MEMBERWORKS INC
Form 10-Q
February 09, 2004

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

FORM 10-Q

X Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended December 31, 2003

or

____ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from ________ to _________.

Commission File No. 0-21527

MEMBERWORKS INCORPORATED
(Exact name of registrant as specified in its charter)

DELAWARE	06-1276882
(State of Incorporation)	(IRS 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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes [X] No [ ]

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

Indicate the number of shares outstanding of each of the registrant's class of common stock as of the latest practicable date: 10,335,240 shares of Common Stock, $0.01 par value as of January 23, 2004.

MEMBERWORKS INCORPORATED
INDEX TO FORM 10-Q

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

	December 31 2003
Assets	(Unaudite
Current assets:	
Cash and cash equivalents	$ 119,99
Restricted cash	3,16
Accounts receivable (net of allowance for doubtful accounts of $1,744 and $1,743, at December 31, 2003 and June 2003, respectively)	11,47
Prepaid membership materials	3,74
Prepaid expenses and other current assets	6,93
Membership solicitation and other deferred costs	62,61
Total current assets	207,93
Fixed assets, net	22,85
Goodwill (Note 4)	42,03
Intangible assets, net (Note 4)	6,27
Other assets	6,10
Total assets	$ 285,20
Liabilities and Shareholders' Deficit	
Current liabilities:	
Current maturities of long-term obligations	$ 2
Accounts payable	29,36
Accrued liabilities	64,98
Deferred membership fees	150,06
Deferred income taxes	6,17
Total current liabilities	250,60
Deferred income taxes	5,15
Other long-term liabilities	2,99
Convertible debt (Note 6)	90,00
Total liabilities	348,75
Commitments and contingencies (Note 11)	
Shareholders' deficit:	
Preferred stock, $0.01 par value -- 1,000 shares authorized; no shares issued	
Common stock, $0.01 par value -- 40,000 shares authorized; 18,998 shares issued (17,847 shares at June 30, 2003)	19
Capital in excess of par value	146,64
Accumulated deficit	(6,26
Accumulated other comprehensive loss	(45
Treasury stock, 8,604 shares at cost (6,126 shares at June 30, 2003)	(203,66
Total shareholders' deficit	(63,55
Total liabilities and shareholders' deficit	$ 285,20

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

MEMBERWORKS INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share data)

	Three months ended December 31, 2003	Three months ended December 31, 2002
Revenues	$ 123,164	$ 114,045
Expenses:		
Marketing	66,745	69,899
Operating	23,042	19,178
General and administrative	19,195	18,764
Amortization of intangible assets	271	346
Operating income	13,911	5,858
Settlement of investment related litigation	-	-
Loss on sale of subsidiary	-	-
Net loss on investment	-	-
Interest expense	(1,456)	(25)
Other income, net	320	246
Income before income taxes	12,775	6,079
Provision for income taxes	5,110	2,432
Net income	$ 7,665	$ 3,647
Basic earnings per share	$ 0.71	$ 0.29
Diluted earnings per share	$ 0.60	$ 0.27
Weighted average common shares used in earnings per share calculations:		
Basic	10,756	12,735
Diluted	14,074	13,396

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

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

	For the s Dec
	2003
Operating activities	
Net income	$ 11,56
Adjustments to reconcile net income to net cash provided by operating activities:	
Change in deferred membership fees	(17,73
Change in membership solicitation and other deferred costs	15,36
Depreciation and amortization	5,24
Deferred income taxes	5,30
Tax benefit from employee stock plans	1,55
Gain on settlement of investment related litigation	-
Loss on sale of subsidiary	-
Net loss on investment	-
Other	72
Change in assets and liabilities:	
Restricted cash	(437
Accounts receivable	(2,764
Prepaid membership materials	(1,996
Prepaid expenses and other current assets	1,243
Other assets	(140
Accounts payable	(3,351
Accrued liabilities	5,872
Net cash provided by operating activities	20,441
Investing activities	
Acquisition of fixed assets	(2,53
Settlement of investment related litigation	
Purchase price adjustments from sale of subsidiary	
Net cash (used in) provided by investing activities	(2,538
Financing activities	
Net proceeds from exercise of stock options	22,55
Treasury stock purchases	(79,07
Net proceeds from issuance of convertible debt	86,56
Payments of long-term obligations	(25
Net cash provided by (used in) financing activities	29,79
Effect of exchange rate changes on cash and cash equivalents	4
Net increase in cash and cash equivalents	47,73
Cash and cash equivalents at beginning of period	72,26
Cash and cash equivalents at end of period	$ 119,99

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

MEMBERWORKS INCORPORATED
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 adjustments) 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 MemberWorks Incorporated ("the Company" or "MemberWorks") 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, 2003 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2004. 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, 2003.

