presentation

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

(c) Use of Estimates

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

(d) Reclassifications

Certain amounts for 2004 and 2003 have been reclassified to conform to the current year presentation.

(e) Risks and Uncertainties

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

- Our ability to successfully integrate business that we acquire, including but not limited to LDMI and NTC
- Dependence on the availability and functionality of the networks of the incumbent local exchange carriers
- Increased price and product competition in commercial and residential voice and data services, and overall competition within the telecommunications industry

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

(f) Concentration of Credit Risk

We maintain our cash and cash equivalents in bank deposit accounts, which at times may exceed federally insured limits. We generally do not have a significant concentration of credit risk with respect to net trade accounts receivable, due to the large number of end users comprising our customer base.

(g) Recognition of Revenue

We derive our revenues primarily from voice and data services. We recognize revenue from voice, data and other telecommunications-related services in the period in which subscribers use the related service. Deferred revenue represents the unearned portion of voice and data services and features that are billed a month in advance.

We also derive access revenue from long-distance companies for access to our network in connection with the completion of long-distance telephone calls. We recognize access revenue based on minutes of traffic captured in a given period. Access revenue represented less than five percent of total revenue for 2005, 2004 and 2003.

(h) Accounts Receivable and Allowance for Uncollectible Accounts

Trade accounts receivable are recorded at the invoice amount. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance based on historical write-off experience. We review our allowance for doubtful accounts monthly. Account balances are charged off against the allowance when we feel it is probable the receivable will not be recovered. We do not have any off balance sheet credit exposure related to our customers.

Receivables consist of trade accounts receivables of $57.4 million and $66.4 million at December 31, 2005 and 2004, respectively. Following are the changes in the allowance for doubtful accounts during the years ended December 31, 2005, 2004 and 2003 (in thousands):

Year Ended December 31,	Balance at Beginning of Year	Acquired Balances	Provision	Write-offs Net of Recoveries	Balance at End of Year
2005	$ 17,508	$ 1,589	19,114	(24,373)	$ 13,838
2004	$ 9,414	--	21,313	(13,219)	$ 17,508
2003	$ 7,821	--	11,599	(10,006)	$ 9,414

(i) Cash and Cash Equivalents

We consider all temporary cash investments purchased with an initial maturity of three months or less to be cash equivalents.

(j) Property and Equipment and Depreciation

Property and equipment are recorded at historical cost. Depreciation and amortization are calculated using the straight-line method over the estimated useful lives of the assets from 1 to 39 years. Leasehold improvements are depreciated over the life of the related lease or asset, whichever is shorter. Capital leases are included in property and equipment with corresponding amortization included in accumulated depreciation. Capital lease assets are amortized over the useful life of the respective assets, or the lease term, whichever is shorter.

Repair and maintenance costs are expensed as incurred. Significant improvements extending the useful life of property are capitalized. When property is retired or otherwise disposed of, the cost of the property and the related accumulated depreciation are removed from the accounts, and any resulting gains or losses are reflected in the consolidated statement of operations.

(k) Computer Software Development Costs

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

Development costs for internally used computer software included in capitalized software and other assets at December 31, 2005 and 2004 were $6.4 million and $5.7 million, respectively, net of accumulated amortization of $7.8 million and $4.5 million, respectively, at December 31, 2005 and 2004. Amortization expense was $3.3 million and $2.4 million, respectively, for the years ended December 31, 2005 and 2004.

(l) Goodwill and Intangible Assets

Effective January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," which establishes the impairment approach rather than amortization for goodwill and intangible assets with indeterminate lives. We do not record amortization expense on goodwill, but instead are required to evaluate these assets for potential impairment at least annually and test for impairment between annual tests, which we conduct in the second quarter, if an event occurs or circumstances change that would indicate the carrying amount may be impaired.

We conducted our annual goodwill impairment test in the second quarter of 2005 and determined that it was not impaired.

Intangible assets at December 31, 2005 are comprised of items that have been acquired as a result of the acquisition of LDMI and consist primarily of purchased customer accounts and trademarks. The customer list is being amortized over a 3 year period using expected customer turnover rates. The trademark is being amortized on a straight line basis over a 2 year period.

