FROM PROMISE TO PROFITABILITY

1998

MemberWorks

Annual

Report

MemberWorks is a leader in bringing value to consumers by designing innovative membership programs that offer services and discounts on everyday needs in healthcare, personal finance, insurance, travel, entertainment, computing, fashion, and personal security. More than 3.5 million members nationwide are enrolled in MemberWorks programs, gaining convenient access to thousands of service providers and vendors. MemberWorks is the trusted marketing partner of leading consumer-driven organizations such as banks, credit card issuers, retailers, mortgage companies, and telecommunications providers and offers them effective tools to enhance their market presence, to strengthen customer affinity, and to generate additional revenue. MemberWorks common stock trades on the Nasdaq National Market under the symbol MBRS. MemberWorks is headquartered in Stamford, Connecticut. www.memberworks.com

MemberWorks Incorporated

Financial Highlights

(In thousands, except per share data)	1998	1997	1996
			Year ended June 30
Revenues	$120,834	$ 79,174	$ 57,012
Expenses	117,749	83,032	62,259
Net income (loss)	3,085	(3,858)	(5,247)
Earnings (loss) per diluted share	0.19	(0.35)	(0.49)
Cash provided by operating activities	8,930	7,835	1
Cash and cash equivalents	35,933	40,758	4,312
Total assets	133,929	84,423	41,927
Shareholders' equity (deficit)	29,080	14,030	(36,332)

MemberWorks Incorporated

Programs and Distribution Channels

PROGRAMS	CHANNELS					
	Credit Card	Mortgage	Bank Account	Cable TV	Telephone	Online
Health & Dental	•	•	•	•		•
Personal Security	•	•			•	
Travel	•	•			•	•
Entertainment	•	•		•		•
Sports & Leisure	•	•				•
Fashion & Fitness	•			•		•
Computers	•					•
Personal Finance	•					•
Insurance			•			•
Credit Monitoring						•

Letter to Our Shareholders

1998 was the most exciting year in MemberWorks history.

In many ways, it was a year of results. We set new records across all aspects of our core business, including membership growth, program innovation, client diversification, marketing efficiency, and financial performance. We also expanded our market presence with our first acquisition and strategic investment. While significant, these achievements are no surprise. They're proof that our strategy for long-term growth, market leadership, and profitability is working—and working well.

More and more consumers recognize the value and convenience of MemberWorks programs. In 1998, we experienced strong demand across all of our programs. Our membership base now totals 3.5 million, a 75% increase over last year. Equally exciting, more of these consumers are renewing year after year. Renewal members continue to account for an increasing percentage of membership revenue.

We know that innovation is key to attracting and retaining consumers. And, today's consumers are more technology savvy than ever. That's why in 1998 we launched *24Protect,* a unique voicemail and hotline program offering emergency service and telecommunications benefits. We also added long distance telecommunications and Internet services to our range of member benefits.

We're building our program portfolio in other strategic ways. In April, we acquired Coverdell & Company, a provider of life, accident, and health insurance. Coverdell's high-quality products are the choice of many financial institutions. In addition, through our strategic investment in ConsumerInfo.Com, a premier online provider of consumer credit information, we began offering members access to innovative, credit monitoring services over the Internet.

We believe that the market potential for MemberWorks programs is large and virtually untapped. Credit card companies were the first to benefit from a MemberWorks partnership. Now, our strong position within financial services is further enhanced by our acquisition of Coverdell & Company. Their expertise in marketing to bank depository account customers immediately opened a new commercial banking channel for MemberWorks programs.

In fact, today we're working with clients in more than six diverse industry channels, ranging from banks to mortgage companies to cable television providers. This year we entered the telecommunications channel by signing agreements to market programs to all six Regional Bell Operating Companies and many of the country's local exchange carriers. These agreements provide marketing access to over 85% of the nation's households or approximately 100 million potential new consumers. We also entered the direct response cable television channel and began working with several leading online service and content providers.

Inside MemberWorks, we're intent on improving the efficiency of delivering our programs. MemberLink, our inbound telemarketing technique, and wholesale programs continued to generate tremendous interest from clients. Demand for MemberLink and wholesale programs more than tripled this year to nearly 6% of annual revenue. Equally important, the investment and operating efficiencies of these newer delivery methods are key drivers behind our increasing profitability.

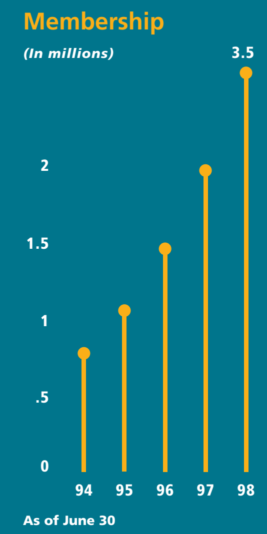
As consumers moved online, so did MemberWorks. Everyday, more of our programs are sold online, dramatically reducing our investment in member acquisition. We're currently leveraging our best resources to expand our online presence. For example, Coverdell's *Right Quote,* an online service that compares policies from multiple providers, was recently rated as the best online insurance program by <u>Consumer Reports</u> and <u>SafeTNet</u>. We believe that the Internet will increasingly become an important and complementary platform for delivering MemberWorks programs.

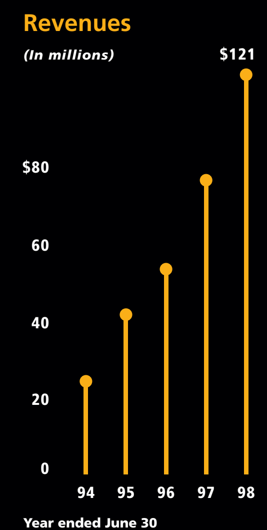
MemberWorks' financial performance is the ultimate proof that our strategy is working. We achieved record annual revenue of $121 million, a 53% growth over fiscal 1997. Our growth was strong and steady with four consecutive quarters of record revenue growth. Our biggest achievement, however, was on the bottom line. This year we earned our first full year of profitability, generating $3.1 million of net income or $0.19 per share.

In summary, our business is stronger than it's ever been. 1998 validated our market strategy and ability to deliver long-term growth and profitability. Now, we're focused on execution. In the year ahead, we'll maintain our sharp focus on program innovation to offer the best value to members. We'll extend our reach into new industries and further penetrate our existing channels and clients. We'll strengthen our delivery capabilities, making them more efficient and profitable. And, we'll stay focused on generating attractive, consistent financial returns.

These are exciting times for MemberWorks. On behalf of our Board of Directors and all MemberWorks employees I'd like to extend our thanks to our shareholders, clients, vendors, and members for your continued support. Our success is your success. We look forward to more success in the years ahead.

