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Whitesmith Consulting: Untangling Service-for-Equity Arrangements

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Abstract. Many service organizations over the last few years have attempted to migrate, sometimes reluctantly and experimentally, from their traditional modus operandi (fee-for-service) to various forms of equity-for-service arrangements. The conversion to an equity-incentivized model could be both defensive (to retain human capital and/or slow down defections to startup companies) and offensive (to generate new business from cash-poor, prospect-rich companies and leverage the firm's core competencies). This case is designed for students to address the strategic, financial, and organizational issues of such equity-enabled arrangements, and to gain a better understanding of the underlying risks and benefits of such innovative service models. It also offers managerial guidance for effective implementation of equity-for-service arrangements.

Keywords: equity-enabled contracts, equity-for-service arrangements, strategy consulting, entrepreneurial realignment of interest, conflicts of interest, professional ethics.

1. Introduction

> Consulting for equity makes sense either when a traditional client is considering a new venture and there's a compelling economic benefit - both for client and consultant - to pursue it on a shared-equity basis; or when an emerging company needs our services and can't afford them on a traditional fee-for-service basis…I believe this will be the exception rather than the rule, and the top strategy firms will maintain a core fee-for-service business. Consulting for equity brings significant potential for conflict and risk.[2]
>
> *– Ralph Shrader, Booz Allen & Hamilton*

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2. Consultant News December 1999

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> If consulting for equity is done instead of getting paid, I do not like it…If it's investing alongside a desirable client or for the firm's own account, I do like it…[3]
>
> – *George Stalk, Boston Consulting Group*

John Peterson leaned back in his chair and sighed with exasperation. The head of Whitesmith's Business Strategy and Technology Expertise (BSTE) practice was torn over the decision of whether to offer alternative pricing arrangements. Many of Whitesmith's senior consultants had jumped ship to dot-com startups, attracted mainly by the huge upside potential of the generous stock option plans offered by these new companies. He also noticed that other strategy consulting firms had begun taking equity in exchange for their services as a way to engage smaller venture-backed clients and to stem the tide of departing consultants.

Should Whitesmith follow the herd and offer equity-based compensation in lieu of fees, and if so, how should such a model be structured? John had all the information before him needed to make an informed decision, yet the choice wasn't clear. The consulting landscape had changed dramatically in a brief period of time and he knew that to stay competitive, Whitesmith had somehow to address this issue. Clients were starting to pressure for such arrangements as well. A partner's meeting was scheduled for June 23rd 2000, and the item was on the agenda. John would have to make the case for equity-for-service arrangements…

2. Whitesmith Consulting

Whitesmith earned its stripes with lengthy consulting engagements for *Fortune 500* companies over the past 30 years. It was similar to other professional services firms in that Whitesmith followed a partnership model, recruited only at Ivy League schools, and prided itself on intellectual honesty and thought leadership. The firm had a worldwide reach and over 900 partners. It was strongly paternalistic and many of the firm's senior partners had come to Whitesmith directly from business school and grew up through the ranks (see Appendix 2 on page 469 for Whitesmith's latest financial statements.)

In the early 1990s the firm sought to build a practice that would marry the company's strategy experience with nascent information technology. This practice area would seek to realize competitive advantage for clients through strategy, not implementation. The business strategy and technology expertise practice (BSTE) did not deploy large enterprise resource planning (ERP) systems, but provided strategic roadmaps for technology investments. By 1997

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3. Consultant News December 1999

the practice was profitable and had developed its own unique methodology, client base and employee recruiting program. Also, BSTE had grown at a rate much faster than Whitesmith as a whole. To further the objectives of BSTE, the practice was given greater autonomy with its own group of senior managers and was reorganized with its own profit and loss responsibility.

After attending a well-known MBA program in the Boston area, John joined Whitesmith as one of the founding consultants in the BSTE Practice. He quickly earned respect from his colleagues and clients with insightful analyses and often counter-intuitive recommendations. After eight years with the firm he was asked to lead BSTE in 1998, guiding it through a complex and fast-moving market.