Amortization expense on intangible assets with a definite life was $3.1 million for December 31, 2005, $2.7 million for December 31, 2004 and $2.8 million for December 31, 2003. Intangible assets with a definite life amounted to $4.6 million at December 31, 2005, net of accumulated amortization of $1.5 million. Amortization expense on intangible assets with a definite life is expected to be $2.8 million, $1.4 million, and $0.4 million for the years ended December 31, 2006, 2007 and 2008, respectively.

(m) Valuation of Long-Lived Assets

We review the recoverability of the carrying value of long-lived assets, including intangible assets with a definite life, for impairment using the methodology prescribed in SFAS 144 whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Based on regulatory changes and the shortening of the remaining useful lives of our long distance switches in the fourth quarter of 2004, we tested for impairment of our long lived assets and determined that they were not impaired.

(n) Income Taxes

Income taxes are accounted for under the asset and liability method. Accordingly, deferred tax assets and liabilities are recognized currently for the future tax consequences attributable to the temporary differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. 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. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets if it is more likely than not that such assets will not be realized.

(o) Net Income Per Share

Basic earnings per share for a period computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects the effect of common shares issuable upon exercise of stock options, warrants and conversion of convertible debt, when such effect is not antidilutive.

(p) Financial Instruments

The carrying values of accounts receivable, prepaid expenses and other current assets, accounts payable and accrued expenses approximate their fair values.

(q) Stock-Based Compensation

We account for our stock option awards under the intrinsic value based method of accounting prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, including FASB Interpretation No. 44 "Accounting for Certain Transactions Including Stock Compensation," an interpretation of APB Opinion No. 25. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. We make pro forma disclosures of net income and earnings per share as if the fair value based method of accounting had been applied as required by SFAS No. 123, "Accounting for Stock-Based Compensation" and SFAS 148, “Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of SFAS 123”. The following disclosure complies with the adoption of this statement and includes pro forma net income as if the fair value based method of accounting had been applied:

	Year Ended December 31, (In thousands)		
	2005	**2004**	**2003**
Net income as reported	$ 26,161	$ 36,812	$ 81,817
Add: Stock-based employee compensation expense included in reported net income, net of taxes	3	5	--
Deduct: Total stock-based employee compensation expense determined under fair value based method for all options, net of taxes	(3,491)	(5,308)	(1,348)
Pro forma net income	$ 22,673	$ 31,509	$ 80,469

	Year Ended December 31,		
	2005	**2004**	**2003**
Basic earnings per share:			
As reported	$ 0.91	$ 1.37	$ 3.10
Pro forma	$ 0.79	$ 1.17	$ 3.05
Diluted earnings per share:			
As reported	$ 0.89	$ 1.32	$ 2.94
Pro forma	$ 0.77	$ 1.15	$ 2.94

For purposes of pro forma disclosures under SFAS 123, the estimated fair value of the options is assumed to be amortized to expense over the options' vesting period. The fair value of the options granted has been estimated at the various dates of the grants using the Black-Scholes option-pricing model with the following assumptions:

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

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payments" (SFAS 123R) which replaces SFAS 123 and supersedes APB 25. Under the new standard, companies will no longer be allowed to account for stock-based compensation transactions using the intrinsic value method in accordance with APB 25. Instead, companies will be required to account for such transactions using a fair value method and to recognize the expense in the statements of operations. The adoption of SFAS 123R will require additional accounting related to the income tax effects of share-based payment arrangements and additional disclosure of their cash flow impacts. SFAS 123R also allows, but does not require, companies to restate prior periods. We will adopt the provisions of SFAS 123R beginning January 1, 2006, using the modified prospective transition method. Under the modified prospective method, non-cash compensation expense will be recognized for the portion of outstanding stock option awards granted prior to the adoption of SFAS 123R for which service has not been rendered, and for future stock option grants. We currently estimate the related compensation expense for 2006 will be approximately $5 million.

In response to the issuance of SFAS 123R, on December 22, 2005, our Board of Directors approved the acceleration of vesting of 347,849 out-of-the-money stock options with an exercise price of $10.49 and held by current employees including executive officers and Board members. As a result, the 2005 pro forma stock-based employee compensation expense disclosed above includes $891,000 ($525,000 after tax) of compensation expense that will now not be recognized in future statements of operations subsequent to the adoption of SFAS 123R.