Gary A. Johnson
President & Chief Executive Officer

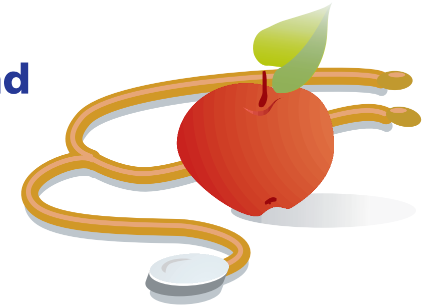




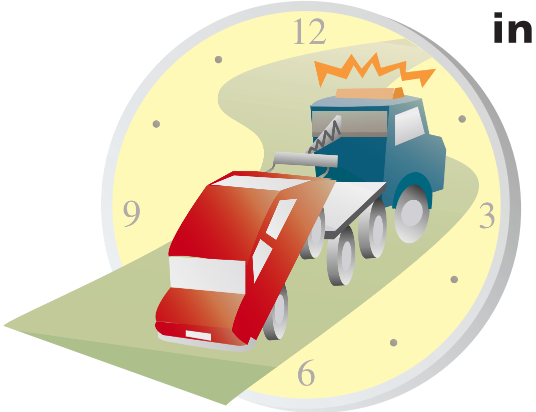
VALUE TO CONSUMERS

Today, MemberWorks offers 12 membership programs delivering valued products and services from healthcare to entertainment to personal finance. Each program generates family savings far exceeding annual membership fees. • MemberWorks' commitment to program innovation continued in 1998. In June, MemberWorks launched 24Protect, a unique voicemail and hotline program, providing emergency service and telecommunications benefits. Through our new Coverdell & Company

Our story has a simple moral: Offer something of value to increase a person's quality of life. Give it to them for a price they can afford, and they'll become intensely loyal members. The power of this cycle is absolute.



• By exploring human nature, to understand what drives the needs and wants of real people, we're able to create innovative programs never before offered in the marketplace. • Such deliberate research builds our membership programs. But it's our valuable insight that guarantees these programs deliver on the promise of value to the consumer and profitability to our partners.



subsidiary, MemberWorks began offering life, accident, and health insurance programs. MemberWorks also began marketing CreditCheck Monitoring Service, an online credit information program offered in strategic partnership with ConsumerInfo.Com. Finally, we added long distance telecommunications and Internet services to our extensive member benefits portfolio. • These key additions form an important part of MemberWorks' ongoing efforts to enhance our programs to meet the needs of today's consumers.

NEW INDUSTRY CHANNELS

Any company serving consumers can benefit from MemberWorks programs. We partner with over 40 clients across a wide range of industries. All of our clients enjoy the enhanced market presence, customer affinity, and incremental revenue we offer. • MemberWorks entered four exciting new industry channels in 1998. Through an extensive agreement with all six Regional Bell Operating Companies and many of the nation's local exchange providers, MemberWorks expanded into the telecommunications

As every profitable business knows, it pays to begin with a strong premise and build upon it. At MemberWorks, we started by distributing our programs almost exclusively through credit card issuers. By seizing this opportunity, we became a market force. • We're now extending our reach—by taking the same rigorously crafted portfolio of programs and strategically partnering in new industries. These industry "channels" include mortgage companies and banks, as well as telecommunications, online, and cable television providers. • It's all part of our long-term growth strategy. And we'll continue to navigate toward fresh channels for delivering valuable programs to new partners and their customers.

channel. Our Coverdell & Company subsidiary added commercial banks and their depository accounts to MemberWorks' strong presence in financial services. In partnership with ConsumerInfo.Com, we began working with online content and service providers to expand program distribution. Also, MemberWorks successfully expanded into cable television, signing agreements with several direct response cable television companies. • Across all channels our strategy is clear: to be the marketing partner of choice today and tomorrow.

MULTIPLE DELIVERY METHODS

We are committed to offering our clients diverse ways to market MemberWorks programs. This flexibility enables our clients to design the most effective marketing strategy to meet their customers' needs. • 1998 brought new and more efficient methods of delivering MemberWorks programs. MemberLink continued to generate strong interest from clients, with several new partners adding MemberLink to their range of delivery methods. Wholesale programs, addressing high-volume needs in a cost-effective

MemberWorks is also expanding how we deliver programs to consumers. One such innovative delivery method—called MemberLink—dramatically lowers the cost of signing up new members. • **MemberLink works this way. Say you call a catalog to order luggage. At the end of the transaction and based on your profile, the representative will ask if you're interested in discount travel services. If so, you're seamlessly transferred to a MemberWorks operator who can sign you up for the program over the phone.** • **This approach, much like our newest Internet capabilities, is a more efficient and cost-effective way to sign up new members. The result fuels rapid growth and ensures greater profitability.**

solution, also grew. Advanced marketing practices from our Coverdell & Company subsidiary contributed to overall marketing effectiveness. In addition, we continued to expand our Internet presence, increasing the number of MemberWorks programs distributed online and leveraging our partnership with ConsumerInfo.Com. All of these achievements yielded lower member acquisition costs and higher returns on our marketing investments. Our efficient delivery creates widespread benefits—clients, members and investors all win.

STRATEGICALLY MANAGING GROWTH

MemberWorks' sights are set on growth. The combination of building a large, loyal membership base, expanding across multiple industry channels, and leveraging efficient delivery methods creates attractive long-term opportunities. Our successful execution yields both top- and bottom-line results. • In 1998, MemberWorks' membership base increased 75% to 3.5 million members. This growth was driven by strong demand for our programs across new and existing industry channels. Record membership

There is nothing more comforting in business, and indeed in life, than predictable results. And that's just what MemberWorks gives our industry partners—and our shareholders. • **MemberWorks' proven direct marketing strategy guarantees a predictable response rate. Based on our experience and proprietary techniques, we know a certain number of customers will become members. In turn, this guarantees a perennial revenue stream through yearly renewals.** • **Business growth—whether designed to reap quickly or cultivate slowly—is squarely in our control. With our base of knowledge, we're able to design and deliver the best programs, into lucrative channels, at just the right time. This is MemberWorks' promise of profitability.**

growth translated into record annual revenue of $121 million. Due to our intense focus on serving members, an increasing percentage of MemberWorks revenue came from profitable renewal memberships. In addition, the expansion of new delivery methods such as MemberLink significantly increased our marketing and operating leverage. As a result, while MemberWorks revenue hit an all-time high, so did our profits. MemberWorks delivered a full year of profitability in 1998—a milestone for our Company.

Programs

24Protect℠	24-hour toll-free emergency hotlines and voicemail service
CardMember Protection Service℠	Credit card registration and security
Connections℠	Entertainment events, leisure time activities, and merchandise
Countrywide Dental Program®	Nationwide dental services
Countrywide Dental & Health Program℠	Nationwide dental services and healthcare products and information
Coverdell / Monumental General Life and Accident Insurance	Term life, accidental death, accidental injury, and hospital indemnity insurance
Essentials℠	Fashion, fitness, and beauty products and services
HealthTrends®	Medical information and healthcare products and services
Leisure Advantage℠	Sporting events, athletic merchandise, and apparel
MoneyMaster℠	Personal financial planning services
SmartSource℠	Personal computer products and Internet services
Travel Arrangements℠	Business, leisure, and vacation travel services

Financial Section

Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

MemberWorks addresses the needs of organizations seeking to leverage the expertise of an outside provider in offering membership service programs. Membership service programs offer selected products and services from a variety of vendors intended to enhance the existing relationships between businesses and consumers. The Company derives its revenues principally from annually renewable membership fees. The Company generally receives full payment of annual fees at or near the beginning of the membership period, but recognizes revenue ratably over the membership period. Similarly, the costs associated with soliciting each new member, as well as the cost of royalties, printing, and mailing of membership materials are amortized ratably over the same period. 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.