As the technology landscape began to change in the late 1990s, John Peterson pushed BSTE to pursue more of an Internet-related focus. Although he faced some resistance within Whitesmith for serving a new breed of client, with the explosion of venture capital and dot-com startups, opportunities could not be ignored. Although profitable, revenues could only grow as the 'body count' increased. While salaries and revenues per consultant increased reflecting industry trends, the group began to experience significantly higher turnover from previous years. As a result, John started to examine alternative forms of revenue generation and methods to stem the tide of departing consultants.

3. A Primer to the Consulting Industry [4]

The management consulting industry emerged in the US around the turn of the century and since then has experienced several phases: emergence, explosive growth, stagnation and rejuvenation.

Emergence: Early consulting projects were conducted to optimize mechanical and human performance via time and motion studies. Large industrial firms that conducted engagements realized tremendous cost savings of 40%-50%. Arthur D. Little, James O. McKinsey and Charles Bedeaux were all 'industrial engineers' seeking to add a scientific rigor to industrial affairs. During this time, many now well-known firms began operations: Booz Allen Hamilton (1914), McKinsey & Company (1926) and PA Consulting (1943). From this point on, management as a discipline gained increased recognition within academic institutions; many professors dedicated summers to consulting, and the number of firms continued to grow.

4. Background to this section was based upon "The European Management Consulting Industry, 1990" , IMD -Institute for Management Development Case #GM 477

Explosive Growth: The post-World War II expansion in the US created a stronger need for consultants to support, validate or create strategy in an increasingly complex environment. Consulting firms created expertise in key areas (generally industries or functions) and peddled new consulting products as they were developed within industry or academe. For example, Bruce Henderson founded the Boston Consulting Group (BCG), a firm focused solely on strategy consulting, by leveraging two management concepts: the experience curve and the portfolio matrix. Accounting firms also entered the fray creating their own consulting divisions as a complementary service to their auditing practices.

Stagnation and Rejuvenation: The growth of consulting did not last. Suffering from two recessions in the 1970s and early 1980s, many management consulting firms merged with others or simply disappeared. Strategy consulting, popular in the 1960s, fell out of favor, when disgruntled conglomerates tried to solve their unrelated diversification mistakes. However, fresh ideas from management gurus such as Michael Porter, Tom Peters and Robert Waterman pushed the industry forward. Several new firms were created including Michael Porter's Monitor Company, LEK, a spin-off of Bain and Co., Mars and Co. and Braxton Associates, spin-offs of BCG, The MAC Group etc. Computer companies such as Digital, IBM, and Siemens all offered system integration services in competition with Andersen Consulting and EDS. By the end of the eighties, several mergers took place causing the "big eight" accounting firms to become the "big five." For example, Deloitte tied the knot with Touche, Arthur Young with Ernst and Whinney and Price Waterhouse with Coopers Lybrand. Over time, consulting revenues of these firms surpassed those of tax and audit. Indeed, as pointed out in a UK study below[5], consulting work led to more lucrative engagements and the ability to 'cross-sell' the client on a myriad of other consulting projects.

Overall, the worldwide consulting industry had grown from a total size of $1 billion in the early 1970s to $3 billion in 1980 to $22 billion in 1990 to about $55 billion in 1999, an average rate of growth of 12%[6].

Table 1: Audit v. Consulting Fees for Big Five in UK, 1999 (Figures in British Pounds)

Firm	Audit Income	Non-Audit Income
PricewaterhouseCoopers	122.5m	222.4m
Deloitte & Touche	16.9m	23.7m
KPMG	87,5m	123.1m
Arthur Andersen	19.6m	24.3m
Ernst & Young	1.7m	47.1m

5. "Conflict of Interest…" Accountancy Age February 10, 2000
6. "Big Question On Consulting…" Chicago Tribune January 22, 1999

4. Evolution in the Consulting Industry Segmentation

Consulting had come a long way since its beginnings in time-and-motion studies. Various types of management consulting services were available - in many combinations of functions, industries and activities.

