Off Wall Street
Consulting Group, Inc.

P.O. Box 2647
Cambridge, MA 02238

tel: 617.868.7880
fax: 617.868.4933
internet: research@offwallstreet.com

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New Rec: Profit Recovery Group (PRGX-$36.19) Dec. 19, 1999

Position: Sell Target: $18 Timing: 2 (1=aggressive; 5=cautious)

000$	Q499e	Q100e	Q200e	Q300e	1999e	2000e	2001e
Revs	105000	89500	116000	118000	351139	459700	530670
EPS$	0.30	0.11	0.23	0.27	0.79	0.97	1.07
YYGr	49%	1380%	-6%	16%	55%	22%	11%
PE	n/a	n/a	n/a	n/a	46x	37x	34x
PSR	n/a	n/a	n/a	n/a	5.2	3.9	3.4
Consn	0.30	0.13	0.25	0.31	0.79	1.11	n/a

Shares Out: 50.1M Mkt Cap: $1.81B FYE: Dec

Summary: Profit Recovery Group provides accounts payable, freight and tax recovery audits to large business and government agencies. The audits find overpayment errors for which refund requests are made to the clients' vendors. PRG's core business is accounts payable audits for large U.S. retailers. The company has expanded internally and by acquisition to serve manufacturers, government clients and others. PRG has also expanded internationally by acquisition.

PRG works on a contingency fee basis, keeping a percentage of the savings it generates for clients. Contingency rates typically range from around 30% to 50%, but large customers are increasingly able to negotiate lower rates. There are reports of large clients with rates in the 18%-25% range. An accounts payable audit recovers on average several hundred thousand dollars to $1 M for every billion dollars in revenues of its retail clients, according to company documents.

There are few acquisition opportunities left, and PRG may have overpaid for recent large acquisitions in order to maintain its growth. PRG's primary competitor is Howard Schultz and Associates. Howard Schultz is private and was the first company to begin providing accounts payable audit recovery services, beginning in 1970. Connolly and Associates is the third largest audit recovery firm and competes for some large clients. Beyond these, there are a number of smaller firms which compete for the small to medium sized customers. In general, they do not compete for the very large accounts and their acquisition would not be meaningful.

Companies also perform these audits internally. Indeed, there is a clear trend to doing more of the audit in house. In house auditors have realized that this is a potential profit center for them, and a way to increase their value to their employer. As a result, more companies are developing software internally and more are using a software program provided by ACL (www.ACL.com) to find overpayments. ACL salespeople report a big boost in its sales of its sampling software for this purpose, and they have discovered that this use is a big selling point for their software.

In some large accounts that are doing more internally the impact on PRG has been significant. Our research indicates that there are many cases where PRG has been unable to increase its revenues at a client despite the client's growth, and there are some large clients where PRG may have lost as much as 50% of its revenue.

There is even one competitor, Audit Integrations, with a new business model designed to train internal auditors to do more of the recovery work using ACL software. This competitor is content to train a client's internal auditors in return for a cut of the profits that the internal auditors discover for an agreed upon period of time. Some major accounts have adopted this approach.

Another problem facing PRG is declining contingency rates. Although it is not unusual for rates to decline, and they have declined steadily over the years, audit clients tell us that the rates are dropping more rapidly now. Some large audit firms are even said to be paying hefty "slotting fees" to get the #1 audit recovery position in an account. These are signs of market saturation.

Finally, PRG made a significant accounting change in July 1999 that was made effective to Dec. 31, 1998. The company changed its revenue recognition method from the accepted claims basis to the invoice basis. Previously PRG had recognized revenue when the work was performed and the client agreed upon the

amount to be refunded. This created a large unbilled receivable balance. Now the company recognizes revenue only when the client is invoiced, which occurs when the client actually takes the credit that is due from the vendor.

While we and the "street" applaud the more conservative revenue recognition method, the accounting changes that were actually made in the transition raise some important issues. First, it is impossible to know how much of the receivables that were written off were actually uncollectable. It is possible that the amount was quite significant and that it actually was the trigger for the change. Thus, PRG may have made a virtue out of necessity. In building its revenue models "street" analysts have assumed that all past revenue was collectible, and they have built on those numbers. It is not certain that they are correct.

Then there is the fact that the write off $69 M of unbilled receivables resulted in a net write off of $29 M, which wiped out 85% of PRG's retained earnings. PRG has net margins of about 11%, but the net charge of $29 M represents 42% of the receivables written off, not 11%. This is because only direct payroll costs associated with the revenue were reversed. By leaving the non direct payroll costs expensed, it appears that PRG can recognize certain future revenue without having to recognize any of the non-direct payroll costs associated with this revenue. This is because PRG has already expensed the overhead costs on the $69 M of unbilled revenue that it will recognize in the future. The overhead expenses that remained expensed (were not reversed) are actually the expenses associated with revenue that will be billed under the new method. As long as PRG does not now defer current overhead expenses to quarters in which the associated revenue is recognized, this potential benefit would be deferred indefinitely. However, it is also possible that PRG could defer some current expenses if it needed to make a quarter. This bears watching. (sic)

It also appears that PRG has created an accounting mismatch going forward. Overhead expense (excluding direct audit payroll cost) will be expensed as incurred, but revenue and the associated auditor's compensation will be recognized later, when the client takes the credit. In effect, it appears that overhead expenses are expensed as incurred but the revenue associated with those expenses will be recognized on average in about 140 days, rather than being matched. To the extent that overhead costs are not fixed, this accounting could result in some lumpiness in earnings.