(r) Comprehensive Income

We have no items of comprehensive income or expense. Accordingly, our comprehensive income and net income are equal for all periods presented.

(s) Advertising

We expense advertising costs as they are incurred. Advertising expenses totaled approximately $3.8 million, $10.5 million, and $7.5 million for the years ended December 31, 2005, 2004 and 2003, respectively.

(t) Asset Retirement Obligation (ARO)

We recognize ARO in accordance with SFAS 143 "Accounting for Asset Retirement Obligations." SFAS 143 provides accounting and reporting standards for costs associated with the retirement of long-lived assets and requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity capitalizes the cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value, and the capitalized cost is depreciated over the estimated useful life of the related asset. Upon settlement of the liability, an entity either settles the obligations for its recorded amount or incurs a gain or loss

Our ARO primarily relates to restoration of leased facilities that house our networking equipment. During 2005, we expanded our networking footprint to support our transformation into a network-based telecommunications provider. This expansion resulted in an increase in our ARO due to the significant build out of our network, the acquisition of LDMI (See Note 13), and changes in cost of restoration estimates based on increased experience as a network-based provider. Changes in ARO were as follows (in thousands):

		2005
Balance at January 1,	$	--
Acquisitions (See Note 14)		1,249
Additions		613
Revisions		1,004
Accretion		96

Retirement		(42)
Balance at December 31,	$	2,920

No assets are legally restricted for the purposes of settling our ARO.

NOTE 2. COMMITMENTS AND CONTINGENCIES

(a) Lease Agreements

We lease facility space and equipment under operating and capital lease agreements. Certain leases contain renewal options and purchase options, and generally provide that we shall pay for insurance, taxes and maintenance. Total rent expense for all operating leases for the years ended December 31, 2005, 2004 and 2003 was $6.1 million, $3.2 million, and $1.9 million, respectively. As of December 31, 2005, we had future minimum annual lease obligations under noncancellable leases with terms in excess of one year as follows (in thousands):

Year Ended December 31,	Operating Leases	Capital Leases	Total
2006	$ 5,175	$ 3,059	$ 8,234
2007	3,135	1,056	4,191
2008	2,678	346	3,024
2009	2,657	--	2,657
2010	2,120	--	2,120
Thereafter	5,744	--	5,744
Total minimum lease payments	21,509	4,461	25,970
Less: interest		404	
Present value of minimum lease payments		4,057	
Less: current installments		2,768	
Long-term obligations		1,289	

(b) Legal Proceedings

We are party to a number of legal actions and proceedings arising from our provision and marketing of telecommunications services (including matters involving do not call and billing regulations), as well as certain legal actions and regulatory matters arising in the ordinary course of business. We believe that the ultimate outcome of the foregoing actions will not result in a liability that would have a material adverse effect on our financial condition or results of operations.

(c) Commitments

We are party to various network service agreements, which contain certain minimum usage commitments. 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. Certain of our network service agreements, including the AT&T agreement contain certain minimum usage commitments. Our AT&T agreement establishes pricing and provides for annual minimum commitments based upon usage as follows: 2006 - $32 million and 2007 - $32 million and obligates us to pay 65 percent of the revenue shortfall, if any. In February 2006, we amended the AT&T agreement to provide that certain services that we purchase or may purchase from AT&T (and its affiliates) will now count toward the minimum commitment. With this amendment we anticipate that we will not be required to make any shortfall payments under this contract. In addition to the AT&T commitment, we have other commitments with various other vendors for telecommunication services.

In addition, at December 31, 2005, we had outstanding purchase orders for capital expenditures of $0.6 million. We have a contract with our invoice printing company that establishes pricing and provides for annual minimum payments as follows: 2006 - $1.2 million, 2007 - $1.2 million, and 2008 - $1.3 million. We also agreed to renew the maintenance agreement associated with a vendor financing agreement we entered into in May 2004 with a software supplier for an additional two years at a cost of $0.6 million per year, which is funded on the anniversary dates.