On September 1, 1998, the Company issued a press release that stated it had contacted the Securities and Exchange Commission ("SEC") to determine whether the SEC staff's view regarding the timing of revenue recognition for companies such as MemberWorks Incorporated that sell services has changed in the wake of Cendant Corporation's agreement (announced on August 27, 1998) with the SEC to modify its revenue recognition practices. The Company had requested the SEC staff to comment on and has provided the SEC staff with information demonstrating the continued appropriateness of its revenue recognition practices. The Company has consistently followed these practices in accordance with generally accepted accounting practices and with the concurrence of PricewaterhouseCoopers LLP, its independent accountants. As a result of this review and several discussions with the SEC staff, the staff has not objected to the Company's decision to presently continue to follow its revenue recognition practices, as described above. The SEC staff did request the Company to change its method of accounting for printing and mailing of membership materials, beginning as of July 1, 1998. The Company will record the cumulative effect of this change in accounting principle in the first quarter of fiscal 1999. See footnote 12 on page 31 for a description of the change and its financial impact.

On September 28, 1998, the SEC issued a press release and stated the "SEC will formulate and augment new and existing accounting rules and interpretations covering revenue recognition, restructuring reserves, materiality, and disclosure;" for all publicly-traded companies. Until such time as the SEC staff issues such interpretative guidelines, it is unclear what, if any, impact such interpretative guidance will have on the Company's current accounting practices. However, the potential changes in accounting practice being considered by the SEC staff could have a material impact on the manner in which the Company recognizes revenue. Any such changes would have no effect on reported cash flow or the economic value of the Company's memberships.

On April 2, 1998, the Company acquired all of the outstanding common stock of Coverdell & Company, Inc. ("Coverdell") for $18.4 million. Coverdell is a marketer of insurance and investment products. The transaction was accounted for as a purchase and accordingly the assets and liabilities at June 30, 1998, and results of operations from the date of acquisition associated with the acquired business have been included in the Company's financial position and the results of operations. On May 14, 1998, the Company purchased a minority interest in ConsumerInfo.Com for $1.6 million in cash. ConsumerInfo.Com is a privately-held, online provider of credit-monitoring membership programs. This transaction has been accounted for as an investment under the cost method.

Fiscal 1998 compared to Fiscal 1997

Revenues

Revenues increased 53% to $120.8 million in 1998 from $79.2 million in 1997 due to an increase in the Company's membership base and an increase in the weighted average program fee. The Company's membership base increased to 3.5 million members at June 30, 1998, from 2.0 million members at June 30, 1997. Excluding the impact of the Coverdell acquisition, revenue increased 47% to $116.0 million in 1998, and the Company's membership base increased to 2.9 million in 1998. The increase in the Company's membership base was due to an increase in the members enrolled in existing programs and the roll-out of new programs introduced in 1997 and 1998. The increase in the weighted average program fee was due to an increase in the percentage of members enrolled in programs with higher fees. Revenues from renewals increased to $50.6 million in 1998 from $33.4 million in 1997. As a percentage of

Management's Discussion and Analysis of Financial Condition and Results of Operations

individual membership revenues, these amounts represented 44% in 1998 and 43% in 1997. In the second half of fiscal 1998 the Company refined its estimate of its program-specific provisions for cancellations to reflect more current experience. The effect of this refinement was to increase revenues and net income by approximately $1.0 million and $0.75 million, respectively.

Operating Expenses

Operating expenses consist of costs incurred in servicing the Company's membership base, including personnel, telephone, and computer processing costs, as well as expenses associated with the production and distribution of membership information kits. Operating expenses increased 47% to $24.6 million in 1998 from $16.8 million in 1997. As a percentage of revenues, operating expenses decreased to 20.4% in 1998 from 21.2% in 1997, primarily due to increased wholesale revenues.

Marketing Expenses

Marketing expenses consist of fees to telemarketers to solicit potential members, royalties to clients, direct mail costs, and other solicitation expenses. Marketing expenses increased 40.6% to $71.6 million in 1998 from $50.9 million in 1997. The increase was due primarily to increased solicitation costs and increased royalty expense associated with the larger membership base. As a percentage of revenues, marketing expenses decreased to 59.2% in 1998 from 64.3% in 1997. The decrease was primarily due to improved member retention, an increase in the weighted average program fee, and increases in MemberLink and wholesale revenues. In addition to marketing expenses, the Company also monitors overall membership solicitation and other deferred costs, which are amortized ratably over the membership period. These costs increased 51% to $94.8 million in 1998 from $62.9 million in 1997 primarily due to increased marketing efforts incurred to expand the membership base. The Company expects these costs will continue to increase in future periods in order to continue the expansion of the Company's membership base.

General and Administrative Expenses

General and administrative expenses primarily consist of personnel and facilities expenses associated with the Company's executive, sales, marketing, finance, product, and account management functions. General and administrative expenses increased 42.6% to $23.2 million in 1998 from $16.3 million in 1997. The increase was attributable to the cost incurred for additional personnel in all areas and related facilities costs. The additional personnel were necessary to support the Company's growth and expansion. As a percentage of revenues, general and administrative expenses decreased to 19.2% in 1998 from 20.6% in 1997. The decrease in this percentage is due primarily to revenues increasing at a greater rate than general and administrative expenses.

Other (Income) Expense, Net

Other (income) expense, net is primarily composed of interest income from cash and cash equivalents. Other income, net of $1.7 million was reported in 1998 compared to other income, net of $0.9 million reported in 1997. The increase in other income, net was due to the interest earned on a full year of cash and cash equivalents resulting from the proceeds of the initial public offering completed on October 23, 1996. The Company invests in short-term, investment-grade, interest-bearing securities, and the amount of interest income fluctuates based upon the amount of funds available for investment and prevailing interest rates.

Provision for Income Taxes

The Company was not required to record a provision for income taxes for the years ended June 30, 1998 and 1997 due to tax losses realized in those years. As of June 30, 1998, the Company had accumulated federal net operating loss carry forwards of $56.4 million.

Fiscal 1997 Compared to Fiscal 1996

Revenues

Revenues increased 39% to $79.2 million in 1997 from $57.0 million in 1996 due to an increase in the Company's membership base and an increase in the weighted average program fee. The Company's membership base increased to 2.0 million members at June 30, 1997, from 1.5 million members at June 30, 1996. The increase in the Company's membership base was due to an increase in the members enrolled in existing programs and the roll-out of new programs introduced in 1996 and 1997. The increase in the weighted average program fee was due to an increase in the percentage of members enrolled in programs with higher fees. Revenues from renewals increased to $33.4 million in 1997 from $23.3 million in 1996. As a percentage of individual membership revenues, these amounts represented 43% in 1997 and 41% in 1996.

Operating Expenses
Operating expenses increased 44% to $16.8 million in 1997 from $11.6 million in 1996. As a percentage of revenues, operating expenses increased to 21.2% in 1997 from 20.4% in 1996. These increases were primarily due to the Company opening a new membership service facility in Houston, Texas which commenced operations during the quarter ended June 1996 as well as increased operating costs necessary to support the growing membership base.

Marketing Expenses
Marketing expenses increased 33% to $50.9 million in 1997 from $38.4 million in 1996. The increase was due primarily to increased solicitation costs and increased royalty expense associated with the larger membership base. As a percentage of revenues, marketing expenses decreased to 64.3% in 1997 from 67.4% in 1996. The decrease was primarily due to increased retention and an increase in the weighted average program fee. Membership solicitation and other deferred costs, which are amortized ratably over the membership period, increased 31% to $62.9 million in 1997 from $48.2 million in 1996 primarily due to increased marketing efforts incurred to expand the membership base.