Despite the accounting change, earnings quality remains poor. In Q3, PRG recognized $4.3 M of unbilled receivables related to the recently acquired Meridian VAT, in an exception to its new accounting policy. This gave a big boost to Meridian VAT's revenue growth, as we discuss below. By selectively using the old accounting rules, will PRG be able to have its cake and eat it too?

The recognition of the unbilled revenue also allowed Meridian VAT to show exceptionally high gross margins in Q3, which we estimate were at least 68%, versus the 50% that PRG usually gets from its European operations.

The Meridian VAT acquisition seems to have benefited PRG in other ways in Q3 as well. PRG booked "one time" business acquisition expenses of $13 M as part of the pooling accounting. However, Meridian VAT has only about $33 M in 1999 revenues. This charge may have allowed PRG to claim higher EPS from operations in Q3 and provided some reserves going forward to help earnings for a while, if needed, as we explain below.

We have other accounting and quality of earnings issues to raise in regard to PRG, which we detail below. The point of this extensive accounting analysis is to demonstrate that PRG has poor quality of earnings. PRG's dependence on aggressive accounting, coupled with our fundamental analysis of the difficulties that PRG is facing in the audit recovery business, convinces us that there are fundamental problems in PRG's business and that it will be increasingly difficult for PRG to continue to meet "street" expectations for earnings growth. We project that these problems should be reflected in lower operating margins than expected, in continued poor earnings quality, and finally in weaker than expected top line growth. We also project year 2000 interest expense to be higher than "street" estimates due to continuing negative free cash flow and interest on debt to be incurred to finance the contingent payments on the Loder Drew and the ITMG acquisitions, which we discuss below. Our estimate for F2000 is $0.97 EPS on sales of $460 M. For F2001 we estimate EPS of $1.07 on $530 M in sales. Based on these estimates, our price target for PRGX shares is $18.

Discussion:

1. Although the number of companies competing for large customers is limited, virtually all large U.S. retailers have already outsourced their accounts payable audit recovery business. This has led PRG to look for growth by acquiring firms specializing in other areas such as manufacturing companies and freight and tax audit recovery.

However, the non-retail audit recovery business is less profitable and many of these companies will continue to perform these audits in house. The difference is that there are many rebates, special deals and other types of discounts and pricing adjustments that can give rise to overpayments in the retailing business, while pricing in non-retail business is typically more straightforward, providing less opportunity to find overpayments. This makes it both less profitable work for PRG, and easier for the company to perform the work in house.

2. Industry sources indicate that contingency rates are falling, particularly for PRGX' core large retail customers, and that the rate of decline is increasing. This is partially due to the fact that there is little other than price to differentiate competitors, assuming the level of service is comparable. With price being so important, competition drives prices down, even where there are only two or three competitors for a piece of business. Industry participants report that customers are negotiating ever better rates. We have heard of rates as low as 18%-25% at some large retailers.

Another problem is that retailer customers are using their internal audit staffs to perform audits in house and finding the "easy money" before letting the primary auditor in. This makes PRGX' assignments less profitable than they used to be. These customers are using internally developed or third party software, such as ACL to screen for duplicate payments, missed discounts, etc. before letting PRGX come in to do the audit. PRG customers such as Albertson's, Kmart, Sears and Wal-Mart are among the licensors of ACL software.

3. PRGX' largest customer, Wal-Mart, provides an interesting example. Table 1 shows revenues from PRGX' largest customer from 1994 through 1997. We think that Wal-Mart was the company's largest customer during each of these years. Since Wal-Mart was no longer a 10% customer in 1998, revenues from Wal-Mart can no longer be determined.

Table 1
In thousands except Wal-Mart COGS

	1994	1995	1996	1997
Wal-Mart as % of total rev (1)	15.5%	12.7%	14.4%	10.4%
PRGX total revenue (1)	34,690	56,031	77,330	112,363
Revenues from Wal-Mart	5,377	7,116	11,136	11,686
% growth in rev from Wal-Mart		32%	56%	5%
Wal-Mart COGS (in billions)	65,586	74,505	83,510	93,438
In % of COGS (times 1,000)	8.20%	9.55%	13.33%	12.51%

(1) Per Co. 10K filings.

Revenues from Wal-Mart grew strongly in 1995 and 1996 but flattened out in 1997. We think that revenues continued to be flat in 1998 and in 1999. If PRGX' growth from its core customers, which are large U.S. retailers, has flattened out, internal growth is clearly limited. It is therefore not surprising that PRGX has been trying to grow through acquisition. The problem is, there are very few substantial audit recovery firms left in the U.S. to be acquired. This has led PRGX to acquire foreign companies, but there are few international companies to buy as well, as we discuss below.