NOTE 3. PROPERTY AND EQUIPMENT

The following is a summary of property and equipment, at cost, less accumulated depreciation (in thousands):

		December 31,			
	Lives		**2005**		**2004**
Land		$	330	$	330
Buildings and building improvements	39 years		7,077		7,004
Leasehold improvements	3-10 years		3,713		2,146
Switching equipment	1-10 years		121,033		68,444
Purchased software	3 years		18,483		11,812
Equipment and other	3-10 years		57,892		49,152
			208,528		138,888
Less: Accumulated depreciation			(110,036)		(73,065)
		$	98,492	$	65,823

The following is a summary of property and equipment recorded under capital leases included above (in thousands):

		December 31,	
	Lives	**2005**	**2004**
Equipment and other	3 years	$ 6,968	$ 3,627
Less: Accumulated depreciation		(2,544)	(1, 457)
		$ 4,424	$ 2,170

For the years ended December 31, 2005, 2004 and 2003, depreciation expense amounted to $38.5 million, $17.8 million and $14.1 million, respectively, this includes depreciation expense excluded from network and line cost of $26.8 million, $6.2 million and $3.4 million, respectively. During 2004, we reduced our estimate of useful lives of certain switching equipment to reflect technological changes. This change had the effect of increasing depreciation for 2005 by $15.1 million and 2004 by $1.4 million.

NOTE 4. DEBT AND CAPITAL LEASE OBLIGATIONS

The following is a summary of our debt and capital lease obligations (in thousands):

	December 31,			
		2005		**2004**
Vendor financing agreement	$	1,220	$	2,057
Capital lease obligations		4,057		2,189
Total long-term debt and capital lease obligations		5,277		4,246
Less: current maturities		3,988		2,529
Total long-term debt and capital lease obligations, excluding current maturities	$	1,289	$	1,717

(a) Vendor Financing Agreement

During May 2004, we entered into a vendor financing agreement with a software supplier for $3.1 million payable over 36 months at 2.9% annual interest rate. This agreement included $2.5 million of software and $0.6 million for an annual maintenance contract. In addition, we agreed to renew the maintenance agreement for an additional two years at the cost of $0.6 million per year, which is funded on the anniversary dates.

(b) Capital Leases

Our capital leases are primarily related to computer and office equipment.

(c) Minimum Annual Payments

As of December 31, 2005, the required minimum annual principal payments of long-term debt obligations, including capital leases, for each of the next five fiscal years is as follows (in thousands):

Year Ended December 31,	
2006	$3,988
2007	954
2008	335
	$5,277

NOTE 5. STOCKHOLDERS' EQUITY

(a) Stockholders Rights Plan

On August 19, 1999, we adopted a Stockholders Rights Plan designed to deter coercive takeover tactics and prevent an acquirer from gaining control of us without offering a fair price to all of our stockholders. Under the terms of the plan, preferred stock purchase rights were distributed as a dividend at the rate of one right for each of our shares of Common Stock held as of the close of business on August 30, 1999. Until the rights become exercisable, Common Stock issued by us will also have one right attached. Each right will entitle holders to buy one three-hundredth of a share of our Series A Junior Participating Preferred Stock at an exercise price of $165. Each right will thereafter entitle the holder to receive upon exercise Common Stock (or, in certain circumstances, cash, property or other securities of us) having a value equal to two times the exercise price of the right. The rights will be exercisable only if a person or group acquires beneficial ownership of 20% or more of Common Stock or announces a tender or exchange offer which would result in such person or group owning 20% or more of Common Stock, or if the Board of Directors declares that a 15% or more stockholder has become an "adverse person" as defined in the plan.

We, except as otherwise provided in the plan, will generally be able to redeem the rights at $0.001 per right at any time during a ten-day period following public announcement that a 20% position in us has been acquired or after our Board of Directors declares that a 15% or more stockholder has become an "adverse person." The rights are not exercisable until the expiration of the redemption period. The rights will expire on August 19, 2009, subject to extension by the Board of Directors.

(b) Treasury Stock

In 2003, we purchased 1,315,789 of our common shares from America Online, Inc. at an aggregate price of $5.0 million.