Some companies such as the auditing firms offered "general management consulting", covering a large breadth of functional services. Other firms focused on one particular function. For example, Bain, BCG, Monitor and LEK promoted themselves as pure strategy boutiques. Hay Management focused most on human resources consulting and Towers Perrin in benefits and risk management services. Often, however, these companies would accept an assignment on complementary services. Some companies focused on an industry where they had specific expertise, especially smaller operations whose founder had come from that particular industry. Larger consulting firms accepted projects from all types of industries. However, some such as Bain and Co. or Mars and Co. would work with only one client per industry, thus avoiding any potential conflict of interest. Not only were there foci on functions, industries but also on activities such as development, data collection, general studies, decision support and implementation. For example, business schools and some process management consulting firms focused on organizational development as their essential activity. Some firms such as Dataquest, Forrester and Gartner Group focused on providing information services or industry reports and organized conferences and symposia on specific topics. The vast majority of the consulting firms, however, offered some form of decision support, advising their clients on best courses of action. Many went one step further by providing implementation services.

5. The Consulting Clients [7]

Many potential clients refused to use management consulting services, preferring to have consulting performed internally. First, they felt that consultants did more harm than good to the morale of the existing management. Secondly, many clients asked why they should hire external consultants who were unfamiliar with their markets and internal structures. Those companies that did engage consulting services cited the following reasons however:

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7. Background to the Client, Supply and Economics sections were based upon "The European Management Consulting Industry, 1990" Institute for Management Development Case #GM 477

- to reduce workload
- to acquire new knowledge and competence to develop the business
- to obtain an unbiased independent view from the outside on issues concerning internal politics.

Typically large corporations and governments were the targets for consulting firms. They could afford the fees, the relationships were longer term and the overhead costs for the consulting firms, such as marketing, were lower. Approximately 70% of the world's top 1000 companies had employed consulting services at one time.

6. The Economics of Management Consulting

Three of the most significant areas affecting the profitability of a management consulting firm were: leverage, size and length of the project, and the number of projects per consultant. In order to remain profitable, a management consulting firm gained leverage from its associates and consultants. Typically consulting firms used a multiplication factor on the consultant's salary to account for overhead expenses. Some organizations loaded up the consultants and associates per partner in order to maximize its leverage and profitability. In return, however, these companies had to ensure that the quality of the output was strictly controlled.

Table 2: Sample Economic Structure of a Management Consulting Firm

Level	Salary ($000s)	Multiplier	Billings	Planned Days per Year	Daily Rates
Partner	400	0.75	300	75	4000
Director	250	1.20	300	100	3000
Manager	160	2.20	350	175	2000
Consultant	100	3.00	300	200	1500

Table 2 presents a typical billing and cost structure for consulting firms, detailing average salaries for partners, directors, managers and consultants, common multipliers are each hierarchical level (the multiplier is the ratio of billings to salary), the planned billable days per year and the average daily rates (in $US). It would seem strange at first sight that partners, with the highest daily rates, would actually not be able to "earn their salaries" in billings, with

their multiplier often below 1.0. One has to look at actual assignments to understand the economics of partners; often referred to as “engagement managers”, their role is essentially on the client selling side. Their commitment to the actual consulting tasks is often minimal, but they very much “prime the pump” of the business, serving as the indispensable contact point with the clients.

Table 3: Consulting Industry Metrics[8]

Issue	Average
Percentage Total Revenue	
Salary Expense	49.7%
Benefits	8%
Outside Labor	9.5%
Business Development	4.9%
Recruiting	0.6%
Unbilled WIP	5.4%
Backlog	14.3%
Key Metrics	
Consultants/Partner	2.5x - 3.5x
Consultants/Support Staff	3x
Senior Partners as % of Total Staff	20%
Days Sales Outstanding	45 - 57
Senior Partner Turnover	10 - 13.8%
Profits/Partner	$90,600
Utilization	59%
Bonus as % Salary	
Partner	25%
Senior Consultant	10%
Junior Consultant	3%

Table 3 illustrates some of the common metrics in the industry. The first section details some key items as percentage of revenues. For example, salaries accounted for roughly half the total revenues, while recruitment

8. Excerpted from “Operating Ratios For Management Consulting Firms” Association of Management Consulting Firms 1999

expenses accounted for less than 1% on average. Other interesting stats were the fact that for each partner, you found 2.5 to 3.5 consultants and about 1 support staff. The average utilization rate of a consultant (often referred to as billable time) was around 59%, which meant that the rest of the time was spent on activities not rebilled to clients.