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

NOTE 2 - RECLASSIFICATIONS

Certain prior year amounts have been reclassified to conform to the current year presentation.

NOTE 3 - STOCK-BASED COMPENSATION

In accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), the Company applies the intrinsic value method in accounting for employee stock options. Accordingly, the Company generally does not recognize compensation expense with respect to stock-based awards to employees. If compensation cost for the Company's stock-based compensation plans had been determined based on the fair value (estimated using the Black-Scholes option-pricing model) at the grant dates for awards under those plans consistent with the method of Financial Accounting Standards Board Statement ("SFAS") No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), and SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure" ("SFAS 148"), the Company's pro forma net income and earnings per share would have been as follows:

Three months ended S

	December 31,		
	2003	2002	20
Net income reported	$ 7,665	$ 3,647	$ 1
Add: Stock-based employee compensation expense determined under the intrinsic value based method for all awards, net of related tax effects	-	-	
Deduct: Stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	1,262	1,486	
Pro forma net income	$ 6,403	$ 2,161	$
Earnings per share:			
As reported:			
Basic	$ 0.71	$ 0.29	$
Diluted	$ 0.60	$ 0.27	$
Pro forma:			
Basic	$ 0.60	$ 0.17	$
Diluted	$ 0.51	$ 0.16	$

MEMBERWORKS INCORPORATED
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 4 - 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, 2003		As of Ju
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount
Amortized intangible assets:			
Membership and Client Relationships	$ 13,405	$ (7,269)	$ 13,195
Other	950	(809)	950
Total amortized intangible assets	$ 14,355	$ (8,078)	$ 14,145
Intangible assets, net	$ 6,277		$ 6,656
Unamortized intangible assets:			
Goodwill	$ 42,039		$ 42,039

Acquired intangibles, except member relationships, are recorded at cost and are amortized on a straight-line basis over their estimated useful lives ranging from 3 to 20 years. The value of member relationships is amortized using an accelerated method based on estimated future cash flows. The future intangible amortization expense for the next five years is estimated to be as follows (in thousands):

Fiscal Year:	
2004	1,090
2005	900
2006	755
2007	599
2008	485

As a result of increased integration of operations and management at three of its five reporting units during fiscal 2003, the Company aggregated these three reporting units into a single reporting unit for fiscal 2004 impairment testing purposes, resulting in a total of three reporting units in the current year. Goodwill was tested for impairment during the quarter ended September 30, 2003 as required by SFAS 142. The Company concluded that none of its goodwill was impaired. Fair value was estimated using discounted cash flow methodologies. In addition, the Company reassessed the estimated useful lives of its definite-lived 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 5 - ALLOWANCE FOR MEMBERSHIP CANCELLATIONS

Accrued liabilities set forth in the accompanying condensed consolidated balance sheets as of December 31, 2003 and June 30, 2003 include an allowance for membership cancellations of $21,320,000 and $20,934,000, respectively. Recording an allowance for membership cancellations has the effect of reducing the amount of deferred membership fees recorded.

NOTE 6 - CONVERTIBLE DEBT

On September 30, 2003, the Company issued $90,000,000 aggregate principal amount of 5.5% convertible senior subordinated notes ("Notes") due September 2010 in a private offering pursuant to rule 144A of the Securities Act of 1933, as amended. The Notes bear interest at the rate of 5.5% per year, which will be payable in cash semi-annually in arrears on April 1 and October 1 of each year, with the first payment due on April 1, 2004. Holders of the Notes may convert their Notes into shares of MemberWorks common stock at any time prior to maturity at an initial conversion price of approximately $40.37 per share, which is equivalent to an initial conversion rate of approximately 24.7739 shares per $1,000 principal amount of the Notes. In accordance with Accounting Principles Board Opinion No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants," these Notes have been classified as a liability.

On December 3, 2003, Memberworks filed on Form S-3 a shelf registration statement with the Securities and Exchange Commission covering the resale of the Notes and the common stock issuable upon their conversion, which has not yet been declared effective.

Debt issuance costs associated with this issuance were $3,432,000 for the six months ended December 31, 2003. Debt issuance costs are capitalized and amortized as interest expense over the term of the Notes using the effective interest method.

