

PRECIS INC  
Form 10-Q  
November 13, 2003

# U. S. SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

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## FORM 10-Q

(Mark One)

### QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2003

### TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from      to

Commission File Number: 001-15667

## PRECIS, INC.

(Name of business issuer in its Charter)

**OKLAHOMA**

(State or other jurisdiction of  
incorporation or organization)

**73-1494382**

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

**2040 North Highway 360**

**Grand Prairie, Texas 75050**

(Address of principal executive offices)

**(972) 522-2000**

(Issuer's telephone number)

(Former name, former address and former fiscal year, if changed since last report)

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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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

### **APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY**

#### **PROCEEDINGS DURING THE PRECEDING FIVE YEARS**

Indicate by check mark whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court. Yes  No

### **APPLICABLE ONLY TO CORPORATE ISSUERS**

State the number of shares outstanding of each of issuer's classes of common equity, as of the latest practicable date: As of November 1, 2003, 11,843,530 shares of the issuer's common stock, \$0.01 par value, were outstanding.

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**PRECIS, INC.**

FORM 10-Q

For the Quarter Ended September 30, 2003

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

Our financial statements which are prepared in accordance with Regulation S-X are set forth in this report beginning on page 15.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion is qualified in its entirety by the more detailed information in our Form 10-KSB and the financial statements contained in this report, including the notes thereto, and our other periodic reports filed with the Securities and Exchange Commission since December 31, 2002 (collectively referred to as the Disclosure Documents). Certain forward-looking statements contained herein and in such Disclosure Documents regarding our business and prospects are based upon numerous assumptions about future conditions that may ultimately prove to be inaccurate and actual events and results may materially differ from anticipated results described in such statements. Our ability to achieve such results is subject to the risks and uncertainties discussed in our Form 10-KSB. Any forward-looking statements contained in this report represent our judgment as of the date hereof. We disclaim, however, any intent or obligation to update these forward-looking statements. As a result, the reader is cautioned not to place undue reliance on these forward-looking statements.

**Overview**

**Consumer Healthcare Savings Solution**

We offer savings on healthcare services throughout the United States to persons who are under-insured. These savings are offered by accessing the same preferred provider organizations (PPOs) that are utilized by many insurance companies. These programs are sold primarily through a network marketing strategy under the name Care Entrée. We design these programs to benefit healthcare providers as well as our program members. Providers commonly give reduced or preferred rates to PPO networks in exchange for steerage of patients. However, the providers must still file claim forms and wait 30 to 60 days to be paid for their services. Our programs utilize these same provider networks to obtain the same savings for the Care Entrée program members. However, the healthcare providers are paid immediately for their services and are not required to file claim forms.

Independent marketing representatives (IMRs) may enroll as representatives by paying an enrollment fee and signing a standard representative agreement. We pay independent marketing representatives commissions equal to 20% of the membership fees of members they enroll for the life of the members' enrollment. Independent marketing representatives can also recruit other representatives and earn override commissions on sales made by those recruited representatives. We pay a total of 35% in override commissions down through seven levels. We have also established bonus pools that allow independent marketing representatives who have achieved certain levels to receive commissions of up to 5% measured in part by our revenues in these programs. Independent marketing representatives can also earn a commission equal to the membership fees if three or more program members are enrolled in a month. In the month of the membership sales, no override commissions are paid to the representative's upline.

**Affordable Healthcare and Insurance Products**

In late 2001, through our subsidiary, SmartCare Insurance Agency, we contracted with numerous insurance companies to offer high deductible and scheduled benefit insurance policies. In September 2003, we renamed our Smart Care Insurance Agency, Care Financial LLP. Through our Care Financial subsidiary we continue to offer our high deductible and scheduled benefit insurance policies, but have recently added a suite of products including life insurance from Lion's Share (Allianz), Healthcare Reimbursement Arrangements (HRAs) and medical and dependent care Flexible Spending Accounts (FSAs). The high deductible and scheduled benefit insurance policies and HRAs and medical and dependent care FSAs, when combined with the Care Entrée program, offer affordable well-rounded solutions for individuals and companies who are no longer able to afford or obtain traditional health insurance policies. The HRAs and medical and dependent care FSAs are also sold by our IMRs who from a regulatory standpoint are not required to be licensed to sell these products. The life insurance products offered through our partner Lion's Share (Allianz) serve to complement our healthcare product

offerings and to focus beyond our member s healthcare cost concerns, through review, assessment and needs requirement pertaining to their overall financial condition. The insurance policies are sold through our independent marketing representatives who are licensed insurance agents.

**Wholesale Membership Solution**

*Healthcare Membership Programs*



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We also design healthcare membership programs for employer groups, retailers and association-based organizations. Memberships in these programs are offered and sold by direct marketing through direct sales or in-bound direct marketing. We believe that our clients, their members, and the vendors of the products and services offered through the programs, all benefit from our membership service programs. The products and services are bundled, priced and marketed utilizing relationship marketing strategies to target the profiled needs of the clients' particular member base. Most of our memberships are sold by third-party organizations and are generally marketed using the third-party's name or brand. We refer to these programs and membership sales as wholesale programs or private label programs.

### *Rental Purchase and Club Membership Programs*



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We also design club membership programs for rental-purchase companies, financial organizations, employer groups, retailers and association-based organizations. Memberships in these programs are offered and sold as part of a point-of-sale transaction or by direct marketing through direct mail or as inserts. Program members are offered and provided our third-party vendors' products and services. We believe that our clients, their customers, and the vendors of the products and services offered through the programs, all benefit from our membership service programs. The products and services are bundled, priced and marketed utilizing relationship marketing strategies to target the profiled needs of the clients' particular customer base. Most of our club membership programs are sold by third-party organizations, generally in connection with a point-of-sale transaction. We refer to these programs and membership sales as wholesale programs.

### **Benefits to Members of Our Programs**

We believe that our programs offer members an economic, efficient and convenient method for the selection of products and services. Members are entitled to savings for products and services that may not otherwise be available to them. Vendors of products and services offered and sold through the programs to members are benefited. Vendors are provided the opportunity demographically to reach a large number of targeted customers with minimal incremental marketing cost.