4. After PRG's acquisitions of Loder Drew & Associates and Robert Beck & Associates, there are few audit recovery firms of any size left to acquire in the U.S., according to industry sources. A list of accounts payable recovery firms that presented at the International Accounts Payable Professionals, Inc. annual conference shows that there were only ten independent accounts payable recovery firms. Of these, five appear to be very small regional firms. Industry sources indicate that this should be a comprehensive list, except for very small firms. Howard Schultz and Associates and Connolly Consulting Associates are the only two larger firms left. Recap, Inc. and Broniec Associates compete with PRG but may not be large enough to make a material difference to PRG's revenues were they to be acquired.

Because acquisition candidates are dwindling and because it is working off a larger base it is getting harder for PRG to maintain its revenue growth rate. PRG should do about $325 million in revenue this year, versus $112 million in 1997 and

$203 million in 1998. Though recent acquisitions will contribute to year over year revenue growth in 2000, the dwindling pool of acquisition candidates will become a more acute problem in 2001.

5. We think there are few international acquisition opportunities as well. The reason is that audit recovery is mainly a U.S. business and there is not enough of a customer base internationally to support many large audit recovery firms. Though this may suggest that there could be a lot of "virgin territory" internationally, there are several reasons to suggest that international growth will not be adequate to make up for market saturation in the U.S.

First, PRGX has found that international companies have been difficult to win as clients. One reason is cultural. European and other international companies are more hesitant to turn over their internal records to a third party. Converting potential customers can be a slow process. Also, the relationship between the retailer and manufacturer is different. Depending on the country, the relationship may not lend itself to auditing complete vendor purchase records and making many claims for refunds, all of which need to be researched by the vendor, and many of which may not be valid.

Another problem is that European retailers are much smaller on average than U.S. retailers. For example, the five largest European retailers combined are the size of Wal-Mart. More audits need to be done to generate the same amount of revenue. International acquisitions also increase integration and execution risk.

6. Revenue per employee is flat. PRG reported on its Q399 conference call that weighted average revenue per employee was flat versus prior year, at $38,000. Table 2 shows that the flat revenue per employee seems to be a trend.

Table 2

	Q497	Q398	Q498	Q399
US employees	709	1,134	1,230	1,621
International employees	465	601	650	1,042
Total employees	1,174	1,735	1,880	2,663
Revenues	35,918	61,803	68,946	91,259
calculated rev's per employee (1)	30.6	35.6	36.7	34.3

(1) Based on end of quarter employees.
Source: Number of employees are per Company conference calls. Year end number is per 10K.

The flat revenue per employee is an indication that productivity growth is flat. That is not surprising, since there is little leverage in this business and PRG's new clients are typically smaller than the core large retail customer base. With average customer size declining and international revenues increasing as a percentage of total revenues, we expect that revenue per employee, and productivity growth, will probably decline over time.

7. PRG cites its proprietary database as a competitive advantage. However, industry sources say this is more of a marketing tactic than a competitive advantage. Manufacturers' deals with large retailers are individually negotiated,

and vary depending on the level of co-op advertising, special display space devoted to a manufacturers' products, and other variables. Therefore, there is no master database which can crosscheck discounts, rebates and such among retailers.

It seems that the main function of the computer processing is to screen for unusual data which may suggest an overpayment or error. Much of this data screening requires relatively simple programming. For example, in order to find duplicate payments, a program would simply screen accounts payable records for same payment amount and same vendor. A screen for discounts and allowances would look to see whether payments made within x number of days after the invoice date are paid at full invoice or at a discounted rate.

8. PRG announced a major accounting change in July, 1999, effective December 31, 1998. An analysis of this change, and some other acquisition accounting, described below, leads us to conclude that PRG's recent accounting is unusual and aggressive, and is indicative of poor earnings quality. With fundamental problems in its core business and few meaningful acquisition opportunities left, PRG may be using aggressive accounting to make its financial results look better.

9. The accounting change was to recognize revenue only when PRG clients receive refunds from their vendors. Under the old method, PRG had recognized revenue when it performed the work. The company referred to the old method of revenue recognition as the "accepted claims basis" because revenue was recognized at the time overpayment claims were presented to and approved by clients, as adjusted for estimated uncollectable claims.

Under this accounting method, the company would book an unbilled receivable and corresponding revenue and cost of revenue when work was performed This created a large "unbilled receivable" balance and DSO ranged from 140 to 180 days. The lengthy DSO made many investors nervous about the ultimate collectibility of the balance, and the change was lauded by bulls because it allowed PRG to "clean up its balance sheet" and to provide greater confidence in the revenue number.

PRG refers to the new revenue recognition policy as the "invoice basis" because it recognizes revenue when it invoices clients. It is similar to a cash basis of revenue recognition because clients are invoiced when they receive "cash" refunds from their vendors (in practice, the refunds generally take the form of credits against future invoices).