NOTE 7 - RESTRUCTURING CHARGES

During fiscal 2002, 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 following is a rollforward of the major components of the restructuring reserve (in thousands) which is recorded in accrued liabilities and other long-term liabilities:

	Workforce Reduction	Lease Obligations	Total
Restructuring reserve balance at June 30, 2002	$ 391	$ 2,546	$ 2,937
Additions to the reserve	-	-	-
Charges to the reserve	300	836	1,136
Restructuring reserve balance at June 30, 2003	91	1,710	1,801
Additions to the reserve	-	-	-
Charges to the reserve	54	41	95
Restructuring reserve balance at December 31, 2003	$ 37	$ 1,669	$ 1,706

NOTE 8 - INCOME TAX EXPENSE

Income tax expense as a percentage of pre-tax income was 40% for the three and six months ended December 31, 2003 and 2002. The effective tax rate was higher than the U.S. statutory rate for the three and six months ended December 31, 2003 and 2002 primarily due to state taxes and other non-deductible items. Tax benefits resulting from the exercise of nonqualified stock options and the disqualifying dispositions of shares issued under the Company's stock based compensation plans reduced taxes payable by $38,000 and $271,000 during the quarter ended December 31, 2003 and 2002, respectively. Tax benefits resulting from the exercise of nonqualified stock options and the disqualifying dispositions of shares issued under the Company's stock based compensation plans reduced taxes payable by $1,553,000 and $297,000 during the six months ended December 31, 2003 and 2002, respectively. Such benefits are credited to capital in excess of par value.

NOTE 9 - 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):

	Three Months Ended December 31, 2003	Three Months Ended December 31, 2002
Numerator:		
Income available to common shareholders used in basic earnings per share	$ 7,665	$ 3,647
Add back: Interest expense on convertible securities	743	-
Income available to common shareholders after assumed conversion of convertible debt for diluted earnings per share	$ 8,408	$ 3,647
Denominator:		
Weighted average number of common shares outstanding - basic	10,756	12,735
Effect of dilutive securities:		
Convertible securities	2,230	-
Options	1,088	661
Weighted average number of common shares outstanding - diluted	14,074	13,396
Basic earnings per share	$ 0.71	$ 0.29
Diluted earnings per share	$ 0.60	$ 0.27

The diluted earnings per share calculation excludes the effect of potentially dilutive shares when their effect is antidilutive. For the three months ended December 31, 2003 and 2002, the Company had 996,000 and 3,041,000 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, 2003 and 2002, the Company had 765,000 and 3,112,000 shares, respectively, of potentially dilutive stock options that are not included in the calculations as they are antidilutive.

NOTE 10 - COMPREHENSIVE INCOME

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

	Three months ended December 31, 2003	Three months ended December 31, 2002	Si 20
Net income	$ 7,665	$ 3,647	$ 1
Foreign currency translation gain (loss)	14	5	
Comprehensive income	$ 7,679	$ 3,652	$ 1

NOTE 11 - COMMITMENTS AND CONTINGENCIES

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.

As of December 31, 2003, the Company has purchase obligations of $1,407,000 outstanding, of which $250,000 has been recorded in the Condensed Consolidated Balance Sheet.

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, 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.

In March 2001, an action was instituted by plaintiff Teresa McClain against Coverdell & Company ("Coverdell"), a wholly-owned subsidiary of the Company, Monumental Life Insurance Company and other defendants in the United States District Court for the Eastern District of Michigan, Southern Division. The suit, which seeks unspecified monetary damages, alleges that Coverdell and the other defendants violated the Michigan Consumer Protection Act and other applicable Michigan laws in connection with the marketing of Monumental Life Insurance Company insurance products. The complaint includes a claim that the suit should be certified as a class action and the plaintiff has filed a motion for class certification to which all of the defendants have filed opposing papers regarding the same. The Court certified a class of Michigan residents. The Court of Appeals denied the defendants' petition for leave to appeal the certification order. No discovery scheduling order has been set. The Company believes that the claims made against Coverdell are unfounded and Coverdell and the Company will vigorously defend their interests against this suit.

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. On June 22, 2003, the Superior Court denied the Company's motion to vacate the award, and the Company filed an appeal of that decision. While the Company intends to take action to prevent the enforcement of the award by, among other things, vigorously pursuing an appeal, 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. If the Company were ultimately unsuccessful in this or other available appeals, and a final non-appealable court order confirming the arbitration award is rendered, the payment of the award could have a material adverse effect on the Company's results of operations in the period in which the final order is entered.

On October 21, 2003, the Florida Attorney General's Office filed a civil complaint against the Company based upon concerns that some of its past marketing practices may have violated various consumer laws. The Company believes that any legitimate concerns have previously been fully addressed, including the implementation of industry-leading Best Marketing Practices and voluntary agreements incorporating those practices, such as the nationwide assurance agreement that the Company entered into with the State of Nebraska in 2001. The Company believes that the allegations of the complaint are unfounded and the Company intends to vigorously defend its interests in this matter. The Company further believes that the potential liability represented by the lawsuit and the final resolution of this matter will not be material to the Company.

NOTE 12 - NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), which was revised in December 2003. FIN 46 clarifies the application of Accounting Research Bulletin No. 51 and provides guidance on the identification of and reporting for variable interest entities. FIN 46 is effective immediately for variable interest entities formed after January 31, 2003 and is effective for periods ending after March 15, 2004 for any variable interest entity formed prior to February 1, 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.