Leverage could also work in terms of the number of the projects each consultant carried at one time. Size and length of projects also determined the profitability of the firm. Large, long-term projects typically required lower up-front development costs than a group of smaller projects of shorter durations, even when the two amounted to the same total fees.

7. Latest Developments in the Consulting Industry (1995-2000)

The past four years saw terrific changes in industry - the US economy soared back to health from a recession in the early 1990s, unemployment was at an all time low, and the Internet phenomena had reached epic heights, ushering in new industries overnight, and shattering the way business was done.

With release of Mosaic at the University of Illinois in late 1995, the rise of Netscape and the first commercial web browser, the Internet was born followed by thousands of new business ideas. Somewhere between the bull market and explosion of Internet-led technologies in the mid-1990s equity began to take on new meanings. It quickly became associated as the currency of choice in the Internet economy to make corporate acquisitions, acquire and retain staff and pay for business-building services. Fueled by strong returns in the venture capital industry, risk capital began to flood private markets. Initially used as a tool to woo senior management to an early stage venture, options had become a standard component of compensation packages for all levels. With hungry public markets, IPOs went off at a rapid clip, rewarding employees who took stock options or direct shares.

Several new generation of consulting firms emerged during this period. Zefer, Scient, iXL, Rare Medium and Viant provided new services such as business strategy, technology implementation and development and web-based design to both start-ups and large established companies looking to gain an internet presence. These Internet consulting firms could not be more different then the old breed: they eschewed the traditional partnership model, were often well capitalized through IPOs and used marketing to create strong brand awareness at industry events, in the business press, and as a recruiting tool. They commonly evolved from birth to IPO in under two years.

Venture capital funds began to increase in size and number and hybrid venture capital firms - part operating companies, part venture creation also began to emerge. Most popular among them included incubators idealab!, CMGI, Internet Capital Group and divineInterventures. These firms fused

access to capital with operational experience, supposedly enabling firms to go from business plan to market in a much shorter period of time. These so-called incubators or accelerators would screen business plans and accept those which met designated criteria. Upon entrance, the entrepreneur would be hosted in a resource-rich environment and have access to capital and expertise in exchange for equity in the company.

8. The Rise of Service-for-Equity Arrangements

Pricing models were relatively standard across the consulting industry, with clients paying on a project basis for an engagement. Pricing models, such as service for equity, were not new; Andersen Consulting took equity stakes in defense contractors it helped restructure in the 1980s[9]. However, the interest and growth in this method of pricing started to take off with the rapid emergence of a more entrepreneurial environment, fueled by the tremendous increases in equity value, generous stock option plans and more-than-receptive IPO markets, and the consequent loss of human talent to startup businesses.

Many Internet consulting firms started first by providing a combination of capital and services to their start-up client base - sometime as consulting services for equity stakes, or as pure investments in clients or as offering incubation services in return for equity. Those that took equity based compensation in 1999 planned to double the number of arrangements in 2000[10], according to a recent study:

> …the potential for equity participation in well-financed start-ups will increasingly appeal to the management team as they continue to seek the highest margin, most repeatable business…[11]

Spurred on by rapidly evolving business models and industry dynamics, the management consulting industry was changing. Six of the largest audit/ consulting firms had decided to split in order that the consulting arms could circumvent the SEC auditor independence rules by allowing them to take equity in lieu of fees for services rendered or to make direct investments in their clients. McKinsey established eight “business accelerators”, part of @McKinsey, which had already taken stakes in more than 50 clients in 1999 alone; BainLab fulfilled the same functions at Bain & Co.[12] (For recent service for equity arrangements of note, refer to Appendix 1. on page 468)

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9. “Cash? How Old Economy…” The Economist May 6, 2000
10. “IT Services Firms Have A Vested Interest…” EDP Weekly’s IT Monitor April 10, 2000
11. Robertston Stephenson Viant Company Report, December 22, 1999
12. “IT Services Firms Have A Vested Interest…” EDP Weekly’s IT Monitor April 10, 2000

9. Service-for-Equity Arrangements at Whitesmith Consulting

In January 2000, John Peterson asked Sue Ellis, junior consultant, to survey the competitive landscape with regard to service for equity arrangements. Sue embarked on an internal consulting engagement to understand what other professional services providers were doing in this space. After reviewing Sue's benchmark study, he spoke with several senior partners within the firm to better understand her findings.