10. Table 3 shows the entry PRG made to change its accounting.

Table 3

Unbilled Receivables at 12/31/98	69,432
Less: Auditor payroll accrual at 12/31/98 associated with unbilled receivables	-21,564
Subtotal	47,868
Less: related income tax effect	-18,673
Cumulative effect of accounting change	29,195
Retained earnings at 12/31/98	34,153
% of retained earnings written off	85%

Source: Q399 10Q.

The write off of the $69 million unbilled receivable balance gave PRG the opportunity to write off any and all uncollectable receivables that had built up over time as part of a one-time charge that was considered a non-operating item.

11. Another important aspect of this accounting change relates to the remainder of the entry. In concept, the entry should have written off $69 million of unbilled receivables (about three months worth of business), and reversed the expenses that had been incurred and recognized when this revenue was generated. A reversal of $69 million of revenue and associated costs at the company's operating profit margin of 16%, adjusted for taxes, would yield a net write off of $6.9 million. However, the actual write off was $29 million. This write off was so large that it wiped out almost all the profit PRGX ever made (see Table 3). In so doing, it also created a "kitty" that could potentially be used to boost future earnings, as explained below.

The reason the entry wrote off 85% of retained earnings is that only the direct payroll costs associated with the $69 million of unbilled receivables were reversed. All other expenses, including other "cost of revenue" and SG&A costs associated with these revenues, remained expensed. These expenses that were not reversed amount to about $36 million, by our estimate. In order to properly match revenue and expenses, we think the company should have recorded these expenses as prepaid expenses. The expenses would have hit the P&L when the company recognized the associated $69 million of revenue.

12. Accounting for accounting changes is governed by APB20 – "Accounting Changes". The accounting literature states that when a change in accounting principle is necessary, the cumulative effect on net income of prior periods is reported as a "cumulative effect of change in accounting principle".

The accounting literature does not address the details of calculating the change in net income on prior periods, and therefore leaves room for discretion. Certainly, it would be logical to expect that the effect of the change on net income would include non-direct payroll cost of revenues and SG&A expenses associated with the revenues. The fact that the entry did not reverse these expenses had the result that PRGX wrote off 85% of its retained earnings. Why would the company take this approach when it makes its balance sheet look much worse?

The reason could be that it gives the company the ability to more easily "manage earnings" going forward. Nevertheless, although this may enable PRG to delay any potential reported earnings disappointment for a couple quarters or so, as discussed below, our analysis of cash flow and return on assets already indicates that financial results are deteriorating. We think these negative trends will continue in future quarters and even PRG bulls will recognize problems before an actual earnings miss. The increased accounting flexibility that arose from the accounting change will be temporary, and even so may not be enough to mask the fundamental problems in the business.

13. Even after changing its accounting policy to no longer record unbilled receivables, and after writing off all $69 million of unbilled receivables at June 30, 1999, PRG again recorded $4.52 million of unbilled receivables in the Q399 quarter.

PRG stated on its conference call that these receivables related to Meridian VAT, and that the revenue was recognized because the tax authorities were obligated to pay. Meridian VAT was acquired in August 1999 in a pooling transaction. The company obtains Value Added Tax (VAT) refunds from governmental agencies for its corporate clients.

In explaining its new revenue recognition policy in its Q299 10Q, PRG stated that "With respect to the Company's contemplated future operations to secure refunds pursuant to statute or regulation of amounts paid by clients to governmental entities, the Company will recognize revenues at the time refund claims containing all required documentation are filed with appropriate governmental agencies in those instances where historical refund disallowance rates can be accurately estimated."

The Meridian VAT acquisition had nearly closed at the time PRG announced this revenue recognition loophole. It seems odd that PRG would create a specific exception to its new accounting policy, unless the quarter was not going as well as planned and it needed extra revenue and earnings. The accounting entry gave Meridian VAT an extraordinary 366% revenue growth rate year over year in Q399, compared to 36% and 18% y/y growth in Q199 and Q299, respectively (see Table 4).

14. We believe only direct payroll costs would have been recorded with this extra revenue, since the quarters period costs were already expensed. Indeed, PRG's gross margin percentage on its international business improved dramatically in Q399 after two quarters of declines, due to an extraordinarily high margin at Meridian VAT. Table 4 shows the revenues and gross margin at PRG and Meridian VAT for Q1-Q398 and Q1-Q399. The gross margins should be looked at on a year over year basis because of seasonality in the business.

Table 4

	Q198	Q298	Q398	Q199	Q299	Q399
Meridian VAT int'l revenues (1)	1,462	9,874	1,142	1,985	11,653	5,326
y/y revenue growth				36%	18%	366%
Total PRG Int'l revenues (1)	12,060	14,267	15,544	13,567	19,225	26,395
PRG Int'l gross margin (2)	53.9%	53.0%	51.7%	46.7%	51.2%	55.0%
Non-Meridian VAT int'l rev. (1)						21,069
Assume prior year margin %						51.7%
Est non-Meridian VAT gross profit						10,893
Total international gross profit (1)						14,517
Est Meridian VAT gross profit						3,625
Est Meridian VAT gross margin %						**68%**

(1) Per Q399 10Q. Revenues prior to Q399 exclude pooled entities. (2) Per 10Q's.