### **Critical Accounting Policies**

#### **Revenue Recognition**

##### *Healthcare Membership Revenues*



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We recognize membership revenues in the month the member joins the program. Membership revenues are reduced by the amount of refunds incurred. Subsequent to the initial membership month, membership revenues are recognized on each monthly anniversary date.

*Membership and Independent Marketing Representatives Enrollment Fees:* Membership enrollment fees, net of direct costs, are deferred and amortized over the estimated membership period, that averages eight to ten months. Independent marketing representative fees, net of direct costs, are deferred and amortized over the term of the contract.

### *Rental Purchase and Club Membership Revenues*



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Rental purchase and club membership revenues are recognized in the month that our products and services have been delivered to our clients. We sell our rental purchase and club membership programs on a wholesale basis to our clients. The wholesale client remits a portion of the rental purchase and club membership revenues to us and retains the balance as compensation for having made the sale. We provide an allowance for those accounts which are considered to be uncollectible.

**Commission Expense**

Commissions are paid to our independent marketing representatives in the month following the month in which a member enrolls in our Care Entrée program. Commissions are only paid in the following month when the related monthly membership fees have been received. We do not pay advanced commissions on membership sales.

**Goodwill**



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We review our goodwill for any impairment on an annual basis. The goodwill arises in connection with our acquisitions of The Capella Group Inc. in June 2001, and Foresight Inc. in December 2000. As of September 30, 2002 goodwill amounted to \$21,077,284. The value of our goodwill is primarily dependent upon continued healthcare and rental purchase and club program membership revenues.

### Results of Operations

**Current and Comparative Prior Period Historical Information.** The following table sets forth selected results of operations for the three months and nine months ended September 30, 2003 and 2002.

	For the Three Months Ended September 30, Unaudited		For the Nine Months Ended September 30, Unaudited	
	2003	2002	2003	2002
Product and service revenues	\$ 10,268,629	\$ 11,445,761	\$ 31,994,932	\$ 31,727,480
Operating expenses:				
Cost of operations	3,221,085	2,973,143	9,793,017	8,075,571
Sales and marketing	3,899,966	4,567,259	12,183,400	12,655,816
General and administrative	1,614,261	1,483,794	4,706,147	4,401,222
Total operating expenses	8,735,312	9,024,196	26,682,564	25,132,609
Operating income	1,533,317	2,421,565	5,312,368	6,594,871
Other expenses:				
Interest income and expense, net	39,608	27,342	113,516	44,770
Total other expenses	39,608	27,342	113,516	44,770
Earnings before income taxes	1,493,709	2,394,223	5,198,852	6,550,101
Provision for income taxes	522,739	852,080	1,774,743	2,348,566
Net earnings	970,970	1,542,143	3,424,109	4,201,535
Preferred stock dividend				14,137
Net earnings applicable to common shareholders	\$ 970,970	\$ 1,542,143	\$ 3,424,109	\$ 4,187,398
Earnings per common share				
Basic	\$ 0.08	\$ 0.13	\$ 0.29	\$ 0.35
Diluted	\$ 0.08	\$ 0.13	\$ 0.29	\$ 0.35
Weighted average number of common shares outstanding:				
Basic	11,851,579	11,805,297	11,840,141	11,805,297
Diluted	11,984,396	11,981,038	11,936,291	11,981,038



**Comparison of the Three Months Ended September 30, 2003 and 2002**

**Product and Service Revenues.** During the three months ended September 30, 2003, revenues were \$10,268,629, a decrease of \$1,177,132 or 10.3%, from \$11,445,761 during the comparable 2002 period. The reduction in actual revenues for the three months ended September 30 2003 as compared to the three months ended September 30, 2002 was primarily due to the Company's implementation of member escrow accounts in response to the market changes in the healthcare savings industry as well as a reduction of revenues in our wholesale club membership programs. Under the escrow arrangement, we now pre-certify the members' ability to pay based on available escrow account balances and process the members' payments directly to the medical providers to solidify the payment process. As a result of this change, we now believe we have created a stronger healthcare product offering for both our members and the healthcare providers. The escrowed funds referred to as cash-in-trust on our balance sheet amount to \$2,000,131 as of September 30, 2003.

**Cost of Operations.** Cost of operations for the three months ended September 30, 2003 increased \$247,942 or 8.3%, to \$3,221,085 from \$2,973,143 during the 2002 comparable period. The increase in cost of operations primarily arose from our increased member service staff and other personnel necessary to support our operations, the increase in preferred provider network costs, and the additional depreciation expense as a result of the capital leases acquired in the three months ended December 31, 2002, offset in part by a decrease in certain other operating costs.

Cost of operations, as a percentage of revenues, was 31.4% of revenues during the three months ended September 30, 2003, while during the comparable 2002 period cost of operations were 26.0% of revenues. The increase was attributable to our increased member service staff, as well as the additional depreciation expense as a result of the capital leases we acquired in the three months ended December 31, 2002.

**Sales and Marketing Expenses.** Sales and marketing expenses decreased \$667,293 or 14.6%, to \$3,899,966 during the three months ended September 30, 2003 from \$4,567,259 during the comparable 2002 period.

Sales and marketing expenses represented 37.9% and 39.9% of revenues for the three months ended September 30, 2003 and 2002, respectively. The decrease as a percentage of revenues, is primarily due to the mix between wholesale and retail healthcare membership sales as well as threshold sales qualifications requirements.

**General and Administrative Expenses.** General and administrative expenses increased \$130,467 or 8.8%, to \$1,614,261 during the three months ended September 30, 2003 from \$1,483,794 during the comparable 2002 period. The increase in general and administrative expenses was due to additional salaries and other administrative costs necessary to support both our systems and financial capabilities, and administrative operations. We have recently recruited a Chief Information Officer and a more experienced systems staff that should benefit our overall systems infrastructure. General and administrative expenses represented 15.7% and 13.0% of revenues for each of the three months ended September 30, 2003 and 2002, respectively.