In May 2003, the Financial Accounting Standards Board issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity " ("SFAS 150"). This statement requires that certain financial instruments that were accounted for as equity under previous guidance be classified as liabilities in statements of financial position. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 did not have a material impact on the Company's financial statements.

9

MEMBERWORKS INCORPORATED

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

OVERVIEW

MemberWorks designs and manages innovative membership programs and provides organizations with an opportunity to leverage the expertise of an outside provider in offering these membership programs to their customers. Membership programs offer selected products and services from a variety of vendors for either an annual fee or a monthly fee. MemberWorks derives its revenues principally from renewable membership fees, which are billed to the customer either on an annual or monthly basis. In the case of annual programs, the

Company receives full payment at or near the beginning of the membership period, but recognizes the revenue as the member's refund privilege expires. Membership fees that are billed monthly are recognized when earned. MemberWorks has traditionally marketed its membership programs with an up-front annual membership fee. However, during fiscal 2003, the Company expanded its marketing of membership programs in which the membership fee is payable in monthly installments. It is the Company's intention to further increase the mix of monthly payment programs during fiscal 2004. 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.

In accordance with Financial Accounting Standards Board ("FASB") Statement 131, "Disclosures about Segments of an Enterprise and Related Information," MemberWorks operates in one reportable operating segment.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are those policies that are important to the Company's financial condition and results of operations 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 goodwill and intangible assets, estimation of remaining useful lives of intangible assets and valuation of deferred tax assets. Estimates in each 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 located in the Company's 2003 Annual Report on Form 10-K.

Revenue recognition
Membership fees are billed through clients of the Company primarily through credit cards. In the case of annually billed membership programs, members may cancel their membership in the program generally for a prorata refund of the membership fee based on the remaining portion of the membership period. In accordance with Staff Accounting Bulletin 101, "Revenue Recognition in Financial Statements" ("SAB 101"), deferred membership fees are recorded, net of estimated cancellations, and are amortized as revenues from membership fees upon the expiration of membership refund privileges. An allowance for membership cancellations is established based on management's estimates and is updated regularly. In determining the estimate of allowance for membership 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 membership cancellations on a current basis. If actual cancellations differ from the estimate, the revenues would be impacted.

Membership solicitation and other deferred costs
The Company's marketing expenses are comprised of telemarketing, direct mail, refundable royalty payments, non- refundable royalty payments and advertising costs. Telemarketing and direct mail costs are direct response advertising costs which are accounted for in accordance with American Institute of Certified Public Accountants Statement of Position 93-7, "Reporting on Advertising Costs" ("SOP 93-7"). Under SOP 93-7, direct response advertising costs are deferred and charged to operations over the membership period as revenues from membership fees are recognized. Refundable royalty payments are also deferred and charged to operations over the membership period in order to match the marketing costs with the associated revenues from membership fees. Advertising costs and non-refundable royalty payments, which include fee per pitch, fee per sale and

fee per impression marketing arrangements, are expensed when incurred.

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

Total membership solicitation costs incurred to obtain a new member are generally less than the estimated total membership fees. However, if total membership solicitation costs were to exceed total estimated membership margins, an adjustment would be made to the membership solicitation and other deferred costs balance and marketing expenses to the extent of any impairment.

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 FASB Statement No. 142, "Goodwill and Other Intangible Assets." The Company reviews the carrying value of its goodwill and other intangible assets for impairment 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 would 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, 2003 and 2002 was tested for impairment during the quarters ended September 30, 2003 and 2002, respectively. The Company concluded that none of its goodwill was impaired as of July 1, 2003 nor 2002.

Income Taxes
The Company accounts for income taxes under the provisions of FASB Statement No. 109, "Accounting for Income Taxes." Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. MemberWorks estimates current tax provisions or benefits based on a projected effective tax rate for the fiscal year ended June 30, 2004 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, 2003 VS. THREE MONTHS ENDED DECEMBER 31, 2002

REVENUES. Revenues increased 8% to $123.2 million for the quarter ended December 31, 2003 from $114.0 million for the quarter ended December 31, 2002. The increase in revenues is primarily due to an increase in the weighted average program price point. As a result of the Company's strategic initiative to shift new marketing towards members on a monthly payment program, the renewal revenues from annual payment programs as a percentage of total revenues decreased to 41% in 2003 from 50% in 2002. Revenues from members who are charged on a monthly payment program increased to $41.4 million for the quarter ended December 31, 2003 from $17.4 million for the quarter ended December 31, 2002 due to an increase in members enrolled in a monthly payment plan. Net active members at

December 31, 2003 were 6.3 million, which is flat from prior year.