First was Ted Roland, senior partner in charge of finance at Whitesmith. John presented a summary of the findings as they might have related to Ted's work. He commented:

> My first concern is that of cash flow - our gross margin is largely determined by salaries; can we forego cash in lieu of stock? What percentage of an engagement should the firm take in non-cash securities? This puts a tremendous deal of faith in growth projections. Another issue is the equity itself: how do we value the stock? This could be done through the latest term sheet and post-money valuation, a third party valuation or us valuing potential clients. What about demanding additional equities for the higher risk profile? Should it be stock or options or a combination?
>
> Another critical area is equity management. Clearly, there is not much investment 'management' that can take place, but at what point are equity positions written off or sold? With an IPO, would it be a post-lockup period? What about installing a put provision if options are issued?

Leaving the meeting, John reflected on his coursework in business school and thought about how venture capitalists were well-known for hitting one or two home runs in a portfolio of 10 companies. Could this approach also be leveraged for Whitesmith?

John's next stop was with Ellen McCartney, senior partner in charge of business development. He addressed issues as they relate to the marketing and business development functions. She began:

> Before we go down this road, consider existing alternative pricing models to provide some component of 'service for upside.' In the advertising industry, innovative pricing strategies have become common: performance-based pay ties an agency's revenues to product performance, market share or another metric. A more traditional model is commission, whereby the agency will take a percentage of the media purchase as its fees. In the management consulting industry, value-based pricing sought to come to a client-consultant agreement over the value of services provided and a fraction of the difference, usually a portion of cost savings, would be paid as the fees to the consultant. Finally, fixed time/fixed price models emerged in response to lengthy systems integration projects and disenchanted clients. Assuming the consulting firm has a high degree of confidence in resources required, this can be more profitable than traditional fee models without the associated risk of

service for equity. Look at this chart to get a sense of different pricing models and their frequency of use (see Table 4 below).

Table 4: Consulting Pricing Models and Frequency of Use

Pricing Model	**Percentage of Firms Citing Use**
Project Basis	39%
Hourly	24%
Daily	16%
Time and Materials	7%
Value-based	7%
Monthly	5%
Other	2%

Source: Consultant News, November 1999

There is also the issue of selecting clients. If we need to perform due diligence on potential clients, the proposal pipeline could become clogged. Engagements might take longer. Clients might not like ‘our’ decision to choose ‘them.’ Another issue is that of word of mouth. Basically, if word ‘gets out’ that we are serving clients in this manner, we will get flooded with RFPs (requests for proposals) and a new client profile. That will make my job a great deal more difficult.

The next day John met with Lewis Tayson, general counsel for Whitesmith Consulting. Knowing that there were two key issues, malpractice and conflict of interest, John pressed Tayson for an opinion:

It is not clear that one can serve a client and be an investor at the same time, as these interests aren’t always aligned. This smells like malpractice. How will it be certain that independent judgement will not be clouded, leading to self-serving advice? Although malpractice insurance is available to us, the extent to which it could cover these claims is uncertain. I’ll send you’re a copy of an article I read on this subject. (see Appendix 3 on page 470 for a copy of the report.)

The other issue, conflict of interest.is also vague. Outside of auditing, no firm rules exist, yet some firms have developed thier own onformal or explicit code of ethics. Until recently, advertising firms would not work with competing clients, but they now ofter serve clients whoes businesses compete directly.[13] This conflict has been mitigated by advent of “Chinese walls”, a

13. “Consultants Are Putting A New Price On Advice” New York Times, January 26, 2000

def facto partitiion across consultanct staffed on competing clients. Andersen Consultuing currently works for Federal Express, the United States Postal Service and United Parcel Service.

Holding an equity position in Federal Express would raise a conflict of interest issue with UPS, yet it is up to Andersen (or any other firm) to choose to reveal which clients it serves. Andersen claims this repositions consultants from servicers of businesses to builders of businesses[14], but I'm not sure if I buy it.