In PRG's 10Qs, the lower gross margin percentage versus prior year in Q199 was explained as increased expansion efforts. The lower gross margin percentage in Q299 was also explained as increased expansion efforts. The higher margin in Q399 was explained as significantly higher revenues in Meridian VAT versus prior year with no significant increase in cost. It would be hard to imagine how Meridian VAT's cost of sales would not have increased on a 366% revenue increase without the benefit of some clever acquisition accounting, since cost of sales mainly represents the cost of direct labor associated with generating these revenues. Revenues are generated in this business much like in a consulting firm. The more hours worked, the more revenues are generated. Assuming fairly stable productivity, revenues shouldn't increase much without a corresponding increase in cost of revenues.

As shown in Table 4, we estimated Meridian VAT's Q399 gross margin percentage by assuming the Q399 gross margin percentage on non-Meridian revenues was the same as prior year. Note that this is a conservative assumption, since the gross margin had declined in the prior two quarters due to costs related to expansion which continued in Q3. At the 51.7% margin, the non-Meridian gross profit would have been $11,516. Therefore, the Meridian gross profit would have been $3,664. On Meridian VAT international revenues of $5,326, the gross margin percentage would have been 69%.

Meridian VAT represents two thirds of the pooled entities on a revenue basis, and PRS International the remaining one third**.** Per PRG's Q399 earnings release, the pooled entities gross margin percentage was 39% for the nine months ended September 30, 1998 and 33% for the six months ended June 30, 1999. A gross margin percentage of about 69% appears to be far higher than the normal historical gross margin for Meridian VAT.

The $4.5 million of additional revenue at a 68% gross margin would equate to $0.04 per share after tax, the difference between a positive earnings surprise and an earnings miss.

15. Also in connection with the Meridian VAT pooling, PRG booked one time business acquisition expenses of $10.4 million in Q399. The company also recorded nearly $3 million of acquisition expenses retroactively to Q199 and Q299 (see p.14 of Q399 10Q). PRG was apparently negotiating with Meridian VAT since Q199 and incurred $1.5 million of acquisition costs in Q199 and another $1.5 million in Q29. We wonder what the nature of these prior period acquisition charges are. Furthermore, the total $13.4 million of business acquisition expenses seem very high in relation to Meridian VAT's annual revenues of about $33 million.

PRG noted on its Q399 conference call that $6 million of the $7.9 million (after tax) Q399 Meridian VAT acquisition charges were paid out in Q399 with the remainder to be paid out over the next couple quarters. These acquisition expenses were referred to by management as a "phantom share payout which is a compensation scheme for Meridian phantom shareholders". We wonder if these payouts are not really Meridian management compensation that would be more appropriately classified as payroll expense.

16. As noted in Table 5, Meridian VAT's and PRS International's (the pooled entities) accrued payroll and other expenses were much higher at September 30 (shortly after the acquisitions), as a percentage of revenue, than the rest of PRG, even after the $6 million payout. This supports the notion that some future operating expenses were actually booked as "one time" acquisition expenses in these accrual accounts. While at least some of the extra accrued expenses could be related to acquisition charges, the accrued payroll balance should be related to payroll expenses. We wonder if some ordinary payroll expenses may have been recorded as one time acquisition charges.

Table 5
At September 30, 1999

	Pooled entities	Non-pooled entities
Revenue for 3 mo. ended 9/30/99	11,104	80,155
Accrued payroll and related expenses	9,655	26,488
In % of revenue	87%	33%
Accounts payable and accrued expenses	7,390	8,135
In % of revenue	67%	10%

Note: Pooled entities are Meridian VAT and PRS International. Non-pooled is the remainder of PRG. Source: Q399 earnings release.

Recording any future compensation or other costs as one time acquisition charges would improve Meridian VAT and PRG post acquisition results beginning in Q399.

17. PRG has structured two recent purchase acquisitions with unusually high contingent considerations. This structure has allowed it to postpone recognition of substantial expenses.

In the July 1998 acquisition of Loder Drew, contingent consideration of $70 million represented about 43% of the total purchase price (including contingent consideration) and 50% of the cash purchase price. In the June 1999 acquisition of Invoice and Tariff Management Group (ITMG), contingent consideration of $20 million represented 50% of the total purchase price.

In the case of Loder Drew, $30 million of the contingent consideration was paid in March, 1999 and the company believes it is "highly probable" that the remaining $40 million will become due based on the 1999 financial results (see Q399 10Q).

In the case of ITMG, $5 million will be payable based on ITMG's financial performance through December 31, 1999 and the remainder payable in February 2000 based on year 2000 financial performance.

Contingent consideration normally represents a financial kicker that ranges from 5% to 25% of the purchase price. If the acquired company does better than expected, additional consideration gets paid. We think these deals may have been structured so that the contingent consideration was readily achievable, or had a high likelihood of being achieved, and the main purpose of this structure may have been to delay recognition of a substantial part of the purchase price, and the related goodwill amortization and interest expense.

