

PRECIS INC  
Form 10-Q  
August 21, 2006

# U. S. SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

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## FORM 10-Q

(Mark One)

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

**For the Three Months Ended June 30, 2006**

**OR**

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

**Commission File Number: 001-15667**

**PRECIS, INC.**

(Exact name of business issuer as specified 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**

(Address of principal executive offices)

**75050**

(Zip Code)

**(866) 578-1665**

(Issuer's telephone number)

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated in Rule 12b-2 of the Exchange Act.

Large Accelerated filer:

Accelerated filer:

Non-accelerated filer:

Indicate by checkmark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of August 17, 2006 the Registrant had outstanding 13,512,763 shares of Common Stock, \$.01 par value.

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PRECIS, INC.

FORM 10-Q  
For the Quarter Ended June 30, 2006

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SIGNATURES

Throughout this report the first personal plural pronoun in the nominative case form "we" and its objective case form "us", its possessive and the intensive case forms "our" and "ourselves" and its reflexive form "ourselves", refer collectively to Precis, Inc., its subsidiaries, and their executive officers and directors.

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)**

Our financial statements which are prepared in accordance with Regulation S-X are set forth in this report beginning on page 17.

**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 2005 Annual Report on Form 10-K 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, 2005 (collectively referred to as the Disclosure Documents). Certain forward-looking statements contained in this report and in the 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 the forward-looking statements. Our ability to achieve these results is subject to the risks and uncertainties discussed in our Form 10-K. Any forward-looking statements contained in this report represent our judgment as of the date of this report. 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.

**CONSUMER HEALTHCARE SAVINGS SOLUTIONS.**

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 through a network marketing strategy under the name Care Entrée™ and through third party marketers under their own brand names. We design these programs to benefit healthcare providers as well as the network members. Providers commonly give reduced or preferred rates to PPO networks in exchange for steering 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 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. We provide transaction facilitation services to both the program member and the healthcare provider.

Our 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 of 100% of the membership fees in the month of a membership sale for the members they enroll. After the month of membership sales, we pay independent marketing representatives 20% of the membership fees of members they enroll for the life of that 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 up to 35% in override commissions down through seven levels. In the month of membership sales, no override commissions are paid to the representative's upline. In addition, we have established bonus pools that allow independent marketing representatives who have achieved certain levels to receive additional commissions measured by our revenues attributable to the Care Entrée™ programs. The total regular or ongoing commission payout, including overrides on monthly membership sales after the enrollment month and our contribution to the bonus pools, is up to 60% of qualified membership sales.

We also design healthcare membership programs for employer groups and third party marketers. 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 or inbound direct marketing to target the profiled needs of the clients' particular member base. Our memberships sold by third-party organizations are generally marketed using the third-party's name or brand or under our wholesale brand For Your Good Health. We refer to these programs and membership sales as wholesale programs or private label programs. While the services offered to consumers by these private label programs are generally similar to the services we offer through Care Entrée™, each of the private label programs can bundle our services to fit the needs of their consumers.

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In the third quarter of 2005, we began offering nutraceuticals, consisting of vitamins, minerals and other nutritional supplements, under the Natrience brand. Nutraceutical sales commenced in late September 2005, but were immaterial through June 30, 2006. Effective June 30, 2006, we discontinued its operations and wrote off the assets of this division.

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## **EMPLOYER AND GROUP HEALTHCARE SERVICES**

For governments and other large, self-funded employers seeking to reduce the cost of offering healthcare benefits to their employees, we offer a streamlined version of our healthcare products and programs. In these cases, we offer access to healthcare through our network of providers and the efficient repricing of bills through our proprietary systems. We can offer these services on a price based on either the number of participants per month or as a percentage of savings on healthcare costs actually realized. With our acquisition of Access HealthSource, Inc. ( Access ) in June 2004, we provide a wide range of healthcare claims administration services and other cost containment procedures that are frequently required by governments and other employers who have chosen to self fund their healthcare benefits requirements. With the services of Access, we offer a more complete suite of healthcare services. Access primary area of expertise is in the public sector market.