NOTE 6. STOCK OPTIONS, WARRANTS AND RIGHTS

(a) Stock Based Compensation Plan

Incentive stock options, non-qualified stock options and other stock based awards may be granted by us to employees, directors and consultants under the 2005 Incentive Plan (“2005 Plan”), 2003 Long Term Incentive Plan (“2003 Plan”), 2000 Long Term Incentive Plan ("2000 Plan"), 1998 Long Term Incentive Plan ("1998 Plan") and otherwise in connection with employment and to employees under the 2001 Non-Officer Long Term Incentive Plan ("2001 Plan"). Generally, the options vest over a three-year period and expire ten years from the date of grant. At December 31, 2005: 504,000; 360,000; 339,306; 541; and 19,055 shares of common stock were available under the 2005 Plan, 2003 Plan, 2001 Plan, 2000 Plan, and 1998 Plan, respectively, for possible future issuances.

Stock options granted in 2005 generally have contractual terms of 10 years. The options granted to employees have an exercise price equal to the fair market value of the stock on the grant date. The vast majority of options granted in 2005 vest one-third each year, beginning on the first anniversary of the date of grant.

Information with respect to options under our plans is as follows:

	Options Shares	Exercise Price Range Per Share	Weighted Average Exercise Price
Outstanding, December 31, 2002	4,185,701	$1.11-$48.54	$6.84
Granted	1,873,171	$3.70-$14.35	$10.33
Exercised	(509,149)	$0.99-$15.75	$2.34
Cancelled	(112,616)	$1.38-$30.18	$12.48
Outstanding, December 31, 2003	5,437,107	$0.99-$47.64	$8.35
Granted	220,833	$5.14-$10.87	$6.83
Exercised	(374,144)	$1.05-$6.81	$1.75
Cancelled	(401,952)	$1.32-$29.63	$12.86
Outstanding, December 31, 2004	4,881,844	$0.99-$47.64	$8.41
Granted	1,670,000	$6.22-$9.57	$8.52
Exercised	(1,240,706)	$0.99 - $10.49	$2.43
Cancelled	(310,334)	$1.11-$30.38	$10.28
Outstanding, December 31, 2005	5,000,804	$1.20-$47.64	$9.82

The following table summarizes options exercisable at December 31, 2005, 2004 and 2003:

	Option Shares	Exercise Price Range Per Share	Weighted Average Exercise Price
2003	2,939,893	$0.99-$47.64	$7.99
2004	3,413,585	$0.99-$47.64	$8.36
2005	3,237,232	$1.20-$47.64	$10.57

The following table summarizes the status of stock options outstanding at December 31, 2005:

Range of Exercise Prices	Number Outstanding at December 31, 2005	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Number Exercisable at December 31, 2005	Weighted Average Exercise Price
$1.20 to $10.31	2,707,611	$ 6.81	7.6	961,838	$ 3.91
$10.32 to $14.35	1,987,250	11.61	6.9	1,969,451	11.62
$14.36 to $21.00	144,335	19.85	3.2	144,335	19.85
$21.01 to $30.00	66,666	26.65	3.1	66,666	26.65
$30.01 to $47.64	94,942	30.94	3.4	94,942	30.94

The weighted average estimated fair values of the stock options granted during the years ended December 31, 2005, 2004 and 2003 based on the Black-Scholes option pricing model were $6.20, $4.99, and $7.79, respectively. The fair value of stock options used to compute pro forma net income (loss) and basic and diluted earnings (loss) per share disclosures is the estimated fair value at grant date using the Black-Scholes option-pricing model with the following assumptions:

Assumption	2005	2004	2003
Expected Term	5 years	5 years	5 years
Expected Volatility	92.16%	93.82%	98.63%
Expected Dividend Yield	--%	--%	--%
Risk-Free Interest Rate	4.10%	3.49%	3.15%

(b) Warrants

In connection with a credit facility agreement with a lender and certain consulting services that the lender provided to us, we issued warrants to the lender as follows: in August 2000, a warrant for 100,000 shares of our common stock, at

an exercise price of $14.19 per share and expiring August 2007; in October 2000 a warrant for 50,000 shares of our common stock, at an exercise price of $13.08 per share and expiring March 31, 2007; in August 2001, a warrant for 50,000 shares of our common stock, at an exercise price of $2.04 per share and expiring August 16, 2006. All of these warrants were outstanding at December 31, 2005.

NOTE 7. INCOME TAXES

The provision (benefit) for income taxes is as follows (in thousands):

	Year Ended December 31,		
	2005	2004	2003
Current income tax expense:			
Federal			