The Loder Drew earn out Agreement is part of PRG's August 12, 1998 8K filing, but the operating profit earn out targets are blanked out. However, the paragraph discussing the first $30 million earn out payments does state that "If the division had operating profit for the first earn out period which is greater than $[ ] but less than or equal to $[ ], the Company will pay to the seller an earn out payment equal to $30,303 for each $1.00 by which such operating profit for the first earn out period exceeds $[ ]." A 30,000 to 1 multiple seems extraordinarily high.

18. We think the accounting change and the acquisition accounting obscure deteriorating financial trends. For example, return on assets based on reported financial results indicates a strong upturn in 1999, after three years of decline. However, the reported results may be misleading.

As shown in Table 6, we added the estimated unbilled receivable balance to average assets in 1999 to put the balance sheet on an apples to apples basis to prior years, and to accurately reflect the investment in unbilled work. We also added the additional goodwill, goodwill amortization and interest expense to the Loder Drew and ITMG acquisitions assuming the contingent payouts were paid at the acquisition dates. We discounted these future payouts to reflect the time value of money at the company's 6.75% borrowing rate. The adjusted return on assets shows a continuing decline from 11.5% in 1998 to 9% in 1999.

Table 6

	yr endec 1995	yr endec 1996	yr endec 1997	yr ended 1998	yr ended 1999	
Assets, end of year	30,268	68,318	133,885	387,382	403,770	(1)
Average assets		49,293	101,102	260,634	395,576	
Average unbilled receivables					113,716	(2)
Goodwill adj, Loder Drew					33,750	(3)
Goodwill adj, ITMG					17,975	(4)
Average assets, adjusted		49,293	101,102	260,634	561,017	
Pre-tax income, as reported		10,939	15,772	29,861	58,503	(5)
Effect of contingent consideration:						
add'l goodwill amort., Loder Drew					2,550	(6)
add'l interest expense, Loder Drew					4,300	(6)
add'l goodwill amort., ITMG (6 mo's)					360	(6)
add'l interest expense, ITMG (6 mo's)					600	(6)
adjusted pro-forma pre-tax income					50,693	
Reported pre-tax return on assets		22.2%	15.6%	11.5%	14.8%	
Pro-forma pre-tax return on assets		22.2%	15.6%	11.5%	9.0%	

Notes:

(1) 1999 asset number is at Sept. 30, 1999.
(2) Assume unbilled receivable represents 35% of revenue, the recent historical average.
(3) Represents $40M contingent payout due 3/00 less present value discount on $70M contingent consideration.
(4) Represents $20M contingent consideration, less present value discount, assumes payment of contingent consideration.
(5) “Street” estimate, less pre-acquisition (Q1-Q299) results of pooled entities.
(6) Represents pro-forma goodwill amortization and interest expense, assuming contingent payouts were paid at acquisition date, with future payments discounted to present value at acquisition date.

19. PRG’s cash flow is deteriorating. Operating cash flow was about break even for the nine months ended September 1999, though it should improve this quarter because Q4 is a strong quarter for collections. More importantly, free cash flow was $120 million negative in 1998 and $58 million negative in 1999 through September. The negative free cash flow is principally because PRG depends on acquisitions for growth. Cash flow benefited from the issuance of shares under the pooling method in the Meridian VAT and PRS International acquisitions in Q399 (all material prior acquisitions were purchases). The FASB is expected to issue rules eliminating pooling as of late 2000.

If cash had been used to acquire these companies, free cash flow would have been negative $294 million for the nine months ended September 30, 1999. But the issuance of over seven million shares in these two transactions has a downside too as the Meridian VAT and PRS International shareholders will want to reduce their large stakes in PRG, putting selling pressure on the stock.

Table 7

	9 month: ending 9/30/99	year ending 12/31/98	year ending 12/31/97	year ending 12/31/96	year ending 12/31/95
Net Income	-16,704	18,146	9,623	3,150	4,507
Cumulative effect of accounting change	29,195	0	0	0	0
Adjusted net income	12,491	18,146	9,623	3,150	4,507
Cash flow from operations	407	11,254	8,216	1,884	2,531
Free cash flow	-57,901	-119,967	-22,535	-3,192	-67
Meridian VAT purchase price	-194,000				
PRS International purchase price	-42,400				

Source: Co. 10K and 10Q's.

20. We think that interest expense will increase in 2000 to about $7 million due to continued negative free cash flow, debt incurred to finance the $40 million Loder Drew contingent payout in March 2000, and the recent rise in short term interest rates. Analyst models have interest expense declining in 2000.

21. Projected 1999 EPS excluding business acquisition expenses and the accounting change charge is $0.79, which represents a 52% increase over historical 1998 results. Earnings before tax per share is projected to grow less, at 44%. If Loder Drew and ITMG contingent payments were made at the acquisition dates, earnings per share before tax, acquisition charges and the accounting change charge would have grown 32% (excluding the pooled entities prior to acquisition dates). Excluding the questionable $4.52 million Meridian VAT revenue in Q399, EPS growth before tax would have been 29%, versus 41% pro-forma in the prior year (prior year actual was 46%). In our view, the 29% pro-forma operating profit growth represents a more accurate reflection of earnings growth than the reported results. Still, this amount assumes none of the $69 million of unbilled receivables written off were uncollectable and none of the $13 million business acquisition costs were really operating costs.

