KPMG International Overview

KPMG International (KPMG) defines itself as a global network of professional services firms providing audit, tax, and advisory services. The company has 113,000 professionals in 148 countries around the world.

KPMG is a Swiss cooperative, operating as an umbrella organization for member firms. It organizes its structure into 3 divisions Europe, the Middle East, and Africa; the Americas; and Asia-Pacific. Each division operates in three business segments composed of audit, tax, and advisory.

KPMG's audit division provides independent auditing services. It will also provide clients with the resources necessary to improve internal controls. They also have the Audit Committee Institute (ACI), which assists audit committee members in keeping up with evolving business governance issues.

The advisory practice gives advice and assistance to enable companies and the government to mitigate risk and improve performance. It also helps clients develop long term strategies.

KPMG's tax division offers services relating to tax compliance and tax risk. There are a number of global service lines including: business tax, international corporate tax, and indirect tax. These services create value by helping companies to fulfill their compliance responsibilities, tax planning, and communicating between markets and regulators.

Audit	Advisory	Tax
Statutory Audit Financial Statement Audit Audit Related Services: International Financial Reporting Standards US GAAP reporting services Prospective reporting Other forms of audit and attestation reporting	Accounting advisory services Business Performance Corporate Finance Financial Risk Management Forensic Internal Audit Services IT Advisory Restructuring Transaction Services	Personal Tax Business Tax: International Corporate Tax Global Indirect Tax services Global Transfer Pricing Services Global Tax Outsourcing Global Mergers and Acquisitions International Executive Services

KPMG was formed in 1987 by the merger of Peat Marwick International (PMI), Klynveld Main Goedeler (KMG), and their subsidiaries. The company strengthened its international operations by separating into three separate sectors, each managed by a senior partner: Europe, the Middle East, and Africa; the Americas; and Asia-Pacific. Since that time the company has maintained an impressive growth rate to become the fourth largest accounting firm in the world. It is also the most international, with operations in more countries than any other firm. Although it is smaller than the other "Big Four" firms in the United states, it's American subsidiary, KPMG LLP's 95 domestic offices and KPMG's over 100 years of experience serving clients are a testament to the company's strength. (DataMonitor, 2010)

Competitive Environment

The public accounting profession is a highly concentrated industry that has only increase over the past decade. The "Big Six" of the early 90's are now the "Big Four" since the merger of PriceWaterhouse and

Coopers & Lybrand, and the collapse of Arthur Andersen. When Andersen failed the remaining "Big Four" absorbed most of the firm's business. The "Big Four" include Deloitte & Touche, PriceWaterhouse Coopers, Ernst & Young, and KPMG. These four firms together audit 78% of all public companies comprising 99% of public company sales; therefore, they effectively retain an oligopoly over the public accounting industry. The services which each firm provides are virtually indistinguishable from one another, even for those trained in accounting. They all generate the largest portion of revenue from audits, followed by taxation services, and then advisory. (Accounting, Auditing, and Bookkeeping services, 2011) (O'Rourke, 2006)

The advantages that size bestows upon accounting firms go far beyond economies of scale. Public companies turn to the "Big Four" without fail because no other company is large enough to back a collateral bond. In other words, companies want a company that is big enough that if there is a mistake or a problem, the client can obtain restitution. (O'Rourke, 2006)

KPMG LLP's Tax Practice

In 2005, KPMG was forced to pay a settlement to the IRS of $465 Million and accept government oversight for 3 years thereafter. They were also forced to pay their tax clients $156 Million in damages. This amounted to 15% of KPMG LLP's revenues for 2005. The issue stemmed from accusations from the IRS that KPMG was selling tax shelters for its clients. These tax shelters had supposedly allowed a select group of wealthy individuals to avoid paying over $2 Billion in taxes. When congress found out about these tax shelters, not only were they banned for the future, as is usually the case, but anyone using them was also retroactively charged with tax evasion. Although other firms had been selling these tax shelters, KPMG was hit especially hard because it resisted an investigation by the Department of Justice.

The Oxford English Dictionary defines tax shelters as "an opportunity for incurring expenses so that they can be used to reduce tax liability." (Weiner, 2011) Accounting firms are able to structure transactions so that the end result will be an accumulation of "paper losses" which can then be used to offset real gains on an income tax return. The accounting firm will then take a fee for allowing the transaction to happen, since firms are not allowed to charge contingent fees, an individual is usually not entitled to a refund if the tax shelter is challenged by the IRS.