General and Administrative Expenses
General and administrative expenses increased 37% to $16.3 million in 1997 from $11.9 million in 1996. The increase was attributable to the cost incurred for additional personnel in all areas and related facilities costs. The additional personnel were necessary to support the Company's growth and expansion. As a percentage of revenues, general and administrative expenses decreased to 20.6% in 1997 from 20.9% in 1996.

Other (Income) Expense, Net
Other income, net of $0.9 million was reported in 1997 compared to other expense, net of $0.3 million reported in 1996. The increase in other income, net was due to the interest earned on cash and cash equivalents resulting from the proceeds of the initial public offering completed on October 23, 1996.

Provision for Income Taxes
The Company was not required to record a provision for income taxes for the years ended June 30, 1997, and 1996 due to tax losses realized in those years.

Liquidity and Capital Resources

The Company's primary sources of capital have been from the issuance of equity securities and internally generated cash from operations. The Company sold 2,400,000 shares of its Common Stock in an initial public offering on October 18, 1996. Net proceeds of the offering, after deducting underwriting discounts, commissions, and offering expenses, approximated $36.4 million. Approximately $2.5 million of the net proceeds were utilized to redeem all outstanding shares of Series E and Series F Preferred Stock on October 23, 1996. The Company expects to use the remainder of the net proceeds of the initial public offering for working capital and other general corporate purposes, including possible acquisitions.

Net cash provided by operating activities was $8.9 million, $7.8 million, and $1.0 thousand for the years ended June 30, 1998, 1997, and 1996, respectively. This improvement in operating cash flow is due to several factors including improved operating results and improved membership solicitation costs. The Company believes that the Coverdell business will have a negative impact on short-term operating cash flow because its member fees have been collected monthly rather than annually, in advance.

Net cash used by investing activities increased to $10.0 million in 1998 up from $3.8 million and $2.3 million in 1997 and 1996, respectively. The increase is primarily due to the Company's acquisition of Coverdell and its investment in ConsumerInfo.Com, which were funded through available cash balances. The Company purchased Coverdell on April 2, 1998, with a cash payment of $3.9

million plus common stock and options worth $14.5 million. The Company funded its investment in ConsumerInfo.Com with a cash payment of $1.6 million. The Company's capital expenditures were $4.6 million in 1998 compared to $3.8 million in 1997, and $2.3 million in 1996. The increased expenditures were primarily related to computer system upgrades and software, as well as office and call center expansion. The Company expects to increase capital expenditures in fiscal 1999 to further increase capacity of its computer systems and increase capacity of its office facilities.

The Company's net cash used by financing activities was $3.7 million in 1998 primarily due to purchases of treasury stock compared to $32.4 million and $1.3 million provided by financing activities in 1997 and 1996, respectively. As discussed above, the Company completed an initial public offering in October 1996 which generated net proceeds of approximately $36.4 million. During 1998, the Company completed the repurchase program authorized by the Board of Directors in January 1997. On January 15, 1998, the Board of Directors authorized the repurchase, as conditions warrant, of up to an additional 150,000 shares of the Company's Common Stock. The Company bought back 156,000 shares for $3.5 million under these plans during fiscal 1998 compared to the purchase of 47,000 shares for $0.7 million in 1997. The repurchased shares will be used to provide Common Stock required for exercises of options granted by the Company under the 1996 Stock Option Plan.

As of June 30, 1998, the Company had cash and cash equivalents of $35.9 million. In addition, the Company has a $7.0 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. Borrowings as of and during the year ended June 30, 1998 were not significant. Because of ongoing costs in connection with soliciting new members, the Company expects to continue to utilize net cash generated from operating activities, if any, to increase the Company's membership base. The Company believes its existing cash balances, bank credit facility, and funds generated from operations will be sufficient to meet its funding requirements for at least the next twelve months.

Year 2000 Issues

The Company has completed an analysis of its software and hardware to determine if its systems are Year 2000 compliant. The Company's project to evaluate, modify, and test its systems is substantially complete and involved communication and testing with all of the Company's clients and vendors. This testing has involved processing of customer files both by the Company and its clients and vendors and the results have been positive.

The cost of the project has not been material to the Company and has been funded through operating cash flows. The Company has expensed all costs associated with this project as incurred.

Although management believes the Company's systems will be Year 2000 compliant, the Company has begun developing contingency plans to address any possible system failures. Because the Company uses multiple vendors to process its billing transactions, its external risk is mitigated as vendors may be used interchangeably. However, there can be no assurance that these, or other companies on which the Company relies, will be timely converted or that any such failure to convert would not have an adverse effect on the Company's systems and operations.

Certain Factors Affecting Future Results

The preceding Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve risks and uncertainties, including the statements in Liquidity and Capital Resources regarding the adequacy of funds to meet funding requirements. The Company's actual results may differ significantly from the results discussed in the forward-looking statements. A number of uncertainties exist that could affect the Company's future operating results, including, without limitation, the Company's history of losses, the Company's ability to retain existing clients and attract new clients, the Company's dependence on membership renewals, intense competition, the Company's continuing ability to develop new programs which generate consumer interest, and general economic factors. The Company has incurred significant operating losses since its inception. Although the Company has experienced revenue growth and has reported net income in recent periods, such growth rates may not be sustainable and are not indicative of future operating results. There can be no assurance that the Company will maintain profitability in the future.

Consolidated Balance Sheets

(In thousands, except per share data)	June 30 1998	1997
Assets		
Current assets:		
Cash and cash equivalents	$ 35,933	$ 40,758
Accounts receivable	7,107	3,193
Prepaid membership materials	2,931	1,678
Prepaid expenses	1,060	284
Membership solicitation and other deferred costs	51,771	31,773
Total current assets	98,802	77,686
Fixed assets, net	9,677	6,377
Intangible and other assets	25,450	360
Total assets	$133,929	$ 84,423
Liabilities and Shareholders' Equity		
Current liabilities:		
Current maturities of long-term obligations	$ 380	$ 724
Accounts payable	21,967	13,854
Accrued liabilities	20,680	13,904
Deferred membership fees	61,753	41,473
Total current liabilities	104,780	69,955
Long-term obligations	69	438
Total liabilities	104,849	70,393
Commitments and contingencies (Note 5)		
Shareholders' equity:		
Preferred stock, $0.01 par value		
1,000 shares authorized; no shares issued	—	—
Common stock, $0.01 par value		
40,000 shares authorized; 15,653 shares issued		
(14,942 shares at June 30, 1997)	156	149
Capital in excess of par value	74,478	59,472
Deferred compensation	(978)	(1,445)
Accumulated deficit	(40,073)	(43,158)
Treasury stock, 377 shares at cost (221 shares at June 30, 1997)	(4,503)	(988)
Total shareholders' equity	29,080	14,030
Total liabilities and shareholders' equity	$133,929	$ 84,423

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

Consolidated Statements of Operations

(In thousands, except per share data)	1998	1997	1996
			Year ended June 30
Revenues	$120,834	$ 79,174	$ 57,012
Expenses:			
Operating	24,610	16,762	11,623
Marketing	71,594	50,904	38,410
General and administrative	23,245	16,296	11,916
Other (income) expense, net principally interest	(1,700)	(930)	310
Total expenses	117,749	83,032	62,259
Income (loss) before income taxes	3,085	(3,858)	(5,247)
Provision for income taxes	—	—	—
Net income (loss)	$ 3,085	$ (3,858)	$ (5,247)
Earnings per share:			
Basic	$ 0.21	$ (0.35)	$ (0.49)
Diluted	$ 0.19	$ (0.35)	$ (0.49)
Weighted average common shares used in earnings per share calculations:			
Basic	14,837	13,901	11,956
Diluted	16,381	13,901	11,956