**Total Operating Expenses.** During the three months ended September 30, 2003, total operating expenses (consisting of cost of operations, sales and marketing expenses, and general and administrative expenses) decreased \$288,884 or 3.2%, to \$8,735,312 from \$9,024,196 during the comparable 2002 period. Total operating expenses represented approximately 85.1% and 78.8% of revenues for the three months ended September 30, 2003 and 2002, respectively. The decrease in operating margins was due to the reasons described above.

**Operating Income and Net Earnings.** During the three months ended September 30, 2003, operating income was \$1,533,317, a decrease of \$888,248 or 36.7%, from \$2,421,565 during the comparable 2002 period. Net earnings applicable to common shareholders were \$970,970, or 9.5% of revenues, net of provision for income taxes of \$522,739. In comparison, during the three months ended September 30, 2002, net earnings applicable to common shareholders were \$1,542,143 or 13.5% of revenues, net of provision for income taxes of \$852,080. During the three months ended September 30, 2003, net earnings per common share calculated on a fully diluted basis were \$0.08 per share compared to \$0.13 from the comparable 2002 period. Net earnings applicable to common shareholders and net earnings per common share calculated on a fully diluted basis for the three months ended September 30, 2003 were impacted by the net cost increases as well as the reduction in revenues, as previously described.

**Comparison of the Nine Months Ended September 30, 2003 and 2002**

**Product and Service Revenues.** During the nine months ended September 30, 2003, revenues were \$31,994,932, an increase of \$267,452 or 1.0%, from \$31,727,480 during the comparable 2002 period. The growth in our revenues has slowed as a result of the previously mentioned product changes introduced in late 2002.

**Cost of Operations.** Cost of operations for the nine months ended September 30, 2003 increased \$1,717,446 or 21.3%, to \$9,793,017 from \$8,075,571 during the 2002 comparable period. The increase in cost of operations primarily arose from our increased member service staff and other personnel in order to accommodate and to support our operations, the increase in preferred provider network costs associated with increased memberships, and the additional depreciation expense as a result of the capital leases acquired in the three months ended December 31, 2002, offset in part by a decrease in certain other operating costs.

Cost of operations, as a percentage of revenues, was 30.6% of revenues during the nine months ended September 30, 2003, while during the comparable 2002 period, cost of operations were 25.5% of revenues. The increase was attributable to our increased member service staff, as well as the additional depreciation expense as a result of the capital leases we acquired in the three months ended December 31, 2002.

**Sales and Marketing Expenses.** Sales and marketing expenses decreased \$472,416 or 3.7%, to \$12,183,400 during the nine months ended September 30, 2003 from \$12,655,816 during the comparable 2002 period.

Sales and marketing expenses represented 38.1% and 39.9% of revenues for the nine months ended September 30, 2003 and 2002, respectively. The decrease as a percentage of revenues is primarily due to the mix between wholesale and retail healthcare membership sales as well as threshold sales qualifications requirements.

**General and Administrative Expenses.** General and administrative expenses increased \$304,925 or 6.9%, to \$4,706,147 during the nine months ended September 30, 2003 from \$4,401,222 during the comparable 2002 period. The increase in general and administrative expenses was due to the increased costs associated with the product training and education of our independent marketing representatives as a result of product changes announced at our National Convention in October 2002, the additional salaries associated with our recently recruited in-house sales team and other salaries and administrative costs to support both our systems and financial capabilities and administrative operations. We have recently recruited a Chief Information Officer and a more experienced systems staff that should benefit our overall systems infrastructure. General and administrative expenses represented 14.7% and 13.9% of revenues for each of the nine months ended September 30, 2003 and 2002, respectively.

**Total Operating Expenses.** During the nine months ended September 30, 2003, total operating expenses (consisting of

cost of operations, sales and marketing expenses, and general and administrative expenses) increased \$1,549,955 or 6.2%, to \$26,682,564 from \$25,132,609 during the comparable 2002 period. Total operating expenses represented approximately 83.4% and 79.2% of revenues for the nine months ended September 30, 2003 and 2002, respectively. The decrease in operating margins was due to the reasons described above.

**Operating Income and Net Earnings.** During the nine months ended September 30, 2003, operating income was \$5,312,368, a decrease of \$1,282,503 or 19.5%, from \$6,594,871 during the comparable 2002 period. Net earnings applicable to common shareholders were \$3,424,109, or 10.7% of revenues, net of provision for income taxes of \$1,774,743. In comparison, during the nine months ended September 30, 2002, net earnings applicable to common shareholders were \$4,187,398 or 13.2% of revenues, net of provision for income taxes of \$2,348,566. During the nine months ended September 30, 2003, net earnings per common share calculated on a fully diluted basis were \$0.29 per share compared to \$0.35 from the comparable 2002 period. Net earnings applicable to common shareholders and net earnings per common share calculated on a fully diluted basis for the nine months ended September 30, 2003 were impacted by the net cost increases as previously described, offset in part by a marginal increase in healthcare membership revenues.

## Liquidity and Capital Resources

**Operating Activities.** Net cash provided by operating activities for the nine months ended September 30, 2003 and 2002 were \$6,095,077 and \$2,523,658, respectively, an increase of \$3,571,419. The increase in net cash from operating activities was positively impacted primarily due to an increase in depreciation expense of \$1,053,369 (a non-cash activity), an improvement in accounts receivable collections of \$1,335,053 and an additional income tax payment of \$791,040 that was made during the nine months ended September 30, 2002. The additional income tax payment was considered to be more timing in nature.

**Investing Activities.** Net cash used in investing activities for the nine months ended September 30, 2003 and 2002 were \$728,337 and \$840,803, respectively. During the nine months ended September 30, 2003, net cash of \$728,337 and \$840,803, respectively, were used to purchase fixed assets necessary to accommodate and support our operations.