Law firms have also been taking equity positions in clients for some time. The supposed conflict of interest could not be greater with a lawyer and client, yet they continued to take place. One third of US lawyers who represented companies that went public in 1999 held stock at the time of the offerings.[15] Venture Law Group, in Menlo Park, California, generally takes a minimum of 1% stake in each client it serves, providing great returns to partners.[16]

Here's another issue for you: at what cost are equities recorded? On the one hand, it would make sense to do so based on fees taken, but that means that ordinary income tax on the book value of that equity must be paid, even though no revenue is received. Later, when (or if) the client reaches its liquidation event, we would pay capital gains. Standard accounting rules tell us we could also record the value of the equity at, say, $.01 per share, as there is not a strong likelihood that we will cash out. Then capital gains will be higher. But to have two book values - one for taxes and another for revenues, doesn't seem right. The corporate tax code isn't clear on this and there have been no legal precedents thus far. It somewhat falls under the category of corporate barter.

John's final stop was to Sylvia Goldberg, partner in charge of human resources. As he suspected, her major concern was that of stemming turnover.

The firm's natural attrition rate has been increasing due to the attractiveness of dot-com work, but will providing equity compensation alter this? Giving our consultants 'skin in the game' can go a long way, if it is equitably distributed. How do we do this? I know we wouldn't want to base equity on those staffed on particular projects and reward only them. What about principals versus junior consultants - do they share equally? I'm skeptical that this can be a panacea.

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14. "…Repositions us from being consultants and advisers to being business partners and really being capitalists,' said Mary A. Tolan, Andersen's managing partner for growth and strategy." Quoted from "Consultants Are Putting A New Price On Advice" New York Times, January 26, 2000
15. "Cash? How Old Economy…" The Economist May 6, 2000
16. "When is a law firm not a law firm?" Inc. 1998.

10. Decision Time: Preparing the Presentation to Partners

John Peterson was cycling through the myriad issues involved in taking equity for service. He would present a proposal to BSTE in two weeks that would also influence Whitesmith's success as a whole. Was this a passing fad or was it for real? What would happen if the stock market continued to tank? The last 2 months had not been too good for internet-related stocks, so could this be seen as the beginning of the end for such companies? How and who should we accept as clients? What "due diligence" up front should we perform? How many of these engagements should we accept? What percentage of revenue should we take on? When could we sell the investment? How would consultants, and the firm, be compensated from the upside potential? How would we account for losses in the deal? Is this going to stem the tide of consultants, or will our best people continue to jump to dot-com start ups?

In dealing with these questions, John felt that he had to keep an eye on the bigger picture as well, which involved finding appropriate answers to the following questions: What were the key issues to consider in the decision to offer equity-for-service deals? Should these be treated as another form of venture capital investments? Where were the major risks and how could they get mitigated? Should this be primarily an investment decision (including portfolio considerations), a marketing and customer acquisition decision or a personnel management decision?

It was now time for him to put the issues on paper as clearly as he could and let his fellow partners argue the desirability to engage into such new business model…

Appendix 1

Recent Announcements Concerning Service for Equity Arrangements (Q2/2000)

- Andersen Consulting will forego $1.2 billion in revenue and develop 22 ‘launch centers’ for dot-com clients which will act as incubators[17]. The centers will provide advice to clients after a first round of financing. In return, Andersen expects to take ownership positions of 5-10%[18].

- The Parthenon Group, a Boston-area strategy consulting firm, has several years’ experience in service for equity arrangements with clients:

> …a Parthenon client can choose to pay cash for services rendered. Many large-cap, public companies would rather part with cash than equity. Those most likely to obtain consulting services in exchange for equity are the small-cap and mid-cap firms, and especially those in the high-tech Internet world, where, as [company president Bill] Achtmeyer puts it, ‘equity is much more often used as a currency to describe and motivate people creating value.’ The Internet-oriented client base has the added effect of allowing Parthenon’s consultants to get a piece of the e-action without having to switch careers.[19]

	1997	**1998**	**1999 (to June)**
Number Equity Compensation Clients	16	14	9
Percentage Equity Compensation Clients	37%	29%	26%
Percentage Revenues in Equity	54%	25%	23%

Source: Consultant News, August 1999

- Organic Online “has taken as much as 30% of a company and as little as 1.5%. [The president]…expects three to go public this year [1999]. ‘I’m expecting 15-30 percent of our revenue base will come from profits based on these IPOs.’ For every equity deal it does -