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

Consolidated Statements of Shareholders' Equity

(In thousands)	Common Stock: Shares	Common Stock: Amount	Capital in Excess of Par Value	Deferred Compensation	Accumulated Deficit	Treasury Stock	Total
Balance—June 30, 1995	5,857	$ 59	$ 1,686	$ —	$ (31,839)	$ (273)	$ (30,367)
For the year ended June 30, 1996:							
Issuance of common stock	—	—	1				1
Issuance of warrants			515				515
Preferred stock dividends and accretion					(1,234)		(1,234)
Deferred compensation			1,400	(1,400)			—
Net loss					(5,247)		(5,247)
Balance—June 30, 1996	5,857	59	3,602	(1,400)	(38,320)	(273)	(36,332)
For the year ended June 30, 1997:							
Issuance of common stock	2,621	26	36,547				36,573
Acquisition of treasury stock						(715)	(715)
Preferred stock dividends and accretion					(980)		(980)
Conversion of preferred stock into common stock	6,464	64	18,854				18,918
Deferred compensation			469	(45)			424
Net loss					(3,858)		(3,858)
Balance—June 30, 1997	14,942	149	59,472	(1,445)	(43,158)	(988)	14,030
For the year ended June 30, 1998:							
Issuance of common stock	711	7	15,006				15,013
Acquisition of treasury stock						(3,515)	(3,515)
Deferred compensation				467			467
Net income					3,085		3,085
Balance—June 30, 1998	15,653	$ 156	$ 74,478	$ (978)	$ (40,073)	$ (4,503)	$ 29,080

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

Consolidated Statements of Cash Flows

(In thousands)	Year ended June 30 1998	1997	1996
Operating Activities			
Net income (loss)	$ 3,085	$ (3,858)	$ (5,247)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Membership solicitation and other deferred costs	(94,835)	(62,929)	(48,201)
Amortization of membership solicitation and other deferred costs	74,837	56,842	43,097
Deferred membership fees	20,280	10,845	7,036
Depreciation and amortization	2,525	1,295	746
Other	514	424	469
Change in assets and liabilities:			
Accounts receivable	(3,319)	3,246	(5,074)
Prepaid membership materials	(1,253)	(613)	(733)
Prepaid expenses	(631)	(80)	(114)
Other assets	(56)	(31)	(252)
Accounts payable	3,556	3,421	2,729
Accrued liabilities	4,227	(727)	5,545
Net cash provided by operating activities	8,930	7,835	1
Investing Activities			
Acquisition of fixed assets	(4,586)	(3,760)	(2,264)
Business combinations, net of cash acquired and other investments	(5,446)	—	(48)
Net cash used in investing activities	(10,032)	(3,760)	(2,312)
Financing Activities			
Net proceeds from issuance of stock and warrants	505	36,573	12,887
Treasury stock purchases	(3,515)	(715)	(175)
Payments of long-term obligations	(713)	(918)	(7,395)
Preferred stock redemption	—	(2,549)	(4,000)
Debt issuance costs	—	(20)	(117)
Proceeds from issuance of notes payable	—	—	502
Preferred stock dividends	—	—	(402)
Net cash (used in) provided by financing activities	(3,723)	32,371	1,300
Net (decrease) increase in cash and cash equivalents	(4,825)	36,446	(1,011)
Cash and cash equivalents at beginning of year	40,758	4,312	5,323
Cash and cash equivalents at end of year	$ 35,933	$ 40,758	$ 4,312

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

Notes to Consolidated Financial Statements

Note 1—Nature of Business

MemberWorks Incorporated (the "Company") is a leading provider of innovative membership service programs. The Company addresses the needs of organizations seeking to leverage the expertise of an outside provider in offering membership service programs. Membership service programs offer selected products and services from a variety of vendors intended to enhance the existing relationships between businesses and consumers.

Note 2—Summary of Significant Accounting Policies

Basis of Presentation—Consolidation

The consolidated financial statements include the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of these consolidated financial statements in conformity with generally accepted accounting principles requires management of the Company to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Fair Value of Financial Instruments and Concentration of Credit Risk

All current assets and liabilities are carried at cost, which approximates fair value because of the short-term maturity of those instruments. The recorded amounts of the Company's long-term obligations also approximate fair value. Financial instruments which potentially subject the Company to concentration of credit risk consist primarily of accounts receivable from financial and other cardholder based institutions (clients of the Company) whose cardholders constitute the Company's membership base. These entities include major banks, financial institutions, large oil companies, and retailers located in the United States.

Fixed Assets

Fixed assets and capital leases are carried at cost, less accumulated depreciation and amortization. Depreciation and amortization are calculated using the straight-line method over the lesser of the estimated productive lives of the assets or the terms of the related leases, and range from three to ten years. Maintenance and repair expenditures are charged to operations as incurred.

Revenue Recognition

Membership fees are billed through clients of the Company primarily through credit cards. An allowance for cancellations is established based on the Company's most recent actual cancellation experience, updated regularly. Deferred membership fees are recorded, net of estimated cancellations, when the trial period has elapsed, and are amortized as revenues from membership fees on a straight-line basis, over the remainder of the membership period, generally twelve months. Membership cancellations are charged to the allowance for cancellations on a current basis. During an initial annual membership term or renewal term, a member may cancel his or her membership in the program, generally for a complete refund of the membership fee for that period. Accrued liabilities set forth in the accompanying consolidated balance sheets as of June 30, 1998 and 1997 include an allowance for membership cancellations of $16,362,000 and $11,401,000, respectively. In the second half of fiscal 1998 the Company refined its estimate of its program-specific provision for cancellations to reflect more current experience. The effect of this refinement was to increase revenues and net income by approximately $1,000,000 and $750,000, respectively.

Accounts receivable includes $2,033,000 and $1,220,000 of unbilled receivables as of June 30, 1998 and 1997, which were billed and collected subsequent to the balance sheet date, and arise in certain instances when the Company elects to bill subsequent to, rather than upon, acceptance of membership.

Membership service programs sponsored by three clients of the Company accounted for 21.9%, 13.9%, and 13.7% of revenues, respectively for the fiscal year ended June 30, 1998. Membership service programs sponsored by two clients of the Company accounted for 30.7% and 13.8% of revenues, respectively, for the fiscal year ended June 30, 1997, and 35.2% and 10.5% of revenues, respectively, for the fiscal year ended June 30, 1996.

Membership Solicitation and Other Deferred Costs

Membership solicitation costs include telemarketing, printing, postage, and mailing costs related directly to membership solicitation (i.e. direct response advertising costs). In accordance with Statement of Position 93-7, "Reporting on Advertising Costs," direct response advertising costs are deferred and charged to operations as revenues from membership fees are recognized. Other deferred costs consist of royalties paid to clients, transaction processing fees, and members' kit costs, which relate to the same revenue streams as the direct marketing costs and are also charged to income over the membership period. Membership solicitation costs incurred to obtain a new member generally are less than the initial membership fee. However, if membership solicitation costs were to exceed membership fees, an adjustment would be made to the extent of any impairment.