## **FINANCIAL SERVICES**

Through our subsidiary, Care Financial of Texas, L.L.C. ( Care Financial ), we offer high deductible and scheduled benefit insurance policies, life insurance and annuities. The high deductible and scheduled benefit insurance policies offer affordable, well-rounded solutions for individuals and employers who are no longer able to afford or obtain traditional health insurance policies. Commission revenue related to these policies was \$24,000 during the second quarter of 2006. The insurance policies are sold through our independent marketing representatives who are licensed insurance agents and other licensed agents who are not Care Entrée independent marketing representatives that are now managed by an outside agency on an independent contractor basis. Additionally, we offer health savings accounts (HSAs), Healthcare Reimbursement Arrangements (HRAs) and medical and dependent care Flexible Spending Accounts (FSAs) through Care125, a division of Access. Our Care125 services allow employers to offer additional benefits to their employees and give employees additional tools to manage their healthcare and dependent care expenses. Our Care125 programs and our medical savings programs can be sold together by agents and brokers with whom we have contracted to offer a more complete benefit package to employers.

## **INSURACO LETTER OF INTENT**

As announced on June 12, 2006, we entered into a non-binding letter of intent with Insurance Capital Management USA, Inc. and Insuraco USA, L.L.C. for the proposed acquisition of Insuraco USA, L.L.C. We are in the due diligence stage of our acquisition of Insuraco USA, L.L.C. and its subsidiaries (Insuraco), awaiting completion of the audit of its 2005, 2004 and 2003 financial statements and progressing with the preparation of the merger agreement and other related agreements. We anticipate that the acquisition of Insuraco USA, L.L.C. in the 2006 fourth quarter following our shareholders approval of the acquisition at our 2006 annual shareholders meeting.

## **CRITICAL ACCOUNTING POLICIES**

### **Revenue Recognition**

#### *Healthcare Membership Revenues*

We recognize our Care Entrée program membership revenues, other than initial enrollment fees, on each monthly anniversary date. Membership revenues are reduced by the amount of estimated refunds. For members that are billed directly, the billed amount is collected almost entirely by automated clearinghouse, electronic check or by electronic charge to the members credit cards. The settlement of those charges occurs within a day or two. Under certain private label arrangements, our private label partners bill their members for the membership fees and our portion of the membership fees is periodically remitted to us. During the time from the billing of these private-label membership fees and the remittance to us, we record a receivable from the private label partners and record an estimated allowance for uncollectible amounts. The allowance of uncollectible receivables is based upon review of the aging of outstanding balances, the credit worthiness of the private label partner and its history of paying the agreed amounts owed.

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 applicable contract. Judgment is involved in the allocation of costs to determine the direct costs netted against those deferred revenues, as well as in estimating the membership period over which to amortize such net revenue. We maintain a statistical analysis of the costs and membership periods as a basis for adjusting these estimates from time to time.

#### *Access Third Party Administration*



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Access principal sources of service revenues include administrative fees for third party claims administration, network provider fees for the preferred provider network and utilization and management fees. These fees are based on monthly or per member per month fee schedules under specified contractual agreements. Revenues from these services are recognized in the periods in which the services are performed and when collection is reasonably assured.

### **Commission Expense**

Commissions are paid to our independent marketing representatives in the month following the month in which a member has enrolled in our Care Entrée program. Commissions are paid in the month following the month in which we receive the related monthly membership fees. We do not pay advanced commissions on membership sales. Commissions are based on established commission schedules and are determined and accrued based upon the recognition of the related healthcare membership revenue, as described above.

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### **Fixed Assets**

Property and equipment are carried at cost less accumulated depreciation and amortization. Depreciation and amortization are provided using the straight-line method over the estimated useful lives of the related assets for financial reporting purposes. Leasehold improvements are depreciated using the straight-line method over the shorter of their estimated useful lives or the lease term.

