KPMG Draws Regulatory Scrutiny Over a Cisco Investment in Its Unit

By Elizabeth McDonald
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The Big Five accounting firm KPMG LLP, in a move that has drawn regulatory scrutiny, has restructured a part of its global consulting arm by incorporating a new unit called KPMG Consulting Inc.

At the same time, KPMG has also sold $1.05 billion of convertible preferred stock in the new unit to Cisco Systems Inc., the San Jose, Calif., computer-networking company. KPMG plans to allot $630 million to its audit and tax businesses, with the remainder flowing to the new KPMG Consulting unit. The new unit initially will wrap together the firm's existing consulting practices in the U.S. and Mexico, with consulting operations in Asia, Latin America, Canada and Europe expected to join later this year.

Cisco is expected to convert its preferred shares into a 19.9% stake in the unit, but that's contingent on KPMG getting approval from the Securities and Exchange Commission for an initial public offering for the unit. Until then, KPMG and its partners will own the new entity. The IPO "may come by late spring or early summer," said Stephen G. Butler, KPMG's chairman and chief executive, who is also now chairman of the new subsidiary.

Concern With Conflicts

But the SEC could reject the IPO due to growing concerns over potential conflicts of interest. Already SEC Chief Accountant Lynn Turner has written a lengthy letter to KPMG noting that any outside ownership in a division controlled by KPMG, while the firm still maintains an audit practice, could place KPMG in violation of the agency's auditor-independence rules.

While KPMG doesn't audit Cisco, the SEC finds problematic a tangle of business relationships that outside companies such as Cisco could bring to this deal, according to the letter. That would include the dozens of alliances Cisco has with other public companies, many of which can be, or eventually could become, KPMG audit clients. At the same time, other new investors in the unit could present similar conflicts. "The public-policy question here is this: Is it appropriate to allow corporate clients to invest in their auditors under these kinds of arrangements?" said Mr. Turner.

The Independence Standards Board, a separate panel of accounting and SEC officials seeking to bolster auditor independence, is currently debating the propriety of the new unit and KPMG's IPO (Mr. Butler sits on this panel). It hasn't yet reached a decision permitting or restricting such offerings. KPMG is confident the new unit will pass regulatory muster.

Profound Changes
Such stepped-up regulatory scrutiny is behind enormous, fundamental changes roiling the accounting profession. They include Ernst & Young's plans to sell its entire consulting division to Cap Gemini Group SA, and PricewaterhouseCoopers's own plans for a restructuring. Many accounting and consulting officials believe all of the Big Five's consulting divisions will be separated off in the next year or so.

"The Big Five have all come to the conclusion that consulting is too problematic to exist within accounting partnerships," said Tom Rodenhauser, industry analyst who runs consultinginfo.com (www.consultinginfo.com\(^1\)). The firms "want to move before the SEC forces their hand," he added.

But no other Big Five firm has been as aggressive as KPMG in trying to push the SEC's hand and revolutionize the accounting profession. "We would rather create the change than react to it," Mr. Butler said. Mr. Butler noted the independence panel received about 40 letters, many from institutional investors, "that were generally supportive of these kinds of transactions because they see very little risk to auditor independence" in these deals.

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