IRS rule stipulate that for a loss to be tax-deductible, it must have a legitimate business purpose other than tax avoidance. The entity must prove to the IRS that the tax shelter does indeed have a business purpose and that it has economic substance. What constitutes a business purpose and economic substance is anything but clear. IRS rules and court decisions defining these rules are vague, confusing, and inconsistent. (Higgins, 2011) (Higgins, 2011) Therefore, firms usually assess a probability of the IRS accepting the tax shelter or challenging the transaction. Usually, if a tax shelter is "more likely than not" to be accepted by the IRS, the firm will market it to potential customers. (O'Rourke, 2006)

The federal investigation into KPMG involved four separate tax shelters, BLIPS, FLIP, OPIS, and SC2. BLIPS, which stand for Bond Issue Linked Premium Structures, were KPMG's most successful product. They were sold to 186 wealthy individuals with over $20 million in ordinary capital gains income. The tax shelters generated over $53 million in revenue for KPMG.

KPMG and Presidio, an investment bank, would approach wealthy individuals and offer a transaction that would generate a loss to offset capital gains. Presidio arranged the necessary investments and financing while KPMG and a separate law firm, Brown & Wood, offered an opinion letter stating that it was "more likely than not" that the tax loss would survive an IRS challenge. This was to provide some assurance of retrieving restitution if the idea fell through.

BLIPS worked by having the taxpayer form a limited liability corporation(LLC) and contributing cash equal to 7% of the gain to be offset(usually $1.4 million). The LLC obtained a loan from a bank for about $50 million, at an above market-rate of interest. The LLC would receive a loan premium equal to the amount of the gain to be offset. The LLC then agreed to severe restrictions on the loan to reduce credit risk. They had to maintain 101% of the loan amount in cash or liquid securities.

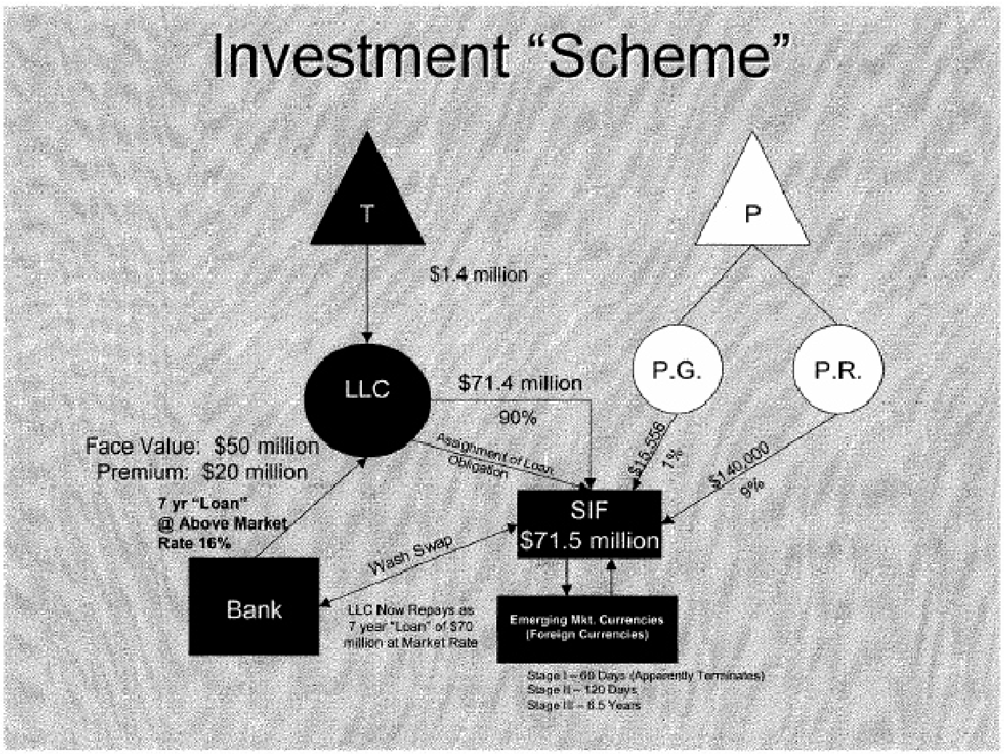
Next, the LLC would form a partnership with two affiliates of Presidio known as a Strategic Investment Fund. The LLC received a 90% partnership interest, one of the affiliates received a 9% interest, and the other affiliate received a 1% interest and assumed the role of managing partner.