The estimation of useful lives is based, in part, upon past experience with similar assets and upon our plans for the utilization of the assets in the future. We periodically review fixed assets, including software, whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable or their depreciation or amortization periods should be accelerated. When any value impairment is determined to exist, the related assets are written down to their fair market value. If we determine that the remaining useful life, based upon known events and circumstances, should be shortened, the depreciation or amortization of the related asset is adjusted on a prospective, going-forward basis based upon the shortened useful lives.

### **Intangible Asset Valuation**

Our intangible assets as of June 30, 2006, consist primarily of goodwill of \$13,072,000. Goodwill represents the excess of acquisition costs over the fair value of net assets acquired. Goodwill is not amortized. Additionally, intangible assets include \$1,190,000 of contracts, net of amortization, acquired as part of our acquisition of Access. During the year ended December 31, 2005, our intangible assets were reduced by \$12,900,000 to reflect the impairment of goodwill related to our acquisition of The Capella Group, Inc. and its Care Entrée program in 2001.

### **Income Taxes**

Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of assets and liabilities for financial and income tax reporting. The net deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. During the three months ended June 30, 2006, we evaluated the probability of recognizing the benefit of deferred tax assets through the reduction of taxes otherwise payable in the future and recorded a \$51,000 adjustment to our deferred tax asset valuation allowance to offset a corresponding increase in deferred tax assets. In our opinion, it is more probable than not that the net assets will be realized.

### **Recent Accounting Pronouncements**

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In December 2004, the Financial Accounting Standards Board ( *FASB* ) issued Statement of Financial Accounting Standard SFAS No. 123(R), Share-Based Payment, *SFAS* 123(R) a revision to SFAS No. 123, Accounting for Stock-Based Compensation. SFAS 123(R) eliminates the alternative to record compensation expense using the intrinsic value method of accounting under Accounting Principles Board Opinion 25 (Opinion 25) that was provided in SFAS No. 123 as originally issued.

Under Opinion 25, issuing stock options to employees generally resulted in the recognition of no compensation cost if the options were granted with an exercise price equal to their fair value at the date of grant. SFAS 123(R) requires companies to measure and record the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award at the date of grant (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service.

We adopted the modified version of the prospective application of SFAS 123(R) as of January 1, 2006. Under SFAS 123(R), we are required to recognize compensation expense, over the applicable vesting period, based on the fair value of (1) any unvested awards subject to SFAS 123(R) existing as of January 1, 2006, and (2) any new awards granted subsequent to the adoption date. See Note 2, Stock Based Compensation in the Notes of our Unaudited Condensed Consolidated Financial Statements appearing elsewhere in this Report for the effect of adoption on our consolidated financial statements. The effect of this adoption is a stock-based compensation expense of \$27,000 and \$17,000 for first quarter and second quarter 2006, respectively.

### **Reclassifications**

Certain prior period amounts have been reclassified for financial reporting purposes to conform to the current period's presentation

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## Results of Operations

### Consumer Healthcare Savings

As discussed above, our Consumer Healthcare Savings segment, our largest segment, offers savings on healthcare services to persons who are un-insured, under-insured, or who have elected to purchase only high deductible or limited benefit medical insurance policies, by providing access to the same preferred provider organizations (PPOs) that are utilized by many insurance companies and employers who self-fund at least a portion of their employee's healthcare risk. These programs are sold primarily through a network marketing strategy and private label programs. The operating results for our Consumer Healthcare Savings segment were as follows:

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2006 (Dollars in Thousands)	2005	Dollar Change	Percent Change	2006 (Dollars in Thousands)	2005	Dollar Change	Percent Change
<b>Revenues</b>	\$ 3,682	\$ 5,541	\$ (1,859 )	-33.5 %	\$ 7,826	\$ 11,814	\$ (3,988 )	-33.8 %
Operating expenses:								
Cost of operations	1,499	2,208	(709 )	-32.1 %	2,854	4,785	(1,931 )	-40.4 %
Sales and marketing	1,210	1,661	(451 )	-27.2 %	2,661	3,472	(811 )	-23.4 %
General and administrative	1,139	1,782	(643 )	-36.1 %	2,212	3,739	(1,527 )	-40.8 %
Total operating expenses	3,848	5,651	(1,803 )	-31.9 %	7,727	11,996	(4,269 )	-35.6 %
<b>Operating (loss) income</b>	\$ (166 )	\$ (110 )	\$ (56 )	51.3 %	\$ 99	\$ (182 )	\$ 281	-154.6 %