MARKETING EXPENSES. Marketing expenses consist of costs incurred to obtain new members and royalties paid to clients. Marketing expenses decreased 5% to $66.7 million for the quarter ended December 31, 2003 from $69.9 million for the quarter ended December 31, 2002 and, as a percentage of revenue, marketing expenses decreased to 54.2% in 2003 from 61.3% in 2002. The improvement in the marketing expense ratio is primarily due to the increase in the mix of marketing in the Company's more profitable MemberLink and online channels.

OPERATING EXPENSES. Operating expenses consist of member service call center costs, membership benefit costs and membership program fulfillment costs. Operating expenses increased 20% to $23.0 million for the quarter ended December 31, 2003 from $19.2 million for the quarter ended December 31, 2002. As a percentage of revenues, operating expenses increased to 18.7% for the quarter ended December 31, 2003 from 16.8% for the quarter ended December 31, 2002. These increases were due to increased call center and other related costs incurred to service the membership base.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses primarily include personnel-related costs, occupancy costs and other overhead costs. General and administrative expenses increased 2% to $19.2 million for the quarter ended December 31, 2003 versus $18.8 million for the quarter ended December 31, 2002. As a percentage of revenues, general and administrative expenses decreased to 15.6% in 2003 from 16.5% in 2002 primarily due to leveraging the increase in our reported revenues.

INTEREST EXPENSE. Interest expense consists primarily of interest expense and the amortization of debt issuance costs related to the Company's line of credit and convertible senior subordinated notes. Interest expense increased to $1.5 million for the quarter ended December 31, 2003 from $25,000 for the quarter ended December 31, 2002. The increase is due to the issuance of the convertible senior subordinated notes in September 2003.

PROVISION FOR INCOME TAXES. During the quarter ended December 31, 2003, the Company recorded a tax provision of $5.1 million based on an effective tax rate of approximately 40%. The effective tax rate was higher than the U.S. federal statutory rate for the quarter ended December 31, 2003 primarily due to state taxes and other non-deductible items. During the quarter ended December 31, 2002, the Company recorded a tax provision of $2.4 million based on an effective tax rate of approximately 40%.

SIX MONTHS ENDED DECEMBER 31, 2003 VS. SIX MONTHS ENDED DECEMBER 31, 2002

REVENUES. Revenues increased 8% to $237.0 million for the six months ended December 31, 2003 from $219.0 million for the six months ended December 31, 2002. The increase in revenues is primarily due to an increase in the weighted average program price point. As a result of the Company's strategic initiative to shift new marketing towards members on a monthly payment program, renewal revenues from annual payment programs as a percent of total revenues decreased to 41% in 2003 from 48% in 2002. Revenues from members who are charged on a monthly payment program increased to $67.7 million for the six months ended December 31, 2003 from $33.8 million for the six months ended December 31, 2002 due to an increase in members enrolled in a monthly payment plan.

MARKETING EXPENSES. Marketing expenses decreased 2% to $133.4 million for the six months ended December 31, 2003 from $135.4 million for the six months ended December 31, 2002 and, as a percentage of revenue, marketing expenses decreased to 56.3% in 2003 from 61.8% in 2002. The improvement in the marketing expense ratio is primarily due to the increase in the mix of marketing in the Company's more profitable MemberLink and online channels.

OPERATING EXPENSES. Operating expenses increased 19% to $44.5 million for the six months ended December 31, 2003 from $37.3 million for the six months ended December 31, 2002. As a percentage of revenues, operating expenses increased to 18.8% for the six months ended December 31, 2003 from 17.0% for the six months ended December 31, 2002. These increases were due to increased call center and other related costs incurred to service the membership base.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses were $38.0 million for the six months ended December 31, 2003 versus $37.6 million for the six months ended December 31, 2002. As a percentage of revenues, general and administrative expenses decreased to 16.0% in 2003 from 17.2% in 2002 primarily due to leveraging the increase in our reported revenues.

INTEREST EXPENSE. Interest expense increased to $1.6 million for the six months ended December 31, 2003 from $57,000 for the six months ended December 31, 2002. The increase is due to the issuance of the convertible senior subordinated notes in September 2003.

PROVISION FOR INCOME TAXES. During the six months ended December 31, 2003, the Company recorded a tax provision of $7.7 million based on an effective tax rate of approximately 40%. The effective tax rate was higher than the U.S. federal statutory rate for the six months ended December 31, 2003 primarily due to state taxes and other non-deductible items. During the six months ended December 31, 2002, the Company recorded a tax provision of $10.5 million based on an effective tax rate of approximately 40%.

LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operating activities was $20.4 million for the six months ended December 31, 2003 versus $32.9 million for the six months ended December 31, 2002. The decrease in operating cash flow in the six months ended December 31, 2003 versus the prior year was primarily due to the impact of changes in assets and liabilities which reduced cash by $1.6 million in the six months ended December 31, 2003 and increased cash by $7.6 million in the six months ended December 31, 2002. The decrease in changes in assets and liabilities over the prior year was primarily driven by the timing of vendor payments. Also contributing to the decrease in operating cash flow were increased operating expenses partially offset by an increase in marketing margin before deferral (revenues before deferral less marketing costs before deferral). As a percent of revenue before deferral, marketing costs before deferral were 53.8% in the six months ended December 31, 2003 compared to 54.8% in the six months ended December 31, 2002.

The Company's management believes that revenues before deferral and marketing costs before deferral are important measures of liquidity. Revenues before deferral are revenues before the application of SAB 101 and represent the actual membership fees billed during the current reporting period less an allowance for membership cancellations. Marketing costs before deferral are marketing costs before the application of SAB 101 and SOP 93-7 and represent the Company's obligation for marketing efforts that occurred during the current reporting period.

Revenues before deferral for the six months ended December 31, 2003 and 2002 are calculated as follows:

	December 3	
	2003	
Revenues reported in the Statements of Operations	$ 236,988	$
Change in deferred membership fees	(17,733)	
Revenues before deferral	$ 219,255	$

Revenues before deferral increased 5% to $219.3 million for the six months ended December 31, 2003 from $209.1 million for the six months ended December 31, 2002. The increase in revenues is primarily due to an increase in the weighted average program price point. The following table summarizes the weighted average price points over the six months ended December 31:

	Fiscal Year 2004	Fiscal Year 2003
Weighted Average Annual Price Points:		
First Quarter	$105	$96
Second Quarter	$107	$104
Weighted Average Monthly Price Points:		
First Quarter	$10.72	$9.44
Second Quarter	$11.54	$9.76

Revenues before deferral from members who are charged on a monthly payment program were $74.7 million during the six months ended December 31, 2003 and $33.8 million during the six months ended December 31, 2002. The following table summarizes the average monthly members billed each month during the six months ended December 31:

	Fiscal Year 2004	Fiscal Year 2003
First Quarter	955	576
Second Quarter	1,239	588

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

The following table summarizes the components of revenues before deferral for the six months ended December 31:

	2003	2002
New annual	19%	35%
Renewal annual	47%	49%
Monthly	34%	16%

As a percentage of total revenues before deferral, renewal revenues from annual payment programs decreased to 47% in the six months ended December 31, 2003 from 49% in the six months ended December 31, 2002 due to the Company's strategic initiative to shift new marketing towards members on a monthly payment program. This shift to monthly payment programs has a near-term negative impact on operating cash flow due to the timing of revenues collected relative to the corresponding timing of marketing expenditures. Net active members as of December 31, 2003 were 6.3 million, which is flat from prior year.

Marketing costs before deferral for the six months ended December 31, 2003 and 2002 are calculated as follows:

	December 3	
	2003	
Marketing expenses reported in the Statements of Operations	$ 133,401	
Change in membership solicitation and other deferred costs	(15,368)	
Marketing costs before deferral	$ 118,033	

Marketing costs before deferral increased 3% to $118.0 million for the six months ended December 31, 2003 from $114.7 million for the six months ended December 31, 2002. As a percent of revenues before deferral, marketing expenses before deferral were 53.8% for the six months ended December 31, 2003 and 54.8% for the six months ended December 31, 2002. The decrease is primarily due to the increase in the mix of marketing in the Company's more profitable MemberLink and Online channels.

Net cash used in investing activities was $2.5 million during the six months ended December 31, 2003 versus net cash provided by investing activities of $15.6 million during the six months ended December 31, 2002. Net cash provided by investing activities during the six months ended December 31, 2002 included $19.1 million of proceeds related to the settlement of a lawsuit and $0.8 million of funds paid in connection with a purchase price adjustment related to the sale of iPlace, Inc. Capital expenditures were $2.5 million during the six months ended December 31, 2003 and $2.8 million during the six months ended December 31, 2002.

Net cash provided by financing activities was $29.8 million for the six months ended December 31, 2003 versus net cash used in financing activities of $14.0 million for the six months ended December 31, 2002. The increase in cash provided by financing activities was primarily due to the issuance of $90.0