**Financing Activities.** Net cash used in financing activities for the nine months ended September 30, 2003 and 2002, were \$1,044,569 and \$710,537, respectively. During the nine months ended September 30, 2003, net cash of \$1,066,800 was used for repayments on capital leases. During the nine months ended September 30, 2002, net cash of \$1,000,000 was used to redeem preferred stock, \$269,402 was used for repayments of capital leases offset, in part by proceeds from the exercise of stock options of \$573,002.

At September 30, 2003, we had working capital of \$7,978,133, and cash and cash equivalents of \$9,933,974. Our capital lease obligation, net of the current portion, was \$631,406 as of September 30, 2003. Pending any future acquisitions, we believe that our existing cash and cash equivalents and cash provided by operations will be sufficient to fund our operations for more than the next 12 months. As of September 30, 2003, the Company's cash-in-trust, which represents members escrow account balances has grown to \$2,000,131, since inception in the fourth quarter of 2002.

## New Accounting Pronouncements

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 143, *Accounting for Obligations Associated with the Retirement of Long-Lived Assets* (SFAS 143). In April and June 2002, The Financial Accounting Standards Board issued Standard No. 145, *Reporting Gains and Losses from Extinguishment of Debt* (SFAS 145), and Standard No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146). In December 2002, the Financial Accounting Standards Board issued Standard No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure* (SFAS 148). In April 2003, the Financial Accounting Standards Board issued Standard No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (SFAS 149). In May 2003, the Financial Accounting Standards Board issued Standard No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (SFAS 150). In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees of Indebtedness of Others - an interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34*. (FIN 45) In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, *Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51* (FIN 46)

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SFAS 143, *Accounting for Obligations Associated with the Retirement of Long-Lived Assets*, establishes accounting standards for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. It also provides accounting guidance for legal obligations associated with the retirement of tangible long-lived assets. SFAS 143 is effective in fiscal years beginning after June 15, 2002, with early adoption permitted.

SFAS 145 rescinds No.4, *Reporting Gains and Losses from Extinguishment of Debt*, SFAS No. 44, *Accounting for Intangible Assets of Motor Carriers* and SFAS No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*. SFAS 145 amends SFAS No. 13, *Accounting for Leases*, to eliminate an inconsistency between the required accounting for sale-leaseback transactions. SFAS 145 is effective in fiscal years beginning after May 15, 2002, with early adoption permitted.

SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, addresses the accounting and reporting for costs associated with exit or

disposal activities. SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Previously, under Emerging Issues Task Force (ETIF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, a liability for an exit cost was recognized at the date of an entity's commitment to an exit plan. Under SFAS 146, an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. Therefore, SFAS 146 eliminates the definition of exit costs in Issue 94-3. SFAS 146 also establishes that fair value is the objective for initial measurement of the liability. The provisions of SFAS 146 are effective for exit or disposal activities that are initiated after December 31, 2002, with early adoption permitted.

Effective January 1, 2003, we adopted SFAS 143, SFAS 145 and SFAS 146 which will not have a material impact on our consolidated results of operations and financial position.

SFAS 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*, amends No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used in reported financial results. SFAS 148, paragraphs 2(a) - 2(e), are effective for financial statements for fiscal years ending after December 15, 2002. SFAS 148, paragraph 2(f), and the amendment to APB Opinion No. 28, *Interim Financial Reporting*, shall be effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. Earlier adoption is permitted.

We adopted the disclosure provisions of SFAS 148 effective December 31, 2002. As permitted under SFAS 148, we continue to apply the recognition provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, in determining our compensation expense.

SFAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, to amend and clarify financial accounting and reporting for derivative instruments embedded in other contracts (collectively referred to as derivatives) and hedging activities. SFAS 149 is effective for contracts entered into or modified after September 30, 2003. Effective April 2003, we adopted SFAS 149, which will not have a material impact on our consolidated results of operations and financial position.

SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both debt and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation to the issuer. Effective June 2003, we adopted SFAS 150, which will not have a material impact on our consolidated results of operations and financial position.

FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees of Indebtedness of Others* elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. The interpretation also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. Effective November 2002, we adopted FIN 45, which will not have a material impact on our consolidated results of operations and financial position.

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FIN 46, *Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51*, addresses consolidation by business enterprises of variable interest which have on of the following characteristics: The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity or the equity investors lack one or essential characteristics of a what is considered a controlling financial interest. Effective January 2003, we adopted FIN 46, which will not have a material impact on our consolidated results of operations and financial position.

### **Cautionary Statement Relating to Forward Looking Information**

We have included some forward-looking statements in this section and other places in this report regarding our expectations. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements, or industry results, to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements.

Some of these forward-looking statements can be identified by the use of forward-looking terminology including believes, expects, may, will, should or anticipates or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategies that involve risks and uncertainties. You should read statements that contain these words carefully because they:

discuss our future expectations;

contain projections of our future operating results or of our future financial condition; or

state other forward-looking information.

We believe it is important to discuss our expectations; however, it must be recognized that events may occur in the future over which we have no control and which we are not accurately able to predict. Readers are cautioned to consider the specific business risk factors described in our annual report on Form 10-KSB for the fiscal year ended December 31, 2002 and our Schedule 14A Proxy Statement for our 2003 annual shareholders meeting, and not to place undue reliance on the forward-looking statements contained herein, which speak only as of the date hereof. We undertake no obligation to publicly revise forward-looking statements to reflect events or circumstances that may arise after the date hereof.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**



We do not have any investments in market risk sensitive instruments.