	For the Three Months Ended June 30,			For the Six Months Ended June 30,		
	2006	2005		2006	2005	
<b>Percent of Revenues</b>	100.0	% 100.0	%	100.0	% 100.0	%
Operating expenses:						
Cost of operations	40.7	% 39.8	%	36.5	% 40.5	%
Sales and marketing	32.9	% 30.0	%	34.0	% 29.4	%
General and administrative	30.9	% 32.2	%	28.2	% 31.6	%
Total operating expenses	104.5	% 102.0	%	98.7	% 101.5	%
<b>Operating (loss) income</b>	-4.5	% -2.0	%	1.3	% -1.5	%

Certain prior period amounts have been reclassified to conform to the current period's presentation.

**Revenues.** Our Care Entrée™ Consumer Healthcare Savings programs have been under continuing pressure from increasing competition and regulatory scrutiny, as well as the unwillingness of some healthcare providers to accept our savings cards based on concerns over assurance of payment. In late 2002, we implemented an escrow account requirement to address provider concerns over assurance of payment. While this feature has shown success in improving healthcare provider acceptance, it has made our programs more complex and difficult to sell. As of June 30, 2006, the percentage of our individual members who had made escrow deposits was approximately 38% of the total individual healthcare membership base. This excludes our private label programs, where the escrow features have not been mandated. In some of the states in which we have a significant number of members, especially Florida, Texas, Illinois, and California, our healthcare savings products are under scrutiny and criticism by state regulators and officials. To address these concerns, we have voluntarily removed the escrow features from our programs in California and Illinois and expect to remove this feature from programs in other states in the near future. In addition, administration of the escrow program in Florida has been modified so that the failure to deposit money into the escrow does not restrict Care Entrée members from seeing a provider. This regulatory scrutiny has impaired our ability to market these products in those states and elsewhere, further contributing to the decline in membership enrollments and increases in terminated memberships. We are currently evaluating alternative products which we may be able to offer in the future in place of the products with escrow features. The table below reflects the decline in our Care Entrée™ Consumer Healthcare Savings program membership over the preceding two years:



	Care Entrée Membership (Count at End of Quarter)							
	3rd Qtr 2004	4th Qtr 2004	1st Qtr 2005	2nd Qtr 2005	3rd Qtr 2005	4th Qtr 2005	1st Qtr 2006	2nd Qtr 2006
<b>Member count</b>	63,840	56,955	51,895	46,514	41,958	37,952	37,281	35,823
<b>Percent change</b>	-14.44	% -10.78	% -8.88	% -10.37	% -9.79	% -9.55	% -1.77	% -3.91
<b>Average revenue per member, net of sales and marketing costs</b>	\$ 25.69	\$ 25.02	\$ 25.70	\$ 26.24	\$ 26.16	\$ 24.03	\$ 23.86	\$ 22.54

During the second quarter of 2006, the decline in our member count increased primarily due to decreases in IMR sales offset by resumption of sales from a major private label in January. This trend resulted in a drop in average revenue per member, net of sales and marketing costs, for second quarter 2006. Sales from private label programs have a lower gross profit margin than those of IMR s.

