CASE FOURTEEN

Pre-Paid Legal Services[1]

The third week of October 1999 was a truly bizarre week in the history of Pre-Paid Legal Services (NYSE: PPD). It was marked by the following significant events.

Monday, October 18:	PPD's stock price opens at $36 on the NYSE, slightly above its Friday close of $35.50. *Forbes* magazine names PPD as number 13 on its annual list of the best 200 small companies in America.
Tuesday, October 19:	PPD announces record results for the third quarter of 1999. EPS increased 50 percent, meeting Wall Street's expectations and marking PPD's 25th consecutive quarter of increased revenues and earnings. The full text of PPD's earnings announcement is attached as Exhibit 1. Following the announcement, PPD's stock price plummets by over 20 percent in frenzied trading on the NYSE.
Wednesday, October 20:	After taking the night to digest PPD's earnings announcement, investors again pummel PPD's stock price, forcing it down another 10 percent. PPD steps into the market in an effort to shore up its stock price, repurchasing 140,000 shares over the remainder of the week.
Friday, October 22:	PPD's stock price closes at $25, a loss for the week of over 30 percent.

Fred Russell, a Tulsa money manager who rates PPD as one of his favorite companies, explains the stock price drop as follows:

> The stock price drop is typical of Wall Street's reaction to significant news. Included in Tuesday's earnings statement was a somewhat complex accounting of increased commission payments. This caused short-term pain during the period for Pre-Paid, but the upswing in sales should benefit the company in the long run.[2]

PPD investor relations spokesperson Melanie Danielson notes that

> Another factor was the impact of comments made by a short-seller on CNBC on Tuesday. The seller pointed out that the company's cash flow for the third quarter, reported Tuesday, was $5.1 million, down $379,000 from the same period in 1998.[3]

Information concerning PPD's business strategy, accounting policies, and financial condition is

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[1] This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation. Copyright © 1999 by Richard Sloan.

[2] "Oklahoma-Based Legal Services Firm's Stock Price Plummets 22 Percent," *Tribune Business News,* October 20, 1999.

[3] Ibid.

provided in PPD's Form 10-K for 1998. Relevant portions of this document are available as an online exhibit at www.lundholmandsloan.com.

QUESTIONS

1. Identify and evaluate the key elements of PPD's business strategy. Make sure you understand the product they are selling and how they go about selling it.
2. Identify the problem revealed by the third-quarter earnings announcement that resulted in PPD's stock price drop. What was the cause of this problem?
3. Suggest an alternative method of accounting for the transactions that led to the problem identified in Question 2 above and recompute PPD's earnings using this method.
4. Do you think that earnings computed using the method you identified in Question 3 above provide a better or a worse indication of PPD's actual performance?
5. What actions would you advise PPD's management take in response to investors' reaction to the third-quarter earnings announcement?
6. What information would you seek from PPD's subsequent press releases and SEC filings in order to determine whether the price reaction to the third quarter announcement was warranted?

EXHIBIT 1

Pre-Paid Announces Record Third Quarter Results

Earnings per share up 50 percent and recruiting up 42 percent

ADA, OK, October 19, 1999—Pre-Paid Legal Services, Inc. (NYSE:PPD), today reported record results for the third quarter and for the nine months ended September 30, 1999. As a result of the 1998 fourth quarter acquisition of TPN, Inc. ("TPN") that was accounted for as a pooling of interests, the 1998 periods have been restated to include the operating results of TPN.

Net income for the third quarter of 1999 rose 49 percent to $9,870,000 from $6,611,000 for the prior year's period, while total revenues rose 23 percent to $49,025,000 from $39,809,000 for the prior year's period despite planned decreases of $4.8 million in TPN product sales. The Company's membership revenues increased 41 percent to $39,748,000 from $28,105,000 for the same period last year. Earnings per share, diluted, increased 50 percent to 42 cents per share from 28 cents per diluted share for last year's comparable quarter.