**Item 4. Controls and Procedures**

Our Chief Executive Officer and Chief Financial Officer are responsible primarily for establishing and maintaining disclosure controls and procedures designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934, as amended (the Exchange Act ) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the U.S. Securities and Exchange Commission. These controls and procedures are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Furthermore, our Chief Executive Officer and Chief Financial Officer are responsible for the design and supervision of our internal controls over financial reporting that are then effected by and through our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. These policies and procedures (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Our Chief Executive Officer and Chief Financial Officer, based upon their evaluation of the effectiveness of our disclosure controls and procedures and the internal controls over financial reporting as of the last day of the period covered by this report, concluded that our disclosure controls and procedures and internal controls over financial reporting were fully effective during and as of the last day of the period covered by this report and reported to our auditors and the audit committee of our board of directors that no change in our disclosure controls and procedures and internal control over financial reporting occurred during the period covered by this report that would materially affected or is reasonably likely to materially affect our disclosure controls and procedures or internal control over financial reporting. In conducting their evaluation of our disclosure controls and procedures and internal controls over financial reporting, these executive officers did not discover any fraud that involved management or other employees who have a significant role in our disclosure controls and procedures and internal controls over financial reporting. Furthermore, there were no significant changes in our disclosure controls and procedures, internal controls over financial reporting, or other factors that could significantly affect our disclosure controls and procedures or internal controls over financial reporting subsequent to the date of their evaluation.

Because no significant deficiencies or material weaknesses were discovered, no corrective actions were necessary or taken to correct significant deficiencies and material weaknesses in our internal controls and disclosure controls and procedures.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

On September 8, 2003, the case styled *Robert Kirk, Individually and D/B/A US Asian Advisors, LLC, Eugene M. Kennedy, P.A., Stewart & Associates, CPAs, P.A. and Kimberly Decamp, Plaintiffs vs. Precis, Inc. and David May, Defendants* was initiated in the District Court of Tarrant County, Texas, Case No. 236 201 468 03. The plaintiffs Robert Kirk (doing business as US Asian Advisors, LLC or U.S. Asian Capital Investors, LLC), Kimberly Decamp and Stewart & Associates, CPAs, P.A. hold warrants exercisable for the purchase of 9,000, 48,000 and 4,000 shares, respectively, of our common stock for \$9.00 per share on or before February 8, 2005. The plaintiffs Eugene M. Kennedy, P.A. and Kimberly Decamp hold stock options that expired on June 30, 2003, and that were exercisable for 15,000 and 170,000 shares, respectively, of our common stock for \$9.70 per share. David May is our Secretary and Vice President and General Counsel.

Plaintiffs Eugene M. Kennedy, P.A. (Eugene M. Kennedy is a member of the Florida bar association and a practicing attorney) and Ms. Decamp (the daughter of Mr. Kirk) at no time presented the stock option agreements evidencing the stock options and payment of the exercise price of the stock options, \$140,550 and \$1,592,900, respectively, as required pursuant to the terms of the stock option agreements for exercise. Furthermore, Plaintiffs Robert Kirk, Kimberly Decamp and Stewart & Associates, CPAs, P.A. at no time tendered the certificates evidencing the warrants and the completed and executed Form of Subscription (Cashless Exercise) required for exercise of the warrants without payment of the exercise price of those warrants.

The plaintiffs allege that they were not allowed to exercise their stock options and warrants in May of 2003 due to actions and inactions of Mr. May and that these actions and inactions constitute fraud, misrepresentation, negligence and legal malpractice. All communications with Mr. May were through the plaintiffs' broker, Burt Martin Arnold Securities, Inc. Plaintiffs are seeking damages equal to the difference between the exercise price of the stock options or warrants and the market value of our common stock on May 7, 2002 (presumably the closing sale price of \$15.75) or an aggregate sum of \$1,592,050, plus exemplary damages and costs.

An answer has been filed indicating the plaintiffs' failure to follow the procedures required by the warrant and stock option agreements for effective exercise. Although we believe the plaintiffs' claims are without merit, this case is in the initial stages of discovery, and, as of the date of this report, we cannot provide any assurance regarding the outcome or results of this litigation.

### **Item 2. Changes in Securities and Use of Proceeds**

(a) None.

(b) None.

(c) None.

(d) None.

**Item 3. Defaults Upon Senior Securities**

None.

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

On July 29, 2003, we held our 2003 annual shareholders meeting. At that meeting our shareholders approved, elected and ratified the following:

**Number of Votes Cast**

	For	Against	Abstained	Broker Non-Votes
Precis, Inc. 1999 Stock Option Plan as amended and restated	6,995,689	144,080	33,412	3,072,016
Election of the following directors:				
Judith H. Henkels	9,878,150	0	366,877	0
Dino Eliopoulos	9,816,164	0	428,863	0
Kent H. Webb	10,011,088	0	233,939	0
Eugene E. Becker	10,212,902	0	32,125	0
Nicholas Zaffiris	10,212,922	0	32,105	0
J. French Hill	10,212,522	0	32,505	0
Kenneth S. George	10,208,322	0	36,705	0
Ratification of BDO Seidman, LLP as our independent accountants for 2003	10,226,915	0	11,170	6,942

Other than the matters mentioned above, no other matters were submitted to vote of our security holders during the three months ended September 30, 2003.

**Item 5. Other Information**

None.

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

(a) Exhibits:

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<b>Exhibit No.</b>	<b>Description</b>
3.1	Registrant's Certificate of Incorporation, incorporated by reference to Exhibit 3.2 of Registrant's Form 8-K/A filed with the Commission on June 25, 2001.
3.2	Registrant's Bylaws as amended and restated on April 30, 2003, incorporated by reference to Exhibit 3.2 of Registrant's Form 10-Q filed with the Commission on May 14, 2003.
4.1	Form of certificate of the common stock of Registrant is incorporated by reference to Exhibit 1.1 of Amendment to Registration Statement on Form 8-A, as filed with the Commission on July 31, 2001.
4.2	Precis, Inc. 1999 Stock Option Plan (amended and restated), incorporated by reference to the Schedule 14A filed with the Commission on June 23, 2003.
10.1	Form of Indemnification and Contribution Agreement entered into with each of the executive officers and directors of Registrant, including Judith H. Henkels, Dino Eliopoulos, Bobby R. Rhodes, David P. May, Kent H. Webb, M.D., Eugene E. Becker, J. French Hill, Nicholas J. Zaffiris and Kenneth S. George.