22. PRG's recent acquisitions were not very profitable businesses prior to their being acquired and even less so with post acquisition goodwill amortization and interest expense costs. Based on the form 8K disclosures, Loder Drew had a loss before tax of $246,000 for the six months ended June 30, 1998. After pro-forma acquisition adjustments, the loss increases to $961,000. After factoring in the $70 million contingent consideration, the pro-forma loss would increase to $4.5 million by our calculation. One could assume the twelve months loss would be about double that. The Robert Beck pro-forma P&L for the six months ended June 30, 1998 showed a profit, but was 5.7% of sales, versus 9.2% for PRG for the same period.

23. No form 8K financial statements were filed for the other two large recent acquisitions, Meridian VAT and PRS International, which were both pooling transactions. However, the Q399 earnings release provides the combined results for these poolings. Revenues for the nine months ended were $37 million for the two companies combined. Excluding business acquisition expenses, the poolings

were not dilutive (or accretive), but the nine month operating results likely benefited from the acquisition charges and the additional $4.5 million of revenue recognized, discussed above. Furthermore, the combined accumulated deficit for Meridian VAT and PRS International was $36 million at Sept. 30, 1999 (which includes the $13 M business acquisition costs), suggesting that these businesses have incurred substantial losses.

24. PRG paid $140 million in cash and a total consideration of $153 million in cash and stock to acquire Loder Drew, assuming the full contingent consideration will be paid, which seems likely. PRG issued over 6 million shares, valued at $194 million, to acquire Meridian VAT. The high purchase prices, and heavy amortization and interest charges (for the companies acquired by purchase) might not be a problem if PRG had a formula to grow revenues and profits at these companies, and to take advantage of synergies with its own operations.

However, PRG is acquiring businesses in non-core ancillary areas such as VAT recovery and non-retail auditing, etc. Moreover, several of these businesses are located in different countries. There seems to be little in the way of synergies or management techniques that PRG can employ to improve post acquisition results at these companies.

The large amount of debt and goodwill that PRG is building on its balance sheet as a result of its acquisitions increases the risk for investors. Goodwill will be greater than total shareholder's equity after the $40 million contingent Loder Drew payment in the spring of 2000.

25. On November 17, 1999, with PRGX shares at $40.50, Ron Loder purchased a collar agreement with a brokerage house that limits his downside risk in PRGX shares to $35.70 and gives the broker any upside over $56 through August 2001.

26. Financial projections

	Q199*	Q299*	Q399	Q499e
Revenues	64,437	90,443	91,259	105,000
Cost of Revenues	38,038	47,441	43,411	50,018
Gross margin	26,399	43,002	47,848	54,982
Selling/Gen./Admin.	21,752	23,180	27,540	29,980
Bus acq exp's,other	1495	1495	10,380	0
Operating income	3,152	18,327	9,928	25,002
Interest, Net	-1414	-1560	-1,304	-1,000
Income Before Taxes	1,738	16,767	8,624	24,002
Income taxes	1,386	4,718	5,495	8,985
Earnings b4 min int and acctg	352	12,049	3,129	15,017
Minority interest in sub	0	0	48	0
Net income b4 acctg change	352	12,049	3,081	15,017
Cum effect of acctg change	-29,195	0	0	0
net income after acctg change	-28,843	12,049	3,081	15,017
Diluted Average Shs.	47,458	48,733	50,094	50,532
Diluted EPS Excl XOrd	0.01	0.25	0.23	0.30

	Q199*	Q299*	Q399	Q499e
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of Revenues	59.0%	52.5%	47.6%	47.6%
Gross margin	41.0%	47.5%	52.4%	52.4%
Selling/Gen./Admin.	33.8%	25.6%	30.2%	28.6%
Bus acq exp's,other	2.3%	1.7%	11.4%	0.0%
Operating income	4.9%	20.3%	10.9%	23.8%
Interest, Net	-2.2%	-1.7%	-1.4%	-1.0%
Income Before Taxes	2.7%	18.5%	9.5%	22.9%
Income taxes	2.2%	5.2%	6.0%	8.6%
Income b4 min int and acctg	0.5%	13.3%	3.4%	14.3%
Minority interest in sub	0.0%	0.0%	0.1%	0.0%
Cum effect of acctg change	-45.3%	0.0%	0.0%	0.0%
Net income	0.5%	13.3%	3.4%	14.3%

* Restated for Q3 99 Meridian VAT and PRS International pooling transactions.