million aggregate principal amount convertible senior subordinated notes ("Notes") due September 2010. The Notes bear interest at the rate of 5.5% per year, which will be payable in cash semi-annually in arrears on April 1 and October 1 of each year, with the first payment due on April 1, 2004. The net proceeds will be used for general corporate purposes, including mergers and acquisitions and additional repurchases of the Company's common stock under its stock buyback program. Upon the occurrence of a change in control, holders of the Notes may require the Company to repurchase all or part of the Notes for cash. In addition, the Company received $22.6 million from the exercise of stock options during the six months ended December 31, 2003. These increases in financing activities during the six months ended December 31, 2003 were offset by increased spending under the Company's stock repurchase program. The Company purchased 2,478,000 shares for $79.1 million, an average price of $31.91, during the six months ended December 31, 2003 compared to 873,000 shares for $15.0 million, an average price of $17.13, during the six months ended December 31, 2002. The Company utilized cash from operations, stock option exercises and the issuance of the Notes to repurchase shares. During the six months ended December 31, 2003, the Board of Directors authorized 2.0 million additional shares to be repurchased under the buyback program. As of December 31, 2003, the Company had 500,000 shares available for repurchase under its buyback program. In January 2004, the Board of Directors authorized an additional 1.0 million shares to be repurchased under the buyback program.

As of December 31, 2003, the Company had cash and cash equivalents of $120.0 million. In addition, the Company has a $28.0 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. As of December 31, 2003, the effective interest rate for borrowings was 4.0%. As of December 31, 2003, availability under the bank credit facility was reduced by an outstanding letter of credit of $5.5 million. The bank credit facility has certain financial covenants, including a maximum debt coverage ratio, a minimum fixed charges ratio, potential restrictions on additional borrowings and potential restrictions on additional stock repurchases. As of December 31, 2003, the Company was in compliance with all such debt covenants. The Company believes that existing cash balances, together with its available bank credit facility, will be sufficient to meet its funding requirements for the foreseeable future.

The Company did not have any material commitments for capital expenditures as of December 31, 2003. The Company intends to utilize its existing cash balances and cash generated from operations to fulfill any capital expenditure requirements for the remainder of fiscal 2004.

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, 2003 are as follows (amounts in thousands):

	Payments Due by Period			
	Total	Less than 1 year	1-3 years	4-5 years
Operating leases	$ 24,314	$ 6,630	$ 9,363	$ 4,83
Convertible notes payable	90,000	-	-	
Purchase obligations	1,407	1,407	-	
Other long-term obligations	28	28	-	
Total payments due	$ 115,749	$ 8,065	$ 9,363	$ 4,83

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.

NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), which was revised in December 2003. FIN 46 clarifies the application of Accounting Research Bulletin No. 51 and provides guidance on the identification of and reporting for variable interest entities. FIN 46 is effective immediately for variable interest entities formed after January 31, 2003 and is effective for periods ending after March 15, 2004 for any variable interest entity formed prior to February 1, 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.

In May 2003, the FASB issued Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity " ("SFAS 150"). This statement requires that certain financial instruments that were accounted for as equity under previous guidance be classified as liabilities in statements of financial position. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 did not have a material impact on the Company's financial statements.

FORWARD LOOKING STATEMENTS

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 or 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 credit card processors;
- Unanticipated termination of marketing agreements;
- The extent to which MemberWorks can continue to successfully develop and market new products and services;
- Unanticipated changes in or termination of the Company's ability to process membership fees through third parties, including credit card 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, including the Federal Trade Commission's 2003 Amendment to its Telemarketing Sales Rule which creates a national do-not-call list; and
- New accounting pronouncements.

Many of these factors are beyond MemberWorks' control, and, therefore, its business, financial condition, results of operations and cash flows 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, 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.

MEMBERWORKS INCORPORATED

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate

As of December 31, 2003, the Company has a $28 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, 2003. As of December 31, 2003, availability under the bank credit facility was reduced by an outstanding letter of credit of $5.5 million. In addition, the Company has $90.0 million aggregate principal amount of 5.5% convertible senior subordinated notes due September 2010. The Notes bear interest at the rate of 5.5% per year payable in cash semi-annually in arrears on April 1 and October 1 of each year, with the first payment due on April 1, 2004. 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 March 29, 2004, 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, 2003. 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 under Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report and have concluded that 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 is required to be disclosed in its reports under the Exchange Act is accumulated and communicated to the chief executive officer and chief financial officer.

Notwithstanding the foregoing, although there can be no assurance that the Company's disclosure controls and procedures will detect or uncover all failures of persons within the Company and its consolidated subsidiaries to disclose material information otherwise required to be set forth in the Company's periodic reports, the Chief Executive Officer's and Chief Financial Officer's evaluation concluded that they are reasonably effective to do so.

Changes in internal control over financial reporting.
During the second quarter of fiscal 2004, there were no changes in the Company's internal control over financial reporting that could have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

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 previously disclosed suits, 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.