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- 10.2 Employment Agreement, dated August 1, 2003, entered into with Judith H. Henkels
- 10.3 Employment Agreement, dated August 1, 2003, entered into with Dino Eliopoulos
- 10.4 Employment Agreement, dated August 1, 2003, entered into with Bobby R. Rhodes
- 31.1 Certification Pursuant to Rule 13a-14(a) and 15d-14(a) of Judith H. Henkels as Chief Executive Officer.
- 31.2 Certification Pursuant to Rule 13a-14(a) and 15d-14(a) of Dino Eliopoulos as Chief Financial Officer.
- 32.1 Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of Sarbanes-Oxley Act of Judith H. Henkels as Chief Executive Officer.
- 32.2 Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of Sarbanes-Oxley Act of Dino Eliopoulos as Chief Financial Officer.

### **(b) Reports on Form 8-K:**

Registrant filed a Form 8-K reporting under Item 7. Registrant's October 30, 2003 press release announcing the results of operations for the three months and nine months ended September 30, 2003.

Registrant filed a Form 8-K reporting under Item 5. Registrant's September 24, 2003 press release announcing the expected results of operations for the three months ending on September 30 and December 31, 2003.

Registrant filed a Form 8-K reporting under Item 7. Registrant's July 23, 2003 press release announcing the results of operations for the three months and six months ended June 30, 2003.

SIGNATURES:

In accordance with the requirements of the Exchange Act, the Registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PRECIS, INC.  
(Registrant)

Date: November 13, 2003

/s/ JUDITH H. HENKELS  
Judith H. Henkels  
Chief Executive Officer

Date: November 13, 2003

/s/ DINO ELIOPOULOS  
Dino Eliopoulos  
Chief Financial Officer

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Condensed Consolidated Balance Sheets as of September 30, 2003 (unaudited) and December 31, 2002

Unaudited Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2003 and 2002

Unaudited Condensed Consolidated Statements of Operations for the Nine Months Ended September 30, 2003 and 2002

Unaudited Condensed Consolidated Statement of Stockholders' Equity for the Nine Months Ended September 30, 2003

Unaudited Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2003 and 2002

Notes to Unaudited Condensed Consolidated Financial Statements

## PRECIS, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2003 (unaudited)	December 31, 2002 (audited)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 9,933,974	\$ 5,611,803
Cash in trust	2,000,131	108,152
Accounts receivable	736,702	1,602,368
Income tax receivable	595,887	1,095,887
Notes receivable	512,904	200,835
Inventory	193,974	236,549
Prepaid expenses	384,452	325,701
Other current assets		25,000
<b>Total current assets</b>	<b>14,358,024</b>	<b>9,206,295</b>
Fixed assets, net	3,642,501	3,913,382
Goodwill, net	21,077,284	21,077,284
Deferred tax asset, net	827,900	827,900
Other assets	33,600	30,825
<b>Total assets</b>	<b>\$ 39,939,309</b>	<b>\$ 35,055,686</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 465,645	\$ 136,898
Accrued liabilities	2,025,144	1,872,245
Income taxes payable	64,568	69,437
Member liabilities	2,000,131	108,152
Deferred income taxes	85,600	85,600
Deferred fees	343,135	738,314
Current portion of capital leases	1,395,668	1,304,140
<b>Total current liabilities</b>	<b>6,379,891</b>	<b>4,314,786</b>
Capital lease obligation, net of current portion	631,406	1,259,228
<b>Total liabilities</b>	<b>7,011,297</b>	<b>5,574,014</b>

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Stockholders' equity:			
Preferred stock, \$1 par value, 2,000,000 shares authorized; 0 shares issued and outstanding (0 issued as of December 31, 2002)			
Common stock, \$.01 par value, 100,000,000 shares authorized; 11,854,852 issued and outstanding (11,825,430 issued as of December 31, 2002)			
		118,548	118,254
Additional paid-in capital		25,812,194	25,790,257
Accumulated earnings		6,997,270	3,573,161
Total stockholders' equity		32,928,012	29,481,672
Total liabilities and stockholders' equity	\$	39,939,309	\$ 35,055,686

See Accompanying Notes to Condensed Consolidated Financial Statements

## PRECIS, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2003	2002
Product and service revenues	\$ 10,268,629	\$ 11,445,761
Operating expenses:		
Cost of operations	3,221,085	2,973,143
Sales and marketing	3,899,966	4,567,259
General and administrative	1,614,261	1,483,794
Total operating expenses	8,735,312	9,024,196
Operating income	1,533,317	2,421,565
Other expenses:		
Interest income and expense, net	39,608	27,342
Total other expenses	39,608	27,342
Net earnings before taxes	1,493,709	2,394,223
Provision for income taxes	522,739	852,080
Net earnings	970,970	1,542,143
Preferred stock dividends		
Net earnings applicable to common shareholders	\$ 970,970	\$ 1,542,143
Earnings per share:		
Basic	\$ 0.08	\$ 0.13
Diluted	\$ 0.08	\$ 0.13
Weighted average number of common shares outstanding:		
Basic	11,851,579	11,805,297
Diluted	11,984,396	11,981,038

See Accompanying Notes to Condensed Consolidated Financial Statements



## PRECIS, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,	
	2003	2002
Product and service revenues	\$ 31,994,932	\$ 31,727,480
Operating expenses:		
Cost of operations	9,793,017	8,075,571
Sales and marketing	12,183,400	12,655,816
General and administrative	4,706,147	4,401,222
Total operating expenses	26,682,564	25,132,609
Operating income	5,312,368	6,594,871
Other expenses:		
Interest income and expense, net	113,516	44,770
Total other expenses	113,516	44,770
Net earnings before taxes	5,198,852	6,550,101
Provision for income taxes	1,774,743	2,348,566
Net earnings	3,424,109	4,201,535
Preferred stock dividends		14,137
Net earnings applicable to common shareholders	\$ 3,424,109	\$ 4,187,398
Earnings per share:		
Basic	\$ 0.29	\$ 0.35
Diluted	\$ 0.29	\$ 0.35
Weighted average number of common shares outstanding:		
Basic	11,840,141	11,805,297
Diluted	11,936,291	11,981,038