Earnings Per Share

The Company has adopted Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share," ("FAS 128"). All earnings per share amounts have been restated to conform to FAS 128. Basic earnings per share is computed using the weighted average number of common shares outstanding during the reporting period. Earnings per share assuming dilution is computed using the weighted average number of common shares outstanding and the dilutive effect of potential common shares outstanding, determined using the treasury stock method. For the year ended June 30, 1998, the diluted weighted average common shares outstanding includes 1,544,000 of dilutive stock options and warrants. Preferred stock dividends of $980,000 and $586,000 have been deducted from net loss for the years ended June 30, 1997 and 1996, respectively, to arrive at net loss available to common shareholders.

Cash and Cash Equivalents

The Company considers highly liquid investment instruments with terms of three months or less at the time of acquisition to be cash equivalents.

Income Taxes

The Company accounts for income taxes under the provisions of SFAS No. 109 "Accounting for Income Taxes" ("FAS 109"). 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.

Intangible Assets

Intangible assets principally include acquired member and customer relationships and goodwill that arose in connection with the acquisition of Coverdell & Company, Inc. Goodwill represents the excess of acquisition costs over the fair value of net assets acquired and is amortized on a straight-line basis over twenty years. Other acquired intangibles, except member relationships, are recorded at cost and are amortized on a straight-line basis over their estimated useful lives, primarily twenty years. The value of member relationships is amortized over twenty years using an accelerated method based on estimated future cash flows. The Company periodically reviews goodwill and other intangibles to assess recoverability from future operations using undiscounted cash flows. Intangible and other assets set forth in the accompanying consolidated balance sheet as of June 30, 1998, include acquired member and customer relationships of $10,199,000 and goodwill of $12,771,000, net of accumulated amortization of $301,000 and $162,000, respectively.

Impairment of Long-Lived Assets

The Company accounts for the impairment and disposition of long-lived assets in accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("FAS 121"). In accordance with FAS 121, long-lived assets to be held are reviewed for events or changes in circumstances which indicate that their carrying value may not be recoverable. As of June 30, 1998, no impairment has been indicated.

Stock-Based Compensation

The Company accounts for stock option grants in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and its related interpretations.

New Accounting Pronouncements

In June 1997, the Financial Accounting Standards Board ("FASB") issued SFAS No. 130 "Reporting Comprehensive Income" ("FAS 130") and No. 131 "Disclosures about Segments of an Enterprise and Related Information" ("FAS 131"). FAS 130 requires the presentation of the components of comprehensive income in a company's financial statements for fiscal years beginning after December 15, 1997. Comprehensive income is defined as the change in a company's equity during a financial reporting period from transactions and other events and circumstances from nonowner sources (including cumulative translation adjustments, minimum pension liabilities, and unrealized gains/losses on available for sale securities). FAS 131 requires that public companies report certain information about operating segments. It also requires that public business enterprises report certain information about their products and services, geographic areas in which they operate, and major customers. FAS 131 is effective for fiscal years beginning after December 15, 1997. In the initial year of application, comparative information for earlier years is to be restated. The adoption of these statements is not expected to materially impact the presentation and disclosure in the Company's financial statements.

Note 3—Business Combinations

Coverdell Acquisition

On April 2, 1998, the Company acquired all of the outstanding common stock of Coverdell & Company, Inc. ("Coverdell"). The purchase price totaled approximately $18,400,000, including $3,900,000 in cash, 448,000 shares of the Company's common stock, with a fair value of $13,600,000, and options to acquire 93,000 shares of the Company's common stock with a fair value of $900,000. Cash for the acquisition was funded entirely from internal cash reserves of the Company. The acquisition was accounted for as a purchase, with the purchase price allocated to the assets acquired and liabilities assumed based upon their respective estimated fair values at the date of acquisition. The results of Coverdell's operations are included in the consolidated financial statements from the date of acquisition.

The fair values of assets and liabilities acquired, based on certain estimates and appraisals obtained are summarized as follows (in thousands):

Current assets	$ 818
Non-current assets	482
Identifiable intangible assets	10,500
Goodwill	12,933
Accounts payable and accrued liabilities	(6,356)
Total	$ 18,377

Pro Forma Results

The following unaudited pro forma results of operations for 1998 and 1997 have been prepared assuming the Coverdell acquisition had occurred as of July 1, 1996. These pro forma results are not necessarily indicative of the results of future operations or of results that would have occurred had the acquisition been consummated as of that date (in thousands except per share data).

	1998	1997
Revenues	$131,200	$ 90,400
Net income (loss)	500	(5,200)
Basic and diluted earnings (loss) per share	$ 0.03	$ (0.43)

ConsumerInfo.Com Investment

On May 14, 1998, the Company purchased a minority interest of less than twenty percent in ConsumerInfo.Com, a privately-held, online provider of credit monitoring membership programs for $1,600,000 in cash. This investment is accounted for under the cost method of accounting.

Note 4—Fixed Assets

Fixed assets are comprised of the following at June 30, (in thousands):

	1998	1997
Computer and office equipment	$ 9,940	$ 5,955
Furniture and fixtures	1,854	875
Telephone equipment	1,737	1,430
Leasehold improvements	1,196	816
	14,727	9,076
Accumulated depreciation and amortization	(5,050)	(2,699)
	$ 9,677	$ 6,377

Depreciation and amortization expense was $1,770,000, $1,183,000, and $614,000 for the years ended June 30, 1998, 1997, and 1996, respectively.

Note 5—Long-Term Obligations

Notes Payable

Notes payable are summarized as follows at June 30, (in thousands):

	1998	1997
Bank Credit Agreement	$ 10	$ 10
Equipment term loans	197	633
	207	643
Less current maturities	200	446
Long-term notes payable	$ 7	$ 197

The Bank Credit Agreement allows borrowings up to $7,000,000. Borrowings under the facility accrue interest at the higher of the base commercial lending rate for the bank or the Federal Funds Rate plus 0.5% per annum. A commitment fee is charged based on the total facility at the rate of 0.5% per annum. The credit agreement is secured by all of the Company's assets, including the stock of its subsidiaries.

The Company has several equipment term loans extending to September 2001, secured by certain computer equipment. Interest is at rates of 7.5% to 11.6%, and principal is repayable monthly. The aggregate amount of payments related to the equipment term loans is $192,000 in 1999, $6,000 in 2000, and $2,000 in 2001.

Other (income) expense in 1998, 1997, and 1996, as shown in the statement of operations, includes interest expense of $146,000, $303,000, and $615,000 respectively.

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. Rent expense under operating leases was $1,640,000, $1,213,000, and $733,000 for the fiscal years ended June 30, 1998, 1997, and 1996, respectively.

During 1996, the Company entered into capital leases for certain computer equipment totaling $406,000 of capitalized cost. Lease amortization for the years ended June 30, 1998, 1997, and 1996 was $137,000, $218,000, and $194,000, respectively, and is included in depreciation and amortization expense.