Although the implementation of escrow requirements negatively impacted our membership base and consequently our revenues and net earnings in 2004 and 2005, the escrow requirements were necessary to provide some assurance of payment to the healthcare providers and, accordingly, their continued willingness to provide healthcare services to our members. This strategic move was critical to our long-term operational and financial viability in the health care savings market, as many healthcare providers throughout the United States will no longer accept a health discount card. We are currently exploring additional alternatives that may address the healthcare providers' concerns related to assurance of payment and that may be better received by potential members as well as our current members. In conjunction with our due diligence and strategic planning associated with our planned acquisition of Insuraco, a Fort Worth, Texas company providing web-based technology, specialty products and marketing for the insurance and financial services industry, which we disclosed in our Form 8-K filed on June 13, 2006, we have accelerated our development and evaluation of new products intended to provide access to affordable healthcare for consumers, while reducing costs associated with providing such products.

Members' escrow or cash-in-trust declined to \$4,631,024 as of June 30, 2006 from \$5,585,000 as of December 31, 2005, primarily for the termination of the Care Entrée program escrow feature in California.

**Cost of Operations.** For the three-month period ending June 30, 2006 and 2005, the decrease in cost of operations was primarily due to a reduction of fixed costs of \$379,000 primarily related to reduced personnel costs and termination of certain equipment leases, described above, as well as decreased variable costs of \$252,000 primarily due to decreased provider network and bank fees related to decreased revenue in our Consumer Healthcare Savings segment.

For the six-month period ending June 30, 2006 and 2005, the decrease in cost of operations was primarily due to a reduction of fixed costs of \$868,000 primarily related to reduced personnel costs and termination of certain equipment leases, described above, as well as decreased variable costs of \$668,000 primarily due to decreased provider network and bank fees related to decreased revenue in our Consumer Healthcare Savings segment.

**Sales and Marketing Expenses.** The decrease in sales and marketing expenses from the second quarter of 2005 to the second quarter of 2006 was primarily due to the decrease in commissions related to the decreased membership revenue of the Care Entrée™ program. The commission decrease was accentuated by the departure of independent marketing representatives from the upper ranks of our multi-level marketing network through which our Care Entrée™ program is offered and elimination of the associated over-ride commissions, resulting in a lower percentage of commissions as a percent of revenue. The decrease was partially offset by an increase in consulting and other marketing costs of \$298,000 for the three month period ending June 30, 2006 and \$541,000 for the six month period of 2006 related to our Care Entrée™ sales and marketing initiatives. Increases in sales and marketing as a percentage of revenue for the three and six months of 2006 are primarily due to increases in our direct marketing and new product testing activities.

**General and Administrative Expenses.** The decrease in general and administrative expenses from 2005 to 2006 and as a percentage of revenues is primarily due to the continued cost reduction measures that began in 2005.



**Employer and Group Healthcare Services**

The primary element of our Employer and Group Healthcare Services segment is our wholly-owned subsidiary, Access. Access provides a wide range of healthcare claims administration services and other cost containment procedures that are frequently required by governments and other large employers who have chosen to self-fund their healthcare benefits requirements. The operating results for our Employer and Group Healthcare Services segment were as follows:

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2006 (Dollars in Thousands)	2005	Dollar Change	Percent Change	2006 (Dollars in Thousands)	2005	Dollar Change	Percent Change
<b>Revenues</b>	\$ 1,943	\$ 2,126	\$ (183 )	-8.6 %	\$ 3,859	\$ 4,219	\$ (360 )	-8.5 %
Operating expenses:								
Cost of operations	1,231	1,333	(102 )	-7.7 %	2,382	2,589	(207 )	-8.0 %
Sales and marketing	154	199	(45 )	-22.6 %	319	390	(71 )	-18.2 %
General and administrative	147	175	(28 )	-16.0 %	306	315	(9 )	-2.9 %
Total operating expenses	1,532	1,707	(175 )	-10.3 %	3,007	3,294	(287 )	-8.7 %
Operating income	\$ 411	\$ 419	\$ (8 )	-1.9 %	\$ 852	\$ 925	\$ (73 )	-7.9 %

	For the Three Months				For the Six Months			
	Ended June 30,				Ended June 30,			
	2006	2005			2006	2005		
<b>Percent of Revenues</b>	100.0	% 100.0	%		100.0	% 100.0	%	
Operating expenses:								
Cost of operations	63.3	% 62.7	%					