See Accompanying Notes to Condensed Consolidated Financial Statements



## PRECIS, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

	COMMON STOCK		ADDITIONAL		ACCUMULATED EARNINGS	Total
	SHARES	AMOUNT	PAID-IN CAPITAL			
Balance, December 31, 2002	11,825,430	\$ 118,254	\$ 25,790,257	\$ 3,573,161	\$ 29,481,672	
Stock options exercised	29,422	294	21,937		22,231	
Net earnings				3,424,109	3,424,109	
Balance, September 30, 2003	11,854,852	\$ 118,548	\$ 25,812,194	\$ 6,997,270	\$ 32,928,012	

See Accompanying Notes to Condensed Consolidated Financial Statements

## PRECIS, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,	
	2003	2002
Net earnings	\$ 3,424,109	\$ 4,201,535
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	1,529,724	476,355
Changes in assets and liabilities -		
Accounts receivable	865,666	(869,387)
Income taxes receivable	500,000	85,250
Notes receivable	(312,069)	(100,000)
Inventory	42,575	(188,020)
Prepaid expenses	(58,751)	(477,354)
Other current assets	25,000	(25,888)
Other assets	(2,775)	100,419
Accounts payable	328,747	(150,077)
Accrued liabilities	152,899	176,513
Deferred fees	(395,179)	
Income taxes payable	(4,869)	(705,688)
<b>Net cash provided by operating activities</b>	<b>6,095,077</b>	<b>2,523,658</b>
Investing activities:		
Purchase of fixed assets	(728,337)	(840,803)
<b>Net cash used in investing activities</b>	<b>(728,337)</b>	<b>(840,803)</b>
Financing activities:		
Exercise of stock options	22,231	573,002
Payments on capital leases	(1,066,800)	(269,402)
Redemption of preferred stock		(1,000,000)
Payment of preferred stock dividends		(14,137)
<b>Net cash used in financing activities</b>	<b>(1,044,569)</b>	<b>(710,537)</b>
<b>Net increase in cash and cash equivalents</b>	<b>4,322,171</b>	<b>972,318</b>
Cash and cash equivalents at beginning of year	5,611,803	3,755,642
<b>Cash and cash equivalents at end of period</b>	<b>\$ 9,933,974</b>	<b>\$ 4,727,960</b>

Supplemental Disclosure:

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Acquisition of fixed assets through issuance of capital leases, net of retirements	\$	529,238	\$	346,833
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**See Accompanying Notes to Condensed Consolidated Financial Statements**

**PRECIS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Interim Financial Information**



The accompanying condensed consolidated financial statements are unaudited, but include all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position at such dates and of the operations and cash flows for the periods then ended. The financial information is presented in a condensed format, and it does not include all of the footnote disclosure normally included in financial statements prepared in accordance with generally accepted accounting principles. Operating results for the three and nine months ended September 30, 2003 and 2002 are not necessarily indicative of results that may be expected for the entire year. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities and reported amounts of revenues and expenses during the reporting periods under consideration. Actual results could differ materially from such assumptions and estimates. The accompanying condensed consolidated financial statements and related footnotes should be read in conjunction with the Company's audited financial statements, included in its December 31, 2002 Form 10-KSB filed with the Securities and Exchange Commission.

## Note 2 Accounting Changes

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 143, *Accounting for Obligations Associated with the Retirement of Long-Lived Assets* (SFAS 143). In April and June 2002, the Financial Accounting Standards Board issued Standard No. 145, *Reporting Gains and Losses from Extinguishment of Debt* (SFAS 145) and Standard No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146). In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure* (SFAS 148). In April 2003, the Financial Accounting Standards Board issued Standard No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (SFAS 149). In May 2003, the Financial Accounting Standards Board issued Standard No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (SFAS 150). In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45, *Guarantors Accounting and Disclosure Requirements for Guarantees of Indebtedness of Others - an interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34*. (FIN 45) In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, *Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51* (FIN 46)

SFAS 143, *Accounting for Obligations Associated with the Retirement of Long-lived Assets*, establishes accounting standards for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. It also provides accounting guidance for legal obligations associated with the retirement of tangible long-lived assets. SFAS 143 is effective in fiscal years beginning after June 15, 2002, with early adoption permitted.

SFAS 145 rescinds SFAS No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, SFAS No. 44, *Accounting for Intangible Assets of Motor Carriers* and SFAS No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*. SFAS 145 amends SFAS No. 13, *Accounting for Leases*, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS 145 is effective in fiscal years beginning after May 15, 2002, with early adoption permitted.

SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, addresses the accounting and reporting for costs associated with exit or disposal activities. SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Previously, under Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, a liability for an exit cost was recognized at the date of an entity's commitment to an exit plan. Under SFAS 146, an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. Therefore, SFAS 146 eliminates the definition of exit costs in Issue 94-3. SFAS 146 also establishes that fair value is the objective for initial measurement of the liability.

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Effective January 1, 2003, the Company adopted SFAS 143, SFAS 145 and SFAS 146, each of which will not have a material impact on our consolidated results of operations and financial position of the Company.

SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, amends SFAS 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value base method of accounting for stock based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method for accounting for stock-based employee compensation and the effect of the method used in reported financial results. SFAS 148, paragraphs 2(a)–2(e) are effective for financial statements for fiscal years ending after December 15, 2002. Earlier application is permitted. SFAS 148, paragraph 2(f), and the amendment to APB Opinion No. 28, *Interim Financial Reporting*, shall be effective for financial reports containing condensed statements for interim periods beginning after December 15, 2002. Earlier adoption is permitted.

The Company adopted the disclosure provisions of SFAS 148 effective December 15, 2002. As permitted under SFAS 148, the Company continues to apply the recognition provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, in determining its stock compensation expense.

SFAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, to amend and clarify financial accounting and reporting for derivative instruments embedded in other contracts (collectively referred to as derivatives) and hedging activities. SFAS 149 is effective for contracts entered into or modified after September 30, 2003. Effective April 2003, we adopted SFAS 149, which will not have a material impact on our consolidated results of operations and financial position.

SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both debt and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation to the issuer. Effective June 2003, we adopted SFAS 150, which will not have a material impact on our consolidated results of operations and financial position.

FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees of Indebtedness of Others* elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. The interpretation also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. Effective November 2002, we adopted FIN 45, which will not have a material impact on our consolidated results of operations and financial position.

FIN 46, *Consolidation of Variable Interest Entities An Interpretation of ARB No. 51*, addresses consolidation by business enterprises of variable interest which have on of the following characteristics: The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity or the equity investors lack one or essential characteristics of a what is considered a controlling financial interest. Effective January 2003, we adopted FIN 46, which will not have a material impact on our consolidated results of operations and financial position.

**Note 3 Common Stock Options**

As of September 30, 2003, the Company has two stock-based compensation plans which are described below. The Company applies APB 25 and related interpretations in accounting for its plan. Under APB 25, compensation for services that a corporation receives through stock-based compensation plans should be measured by the excess, if any, of the quoted market price of the stock at the measurement date less the amount that the individual is required to pay. No compensation expense was recorded during the three and nine months ended September 30, 2003 and 2002 related to its stock option plans under APB 25. If the Company had elected to recognize compensation based on the fair value of the options granted at the grant date as prescribed by Statement of Financial Accounting Standards No. 123 ( SFAS 123 ) Accounting for Stock-Based Compensation , net earnings and net earnings per share would have decreased as shown in the pro forma amounts below for the three months ended September 30, 2003 and 2002.

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	FOR THE THREE MONTHS ENDED SEPTEMBER 30,			
	2003		2002	
Net earnings applicable to stockholders	\$	970,970	\$	1,542,143
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects		(165,915)		(185,559)
Pro forma net earnings	\$	805,055	\$	1,356,584

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,			
	2003		2002	
Earnings per share:				
Basic - as reported	\$	0.08	\$	0.13
Basic - pro forma	\$	0.07	\$	0.11
Diluted - as reported	\$	0.08	\$	0.13
Diluted - pro forma	\$	0.07	\$	0.11

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,			
	2003		2002	
Net earnings applicable to stockholders	\$	3,424,109	\$	4,187,398
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects		(278,935)		(221,597)
Pro forma net earnings	\$	3,145,174	\$	3,965,801

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,			
	2003		2002	
Earnings per share:				
Basic - as reported	\$	0.29	\$	0.35
Basic - pro forma	\$	0.27	\$	0.34
Diluted - as reported	\$	0.29	\$	0.35
Diluted - pro forma	\$	0.27	\$	0.33

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used for grants: weighted average risk free interest rate of 4.90%; no dividend yield; volatility of 40%; and expected life less than five years.

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The intent of the Black-Scholes option valuation model is to provide estimates of fair values of traded options that have no vesting restrictions and are fully transferable. Option valuation models require the use of highly subjective assumptions including expected stock price volatility. In management's opinion, existing valuation models do not

necessarily provide a reliable single measure of the fair value of its employee stock options because the Company's employee stock options have significantly different characteristics from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate.

In November 1999, the Company's Board of Directors restated and adopted the Company's 1999 Stock Option Plan with an effective date of November 30, 1999. The Company has reserved 700,000 shares of our common stock for issuance upon the exercise of options granted under this plan. Under the 1999 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.

In July 2002, the Company's shareholders adopted the Company's 2002 Non-Employee Stock Option Plan with an effective date of July 29, 2002. The Company has reserved 500,000 shares of our common stock for issuance upon the exercise of options granted under this plan. Under the 2002 Non-Employee 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.

In July 2002, the Company's shareholders adopted the Company's IMR Stock Option Plan with an effective date of July 29, 2002. The Company has reserved 500,000 shares of the Company's common stock for issuance upon the exercise of options granted under this plan. Under the 2002 IMR 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.

On January 29, 2003, the Board approved a motion effective June 1, 2003 for the discontinuance of any further stock option grants under the 2002 IMR Stock Option Plan.

On June 29, 2003, the Company's Shareholders approved an amendment to increase the number of shares reserved under the Company's 1999 Stock Option Plan from 700,000 to 1,400,000 shares of common stock for issuance upon the exercise of options under this plan. Under the 1999 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.

#### **Note 4 Contingencies**

In September 2003, the Company was served with a lawsuit. The plaintiffs of this lawsuit have alleged that in May 2002 they were not allowed to exercise stock options and warrants issued by the Company. The plaintiffs are claiming damages based on the difference of the fair market value of the stock price of \$15.75 and their exercise prices of \$9.00 per share of common stock for each of the 61,000 warrants and \$9.37 per share of common stock for each of the 185,000 stock options of the Company, for potential damages of approximately \$1.6 million. Although, the lawsuit is in the very early stages the Company believes that there are no merits to the plaintiffs' arguments, as the plaintiffs never tendered their stock option and warrant exercise documents to the Company, nor did they comply with their terms of agreement regarding the manner in which the stock options and warrants should be exercised.

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In January 1999, the former parent of Foresight, Inc., Universal Marketing Services, Inc., purchased the outstanding common stock of Foresight, Inc. for \$4,540,000. Universal Marketing Services agreed to indemnify the former owners of the common stock of Foresight, Inc. for the increase in federal income taxes and any applicable penalties to the extent that \$4,540,000 of the purchase price does not qualify for long-term capital gain. These former shareholders reported \$4,532,000 of the purchase price as long-term capital gain. In connection with the Company's merger-acquisition of Foresight, Inc., the Company assumed the indemnification obligation of Universal Marketing Services. Upon examination, the Internal Revenue Service may take the position that a portion of the \$4,540,000 should be classified as ordinary income taxable at the maximum federal income tax rate of 39.6% rather than the long-term capital gain 20% rate. In the event the Internal Revenue Service successfully asserts that long-term capital gain classification was improper, the Company will be required to indemnify the former shareholders for any potential tax liability.