In March 2001, an action was instituted by plaintiff Teresa McClain against Coverdell & Company ("Coverdell"), a wholly-owned subsidiary of the Company, Monumental Life Insurance Company and other defendants in the United States District Court for the Eastern District of Michigan, Southern Division. The suit, which seeks unspecified monetary damages, alleges that Coverdell and the other defendants violated the Michigan Consumer Protection Act and other applicable Michigan laws in connection with the marketing of Monumental Life Insurance Company insurance products. The complaint includes a claim that the suit should be certified as a class action and the plaintiff has filed a motion for class certification to which all of the defendants have filed opposing papers regarding the same. The Court certified a class of Michigan residents. The Court of Appeals denied the defendants' petition for leave to appeal the certification order. No discovery scheduling order has been set. The Company believes that the claims made against Coverdell are unfounded and Coverdell and the Company will vigorously defend their interests against this suit.

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 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. On June 22, 2003, the Superior Court denied the Company's motion to vacate the award, and the Company filed an appeal of that decision. While the Company intends to take action to prevent the enforcement of the award by, among other things, vigorously pursuing an appeal, 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. If the Company were ultimately unsuccessful in this or other available appeals, and a final non-appealable court order confirming the arbitration award is rendered, the payment of the award could have a material adverse effect on the Company's results of operations in the period in which the final order is entered.

On October 21, 2003, the Florida Attorney General's Office filed a civil complaint against the Company based upon concerns that some of its past marketing practices may have violated various consumer laws. The Company believes that any legitimate concerns have previously been fully addressed, including the implementation of industry-leading Best Marketing Practices and voluntary agreements incorporating those practices, such as the nationwide assurance agreement that the Company entered into with the State of Nebraska in 2001. The Company believes that the allegations of the complaint are unfounded and the Company intends to vigorously defend its interests in this matter. The Company further believes that the potential liability represented by the lawsuit and the final resolution of this matter will not be material to the Company.

18

MEMBERWORKS INCORPORATED
PART II. OTHER INFORMATION (CONTINUED)

Item 2. Changes in Securities and Use of Proceeds

On September 30, 2003, the Company completed the sale of $90.0 million aggregate principal amount of 5.5% convertible senior subordinated notes due September 2010 to qualified institutional buyers pursuant to Rule 144A of the Securities Act of 1933, as amended. Net proceeds from this offering are estimated to be $86.6 million. The net proceeds will be used for general corporate purposes, including mergers and acquisitions and additional repurchases of the Company's common stock under its stock buyback program. The Notes bear interest at a rate of 5.5% per year payable in cash semi-annually in arrears on April 1 and October 1 of each year, with the first payment due on April 1, 2004.

The Notes are convertible into shares of MemberWorks common stock at any time prior to maturity at an initial conversion price of approximately $40.37 per share, which is equivalent to an initial conversion rate of approximately 24.7739 shares per $1,000 principal amount of the Notes. The conversion rate is subject to adjustment in certain circumstances.

The Company may redeem all or a portion of the Notes for cash at any time on or after October 6, 2008, at 100% of their principal amount plus accrued and unpaid interest to, but excluding, the redemption date.

On December 3, 2003, MemberWorks filed on Form S-3 a shelf registration statement with the Securities and Exchange Commission ("SEC") covering the Notes and the common stock issuable upon their conversion, which has not yet been declared effective. MemberWorks intends to use its best efforts to cause the shelf registration statement to be declared effective by the SEC no later than 210 days after the original issuance of the Notes.

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

a) MemberWorks Incorporated's 2003 Annual Meeting of Stockholders was held on November 20, 2003.

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

Alec L. Ellison:	For -	9,514,279
	Against -	508,793
	Abstain -	0
	Nonvotes -	0
Marc S. Tesler:	For -	8,796,790
	Against -	1,226,282
	Abstain -	0
	Nonvotes -	0

Class II Directors, Scott N. Flanders, Michael T. McClorey and Edward M. Stern, and Class III Directors, Gary A. Johnson and Robert Kamerschen 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 -	9,046,744
Against -	971,382
Abstain -	4,945
Nonvotes -	0

MEMBERWORKS INCORPORATED
PART II. OTHER INFORMATION (CONTINUED)

Item 6. Exhibits and Reports on Form 8-K

a) Exhibits
   - 31.1 Rule 13a-14(a) CEO Certification.
   - 31.2 Rule 13a-14(a) CFO Certification.
   - 32.1 CEO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
   - 32.2 CFO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

b) Reports on Form 8-K

On October 24, 2003, the Company filed on Form 8-K under Item 5 "Other Events" and Item 7 "Financial Statements and Exhibits" a press release announcing a civil complaint filed by the Florida Attorney General.

On October 27, 2003, the Company furnished on Form 8-K under Item 7 "Financial Statements and Exhibits" and Item 12 "Results of Operations and Financial Condition" a press release announcing fiscal year 2004 first quarter results.

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 7, 2004 By: /s/ Gary A. Johnson

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

February 7, 2004 By: /s/ James B. Duffy

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