The future minimum lease payments under capital leases (including present value of net minimum lease payments) and operating leases as of June 30, 1998 are as follows (in thousands):

Fiscal Year	Capital leases	Operating leases
1999	$ 197	$ 2,335
2000	56	2,559
2001	9	2,354
2002	—	2,340
2003	—	1,706
Thereafter	—	3,494
Total minimum lease payments	262	$ 14,788
Less—Amount representing interest	20	
Present value of net minimum lease payments including current maturities of $180 with interest rates ranging from 6.9% to 10.4%	$ 242	

Note 6—Income Taxes

There was no current or deferred provision for income taxes for the years ended June 30, 1998, 1997, and 1996. No current provision was required because tax losses were incurred in those years. Deferred tax assets and liabilities result from differences in the basis of assets and liabilities for tax and financial statement purposes. The tax effects of the basis differences and net operating loss carry forwards, and the valuation allowance established in accordance with FAS 109, are summarized below as of June 30, 1998, and 1997 (in thousands):

	1998	1997
Benefit of net operating loss carry forward	$ 22,122	$ 12,632
Deferred membership fees	6,565	8,542
Allowance for membership cancellations	5,492	3,687
Other deferred tax assets	419	428
Membership solicitation and other deferred costs	(20,859)	(12,312)
Total deferred tax assets	13,739	12,977
Less: Valuation allowance	(13,739)	(12,977)
Net deferred tax asset	$ —	$ —

The valuation allowance for deferred tax assets as of July 1, 1996 was $11,599,000. The net change in the valuation allowance for the years ended June 30, 1998 and 1997 were increases of $762,000 and $1,378,000 respectively. At June 30, 1998, the Company had federal net operating loss carry forwards of $56,422,000 expiring at various dates from June 30, 2005 to June 30, 2013. Approximately $5,832,000 of the net operating loss carry forwards are limited in their use to the future taxable income of Coverdell. The Company's ability to use these losses to offset future taxable income would be subject to limitations under the Internal Revenue Code if certain changes in the Company's ownership occur. The Company also has state net operating loss carry forwards expiring at various dates through June 30, 2003 available to reduce future state taxable income.

Note 7—Redeemable Preferred Stock

As a result of the Company's initial public offering of its Common Stock (see Note 8), there is no redeemable preferred stock outstanding as of June 30, 1998.

During fiscal 1996, the Company issued 317,150 shares of Series H preferred stock for a total of $13,000,000. In addition, warrants to acquire 72,000 shares of common stock at $0.0014 per share were issued in conjunction with the issuance of Series H preferred stock. As a result, the recorded value of the Series H preferred stock was $12,800,000, reflecting a $200,000 discount attributable to the warrants, which was being accreted through the exercise date using the interest method. Additionally, the Company paid $114,000 of issuance costs in connection with this offering, which was recorded as a reduction in net proceeds, and was being accreted to the redemption date.

On August 3, 1995, the Company redeemed 40,000 shares of issued and outstanding Series G preferred stock and redeemed attached warrants to acquire 288,000 shares of common stock of the Company for $4,000,000, and also paid the investor a preferred dividend in the amount of $402,000. Additionally, the Company substituted 113,227 warrants to acquire common stock, exercisable at $0.0014 per share, in exchange for the 288,000 warrants previously redeemed. As a result the substituted warrants issued were accounted for at fair value of $315,000 and recorded as a charge to operations as a cost of redeeming the preferred stock.

Note 8—Shareholders' Equity

Initial Public Offering

Effective October 18, 1996, the Company sold 2,400,000 shares of its Common Stock at $17.00 per share in an initial public offering. Net proceeds of the offering, after deducting underwriting discounts, commissions, and offering expenses, aggregated $36,401,000. Approximately $2,549,000 of the proceeds of the offering was used to redeem all outstanding shares of Series E and Series F Preferred Stock. The remaining $33,852,000 in proceeds were retained for general corporate purposes, including acquisition of new members, program development, capital expenditures, and working capital. Consummation of the initial public offering resulted in the automatic conversion of Series A, B, C, D, and H Preferred Stock into Common Stock.

Stock Repurchases

During fiscal 1998, the Company completed the repurchase program authorized by the Board of Directors in January 1997 which authorized the repurchase of 150,000 shares of the Company's Common Stock. On January 15, 1998, the Board of Directors authorized the repurchase, as conditions warrant, of up to an additional 150,000 shares of the Company's Common Stock. The Company bought back 156,000 shares for $3.5 million under these plans during fiscal 1998, compared to the purchase of 47,000 shares for $0.7 million in 1997. The repurchased shares will be used to provide Common Stock required for exercises of options granted by the Company under the 1996 Stock Option Plan.

Note 9—Stock Options and Warrants

Stock Compensation Plans

At June 30, 1998, the Company has five stock-based compensation plans, which are described below. The Company applies APB Opinion 25 and related interpretations in accounting for its plans. Compensation expense of $467,000, $424,000, and $3,000 has been recognized during 1998, 1997, and 1996, respectively, related to its stock option plans under APB 25. Had compensation cost for the Company's stock based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's pro forma net income (loss) would have been $1,871,000, ($4,464,000), and ($5,356,000), for 1998, 1997, and 1996, respectively, and pro forma basic earnings (loss) per share would have been $0.13, ($0.39), and ($0.50), for 1998, 1997, and 1996, respectively. For the year ended June 30, 1998, pro forma diluted earnings per share would have been $0.11. The pro forma effect on fiscal 1998, 1997, and 1996 results is not representative of the pro forma effect on net income (loss) in future years because it does not take into consideration pro forma compensation expense related to grants made prior to July 1, 1995.

Under the stock option plans and the agreement with an executive officer described below, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions for the years ended June 30, 1998, 1997, and 1996: Dividend yield of 0%, expected volatility of 42%, risk-free interest rates of 5.8% for 1998, 6.4% for 1997, and 6.7% for 1996, and expected lives of 4.5 years for 1998, 4.8 years for 1997, and 6.3 years for 1996. The weighted-average fair value of options granted at market value were $9.04, $4.34, and $1.32 for the years ended June 30, 1998, 1997, and 1996, respectively. The weighted-average fair value of options granted below market value were $11.90 and $5.67 for the years ended June 30, 1997, and 1996, respectively.

The Company's 1990 Employee Incentive Stock Option Plan ("Amended 1990 Stock Option Plan") provides for the grant of "incentive stock options" to employees and officers of the Company and non-qualified stock options to employees, consultants, directors, and officers of the Company. On August 13, 1996, the Board of Directors voted that no further options may be granted under the Amended 1990 Stock Option Plan effective upon the closing of the initial public offering.

During fiscal 1997, the Board of Directors approved the Company's 1996 Stock Option Plan (the "1996 Stock Option Plan"), which became effective upon the closing of the Company's initial public offering. The 1996 Stock Option Plan authorizes the issuance of up to 1,800,000 shares of Common Stock pursuant to the grant to employees of incentive stock options and the grant of non-qualified stock options to employees, consultants, officers or directors of the Company. Under the 1996 Stock Option Plan the Board can determine the date on which options can vest and become exercisable as well as the term of the options granted.

During fiscal 1996, the Board of Directors and stockholders of the Company approved the adoption of the 1995 Executive Officers' Stock Option Plan and the 1995 Non-Employee Directors' Stock Option Plan under which the Board is authorized to grant 360,000 and 180,000 options, respectively, to acquire shares of Common Stock at a price per share equal to or greater than fair market value at the date of grant. Under the Executive Officers' Stock Option Plan, the Board can determine the date on which options vest and become exercisable. Options become exercisable over a four-year period under the Non-Employee Directors' Stock Option Plan.

Under the stock option plans described above, options generally become exercisable over a four year period and expire at the earlier of termination of employment or ten years from date of grant (eight years for grants prior to December 31, 1995).