17. “Cash? How Old Economy…” The Economist May 6, 2000
18. “If You Can’t Beat Them, Invest In Them…” The Independent April 23, 2000
19. “The Case Of Consulting For Equity” Consultant News August 1999

always getting expenses in cash, Organic turns down 20 to 40 offers from startups…'[20]

- McKinsey & Company "…has taken small stakes in more than 50 clients, in exchange for lower fees. Across Europe and North America, the firm is opening eight 'business accelerators,' where consultants will spend up to nine months helping to start companies in which the firm could own a stake."[21]

- CREDO Group links fees to "equity, equity options or a link to future revenue/profit performance."[22]

Appendix 2

Whitesmith Consulting Financials and Key Staff Turnover Metrics

BSTE Year End Financial Results (FY Ending 31 December 1999)

	Figures in $000	
Revenues		$112,358
Cost of Service		
Salary Compensation	$47,343	
Other Compensation	$22,343	
Other	$19,890	$89,576
Gross Margin		*$22,782*
SG&A		$14,797
Operating Income		*$7,803*
Interest Expense		$1,410
Income Before Tax, Distributions		**$6,393**

20. 'IPO Craze Has Contractors Asking…' Internet World April 19, 1999
21. 'Consultants Are Putting A New Price On Advice' The New York Times January 19, 2000
22. "CREDO Develops Yardstick To Value…" Company news release October 21, 1999

Voluntary Staff Turnover Rates, 1992-1999

	1992	1993	1994	1995	1996	1997	1998	1999
Whitesmith	5%	6%	5%	7%	6%	10%	12%	18%
BSTE Practice	N/A	17%	18%	18%	21%	28%	32%	37%
Industry Average	10%	9%	11%	10%	12%	15%	15%	16%

Appendix 3

Copy of news article provided to John Peterson from Lewis Tayson

Auditors are under tremendous scrutiny when performing work for clients. The US Securities and Exchange Commission maintains regulations on this independence, which basically prevents ownership of any publicly traded companies with which the audit firm does business. This has become increasingly difficult with the consolidation in the professional services industry and the rise in consulting services. As such, consulting firms have sought to carve out their own independence. This was first demonstrated with the separation of Andersen Consulting from its tax and audit group, Arthur Andersen, in 1989. Additional information about the ‘fate’ of the Big Five appears below:

Auditor Independence Prompts Consulting-Audit Divorces

Parent Company	Spin Off	Details
BDO Seidman	Consulting Unit	Expected June, 2000[a]
Ernst & Young	Ernst & Young Consulting	Acquired by Cap Gemini, February 2000[b]
KPMG	KPMG Consulting	S-1 Filed April, 2000[c]
Andersen Worldwide	Andersen Consulting	Separated in 1989, IPO under discussion
PwC	Consulting Unit	Separation approved, spin off expected[d]
Deloitte & Touche	Deloitte Consulting	Spin off/separation under discussion[e]
Grant Thornton	Consulting Unit	Intention to go public. Announced February, 2000[f]

a.“Accounting Firm BDO Seidman...”Dow Jones Business Week May 8, 2000
b. “A Big Five Firm Gets A Lot Smaller” Business Week March 13, 2000
c.“KPMG Consulting Plans...” Houston Chronicle May 5, 2000
d.“Ernst & Young Executive...” Dow Jones News Service February 29, 2000
e.“Ernst & Young Executive...” Dow Jones News Service February 29, 2000
f.“Grant Thornton Takes Actio To Unlock..” Company News Release February 25, 2000

More recently, PricewatershouseCoopers was found guilty of widespread conflict of interest violations. The majority of the firm’s 2,700 partners held equity positions in clients in which the firm did business. The SEC maintains that “any connection between the auditor and the company that is being audited is a threat to the independence of the auditor.”[23] Many of the larger professionals services firms have thus decided that creating complete independence will accomplish several objectives: to circumvent SEC concerns, release value of e-business consulting groups through public offerings or sales, and create a decidedly Internet culture which is able to reward and retain employees.

23. “Spinning Off e-Business Consulting…” Computer Reseller News February 21, 2000