Nine-month net income during 1999 increased 56 percent to $28,524,000 from $18,296,000 for the first three quarters of 1998. Earnings per share, diluted, for the 1999 nine-month period increased 59 percent to $1.21 per share from 76 cents per diluted share for last year's comparable period. Revenues for the nine months were up 20 percent to $141,567,000 from $117,500,000 for the initial nine months of the prior year despite planned decreases of $19 million in TPN product sales.

Even though commission advances increased $9.2 million as a result of increasing membership sales during the third quarter of 1999, cash flow from operations was $5,119,000, a decrease of $379,000, or 7 percent, from the cash flow of $5,498,000 for the comparable quarter of 1998. Cash flow from operations for the first nine months of 1999 was $12.9 million compared to $8.8 million for the comparable period of 1998, an increase of $4.1 million, or 46 percent. At September 30, 1999, the Company had cash and investment balances exceeding $42,500,000.

For the third quarter of 1999, the Company added 134,725 new members, 41 percent above the 95,619 new members added during the same period of 1998. New sales associates recruited during the third quarter of 1999 were 22,493 compared to 15,820 for the comparable period of 1998, an increase of 42 percent.

"We are obviously very pleased with our third quarter operating results, but more than ever, firmly believe the best is yet to come. As we celebrate our 28th year in business, we are in the best financial condition in our history with cash and investment balances of more than $42.5 million, no long term debt and significant positive cash flow while still continuing to grow our membership revenues at better than 40 percent. Our continued revenue growth, financial condition, enhanced Internet presence and increases in recruiting all contribute to our belief that the best is still ahead of us," Harland Stonecipher, Chairman, said.

Pre-Paid Legal Services, Inc. develops, underwrites and markets legal service plans nationally. The plans provide for legal service benefits, including unlimited attorney consultation, will preparation, traffic violation defense, automobile-related criminal charges, letter writing, document preparation and review and a general trial defense benefit. More information can be located at the Company's homepage on the worldwide web at prepaidlegal.com.

FIGURE 1
Pre-Paid Legal Services, Inc., Financial Highlights (Unaudited)
(Dollars and shares in 000s, except per share amounts)

	Three Months Ended		Nine Months Ended	
	9/30/99	9/30/98	9/30/99	9/30/98
Revenues:				
Membership premiums	$39.748	$28,105	$112,017	$78.443
Product sales	1,256	6,102	4,426	23,437
Associate services	5,832	4,093	16,201	23,437
Interest income	897	819	2,665	1,881
Other	1,292	690	6,204	1,929
	49,025	39,809	141,567	117,500
Costs and expenses:				
Membership benefits	13,764	9,297	37,388	25,893
Product costs	790	3,711	2,899	14,321
Commissions	9,819	6,422	26,200	17,299
General and administrative	4,428	5,074	13,938	17,971
Associate services and direct marketing expenses	3,767	3,306	10,637	10,518
Depreciation and amortization	688	823	2,372	2,025
Premium taxes	389	277	1,090	908
Other	285	—	3,160	—
	33,839	28,910	97,684	88,935
Income before income taxes	15,186	10,899	43,883	28,565
Provision for income taxes	5,316	4,288	15,359	10,269
Net income	9,870	6,611	28,524	18,296
Less dividends on preferred shares	2	2	7	7
Net income applicable to common shares	$9,868	$6,609	$28,517	$18,289
Basic earnings per common share	$.43	$.28	$1.23	$.78
Diluted earnings per common share	$.42	$.28	$1.21	$.76
Weighted average number of common shares:				
Basic	22,927	23,496	23,246	23,446
Diluted	23,313	23,887	23,587	23,926
Net cash provided by operating activities	$5,119	$5,498	$12,852	$8,790
New membership sales	134,725	95,619	376,424	273,048
New sales associates recruited	22,493	15,820	68,035	46,530
Number of active memberships at end of period	759,341	546,358		

Statements in this press release other than purely historical information, including statements relating to the Company's future plans and objectives and expected operating results constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are based on certain assumptions which may not be correct and are subject to all of the risks and uncertainties incident to the Company's business which are described in the reports and statements filed by the Company with the Securities and Exchange Commission. As a result, actual results may vary materially from those described in the forward-looking statements.