	Q100e	Q200e	Q300e	Q400e
Revenues	89,500	116,000	118,000	136,200
Cost of Revenues	50,389	59,740	58,174	65,376
Gross margin	39,112	56,260	59,826	70,824
Selling/Gen./Admin.	29,088	35,380	35,754	39,226
Bus acq exp's,other	0	0	0	0
Operating income	10,024	20,880	24,072	31,598
Interest, Net	-1,100	-1,793	-1,974	-2,155
Income Before Taxes	8,924	19,087	22,098	29,443
Income taxes	-3,302	-7,062	-8,176	-10,894
Income b4 min int and acctg	5,622	12,025	13,922	18,549
Minority interest in sub	0	0	0	0
Net income	5,622	12,025	13,922	18,549
Diluted Average Shs.	51,200	51,750	52,250	52,500
Diluted EPS Excl XOrd	0.11	0.23	0.27	0.35
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of Revenues	56.3%	51.5%	49.3%	48.0%
Gross margin	43.7%	48.5%	50.7%	52.0%
Selling/Gen./Admin.	32.5%	30.5%	30.3%	28.8%
Bus acq exp's,other	0.0%	0.0%	0.0%	0.0%
Operating income	11.2%	18.0%	20.4%	23.2%
Interest, Net	-1.2%	-1.5%	-1.7%	-1.6%
Income Before Taxes	10.0%	16.5%	18.7%	21.6%
Income taxes	-3.7%	-6.1%	-6.9%	-8.0%
Income b4 min int and acctg	6.3%	10.4%	11.8%	13.6%
Minority interest in sub	0.0%	0.0%	0.0%	0.0%
Net income	6.3%	10.4%	11.8%	13.6%

	1999e	2000e	2001e
Revenues	351,139	459,700	530,670
Cost of Revenues	178,908	233,679	271,703
Gross margin	172,231	226,022	258,967
Selling/Gen./Admin.	102,452	139,447	156,548
Bus acq exp's,other	13,370	0	0
Operating income	56,409	86,574	102,419
Interest, Net	-5,278	-7,022	-10,500
Income Before Taxes	51,131	79,552	91,919
Income taxes	20,584	-29,434	34,010
Income b4 min int and acctg	30,547	50,118	57,909
Minority interest in sub	48	0	0
Net income	30,499	50,118	57,909
Cum effect of acctg change	-29,195	0	0
net income after acctg change	1,304	50,118	57,909
Diluted Average Shs.	49,200	51,925	54,000
Diluted EPS Excl XOrd	0.62	0.97	1.07
Diluted EPS excl. Extr. & bus. acquisiton expenses	0.79	0.97	1.07
Revenues	100.0%	100.0%	100.0%
Cost of Revenues	51.0%	50.8%	51.2%
Gross margin	49.0%	49.2%	48.8%
Selling/Gen./Admin.	29.2%	30.3%	29.5%
Bus acq exp's,other	3.8%	0.0%	0.0%
Operating income	16.1%	18.8%	19.3%
Interest, Net	-1.5%	-1.5%	-2.0%
Income Before Taxes	14.6%	17.3%	17.3%
Income taxes	5.9%	-6.4%	6.4%
Income b4 min int and acctg	8.7%	10.9%	10.9%

ASSETS	Q498*	Q199*	Q299*	Q399
Cash/Equivalents	28,344	28,986	31,639	40,462
Billed Receivables	26,348	32,936	38,093	58,971
Unbilled Receivables	68,001	64,204	0	4,520
Employee Advances	6,791	6,913	5,822	10,461
Prepaid/Other	2,520	1,815	2,154	5,441
Deferred Taxes	0	0	4,484	4,484
Total Current Assets	132,004	134,854	82,192	124,339
Computer/Equip.	26,123	30,155	34,643	43,675
Furniture/Fixt.	2,738	3,231	3,445	5,157
Leasehold Improvment	4,410	5,046	5,052	5,884
Depreciation	-10,514	-13,098	-15,629	-24,308
Net fixed assets	22,757	25,334	27,511	30,408
Noncompete Agr., Net	2,475	2,202	1,936	1,800
Loan Costs, Net	1,802	1,542	1,388	1,405
Goodwill, Net	223,508	218,254	239,615	239,192
Other Assets	1,678	2,312	2,171	2,577
Deferred Taxes	3,158	3,699	3,786	3,680
Total Assets	387,382	388,197	358,599	403,401

LIABILITIES	Q498*	Q199*	Q299*	Q399
Notes Payable	49	49	49	6,480
Cur. Port. LT Debt	630	362	450	258
A/P & accrued exp	13,556	9,585	5,255	15,525
Accrued payroll	44,678	39,335	22,630	36,143
Accrued bus. acq.cons.	30,000	0	0	0
deferred income tax	13,310	13,290	0	
Deferred audit revs.	1,238	1,219	982	1,195
Total Current Liabs	103,461	63,840	29,366	59,601
Long-term Debt	112,886	58,567	73,358	71,917
LT deferred comp.	3,453	3,642	3,154	3,088
Other LT Liabs.	2,078	1,418	678	968
Total Liabilities	221,878	127,467	106,556	135,574
SHAREHOLDER EQUITY				
Common Stock	24	27	41	49
Add'l paid-in capital	133,725	228,745	241,310	287,270
Translation/Other	-2,398	-4,702	-3,503	-3,640
Retained Earnings	34,153	36,640	14,195	-15,852
Total Equity	165,504	260,710	252,043	267,827
Total Liab & equity	387,382	388,177	358,599	403,401

* Not restated for Q399 poolings.