The Company had an agreement with an executive officer, whereby the Company was required to grant options to purchase up to 144,000 shares of Common Stock to the executive for achievement of certain performance goals. These options have a stated exercise price of $2.78 per share and vest ratably over a four year period from date of grant. The executive was granted 43,200 and 14,400 options to purchase Common Stock in 1997 and 1996, respectively. The Company recognized compensation expense of $122,000, $79,000, and $3,000 for the years ended June 30, 1998, 1997, and 1996, respectively.

In connection with a grant of options in June 1996 to purchase 360,000 shares of Common Stock, the Company recognized compensation expense of $345,000 during each of the years ended June 30, 1998, and 1997. Compensation expense is being recognized over the four-year vesting period and is measured based on the excess of the fair market value of the Company's stock over the grant price of the options.

In connection with the acquisition of Coverdell on April 2, 1998 (see Note 3), the Company substituted 93,000 options to acquire Common Stock for options to acquire Coverdell common stock with the same terms and conditions at an exercise price of $20.81 per share. The fair value of these options, approximately $900,000, has been accounted for as a part of the Coverdell purchase price.

Information with respect to options to purchase shares issued under the plans is as follows:

	1998		1997		1996	
(Shares in thousands)	Shares	Average Exercise Price	Shares	Average Exercise Price	Shares	Average Exercise Price
Outstanding at beginning of year	1,649	$ 4.78	1,278	$ 2.62	652	$ 1.64
Granted at market value	257	21.84	486	9.88	300	2.78
Granted below market value	—	—	43	2.78	374	4.12
Replaced	93	20.81	—	—	—	—
Exercised	(202)	2.30	(93)	1.50	—	2.08
Forfeited	(43)	11.45	(65)	3.83	(48)	1.95
Outstanding at end of year	1,754	$ 8.25	1,649	$ 4.78	1,278	$ 2.62

	Options Outstanding			*Options Exercisable*	
	Number Outstanding at 6/30/98	Average Remaining Life (Years)	Average Exercise Price	Number Outstanding at 6/30/98	Average Exercise Price
$1.27 to $1.99	240	2.5	$ 1.58	240	$ 1.58
$2.00 to $3.99	394	6.0	2.61	186	2.55
$4.00 to $7.99	351	8.0	4.17	171	4.17
$8.00 to $15.99	433	8.2	9.99	91	10.05
$16.00 to $19.99	143	9.0	16.03	—	—
$20.00 and over	193	11.7	25.76	93	20.81
	1,754	7.3	$ 8.25	781	$ 5.66

Options exercisable as of June 30, 1997, and 1996 were 630,000 and 378,000, respectively.

Employee Stock Purchase Plan

During fiscal 1997, the Company adopted the 1996 Employee Stock Purchase Plan, which provides for the issuance of up to 360,000 shares of common stock. The plan permits eligible employees to purchase Common Stock through payroll deductions, which may not exceed 10% of an employee's compensation, at a price equal to the lower of (a) 85% of the closing price of the Common Stock on the day the purchase period commences, or (b) 85% of the closing price of the Common Stock on the day the purchase period terminates. Purchases under the plan during fiscal 1998 were not significant.

Warrants

During fiscal 1998, warrants to acquire 57,509 shares of Common Stock were exercised (28,121 at $0.0014 per share and 29,388 at $3.56 per share). As of June 30, 1998, the Company had outstanding warrants to purchase an aggregate of 198,125 shares of Common Stock with the following per share exercise prices: 26,779 at $3.56; 127,467 at $2.05; and 43,879 at $0.0014. These warrants expire at various dates between March 1999 and August 2000.

Note 10—Employee Benefit Plan

Effective April 1, 1996, the Company adopted a 401(k) profit sharing plan. Employees of the Company are eligible to contribute to the plan once they have completed one year of service and attained age 18. Employees may contribute up to 15% of their compensation subject to certain limitations. The Company may elect to make matching contributions or profit sharing contributions to the plan. There were no Company contributions made for the years ended June 30, 1998, 1997, and 1996.

Note 11—Statement of Cash Flows

Supplemental disclosure of cash flow information (in thousands):

	Year ended June 30		
	1998	1997	1996
Cash paid during the period for interest	$ 114	$ 205	$ 493
Cash paid during the period for income taxes	—	30	45
Supplemental schedule of non-cash investing and financing activities:			
Capital lease obligation related to acquisition of fixed assets	—	—	406
Dividends accumulated on Series E, F, and G preferred stock	—	53	212
Accretion of discount on Series E, F, G, and H preferred stock	—	563	219
Accretion to redemption value on Series A, B, C, and D preferred stock	—	364	648
Issuance of warrants	—	—	200

Note 12—Subsequent Events

Effective July 1, 1998, the Company changed its method of accounting for printing and mailing of membership materials. Historically, the Company has accounted for the costs of printing and mailing of membership materials by amortizing these costs ratably over the membership period as revenue is recognized. Effective July 1, 1998, the Company will expense these costs upon the mailing of membership materials. The cumulative effect of this change in accounting principle as of July 1, 1998, of $3.4 million will be recorded in the first fiscal quarter ended September 30, 1998, as a reduction of membership solicitation and other deferred costs and net income. If this accounting principle had been followed in previous years net income for fiscal 1998 would have been reduced by $603,000 ($0.04 per share) and net losses for fiscal 1997 and 1996 would have been increased by $478,000 ($0.03 per share) and $576,000 ($0.05 per share), respectively.

Report of Independent Accountants

To the Board of Directors and Shareholders of MemberWorks Incorporated:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of shareholders' equity, and of cash flows present fairly, in all material respects, the financial position of MemberWorks Incorporated and its subsidiaries at June 30, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit 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 the opinion expressed above.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
New York, New York

July 28, 1998

MemberWorks Incorporated

Board of Directors

Gary A. Johnson
President and Chief Executive Officer

Dennis P. Walker
Executive Vice President

Stephen J. Clearman
General Partner, Geocapital Partners

Alec L. Ellison
Managing Director, Broadview Associates LLC

Michael R. O'Brien
Chairman Emeritus, Catalina Marketing Corporation

Marc S. Tesler
General Partner, Technology Crossover Ventures L.P.

MemberWorks Incorporated

Officers

Gary A. Johnson
President and Chief Executive Officer

Dennis P. Walker
Executive Vice President

James B. Duffy
Senior Vice President and Chief Financial Officer

Wayne Gattinella
Senior Vice President, Marketing

Stephen Landis
Senior Vice President, Teleservices

Laura J. Pelco
Senior Vice President, Sales

David Schachne
Senior Vice President, New Business Development

Design: California Design International, San Francisco

MemberWorks Incorporated

Corporate Offices

Headquarters
9 West Broad Street
Stamford, CT 06902
203.324.7635
www.memberworks.com

Other Locations
1718 Peachtree Street, N.W., Suite 276
Atlanta, GA 30309
404.881.8641

11165 Mill Valley Road
Omaha, NE 68154
402.493.8498

7324 Southwest Freeway, Suite 2000
Houston, TX 77074
281.552.6100

Transfer Agent
American Stock Transfer and Trust Company
40 Wall Street, 46th Floor
New York, NY 10005

Form 10-K
A copy of the Annual Report on Form 10-K, filed with the Securities and Exchange Commission, is available without charge to shareholders. Request for the Annual Report on Form 10-K or for information relating to other matters should be addressed to:

James B. Duffy
Senior Vice President and Chief Financial Officer
MemberWorks Incorporated
9 West Broad Street
Stamford, CT 06902
203.324.7635

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