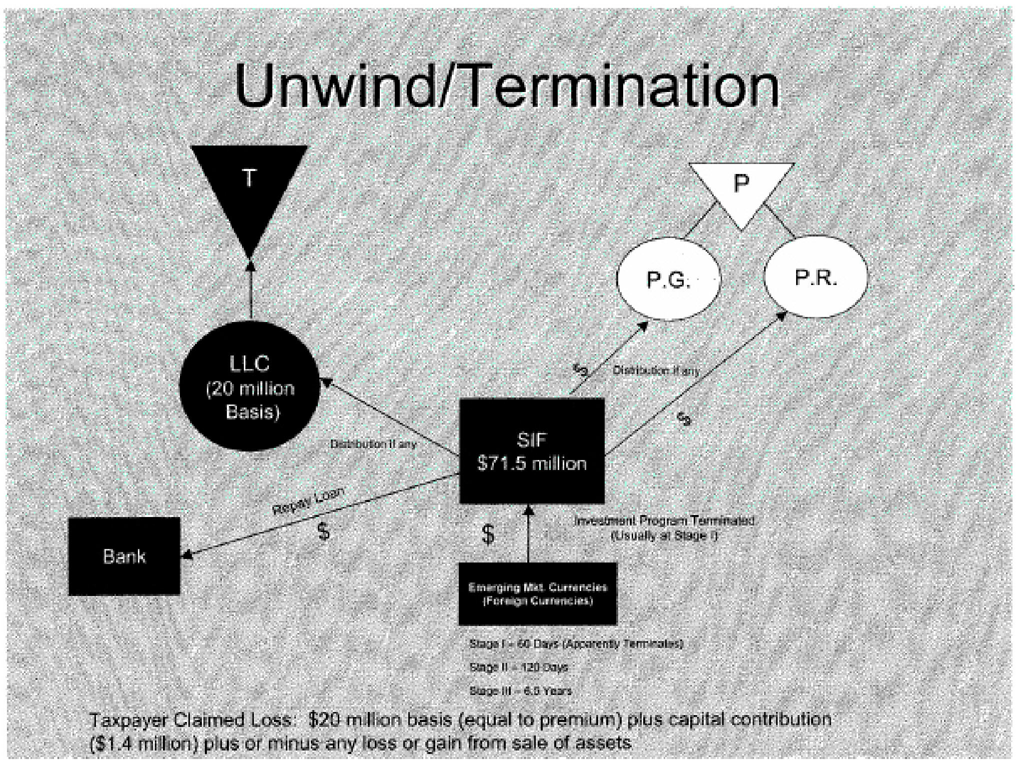
The LLC then contributed all assets, including the loan, the loan premium, and the cash contribution, to the partnership. The two affiliates also contributed cash in the amount of 10% of the LLC's total assets or about $155,000. The Fund then had total capital of $71.6 million. The partnership assumed obligation to repay the loan. At this point, the Fund entered into an interest rate swap with the bank, which effectively reduces the interest rate of the loan to a market based rate.

The Fund converted most of the US dollars to Euros with a contract to convert back to US dollars in 30-60 days. The Fund used the Euros to engage in short-selling low-risk foreign currencies, which were monitored by the bank to ensure the restrictions on the loan were not violated. This was to provide a token business purpose for the transaction.

After 60-180 days, the LLC withdrew from the partnership and the partnership was liquidated. All of the Euros were converted back to US dollars, which were then used to pay off the loan. Any remaining assets in the partnership were divided among the three owners and the LLC sold any securities it had obtained at fair market value.

For tax purposes, the LLC passed its gains or losses to the individual owner. The opinion letter issued by KPMG and the law firm stated that the LLC should be able to claim both the cash contribution of $1.4 million and the $20 million of loan premium as losses for tax purposes. This is how the original gain of $20 million was claimed to be offset. KPMG profited through the receipt of up to 7% of the imaginary loss figure. (O'Rourke, 2006)





The Justice Department knew that if it indicted KPMG on criminal charges it would have meant the end of the company. The professional staff of KPMG would not risk being with a company whose reputation was called into question. Arthur Andersen had lost almost all of its staff and customers almost as soon as it went to court. A reluctance to see the industry become even more concentrated probably resulted in the hefty settlement against KPMG, instead of the indictment. (Sloan, 2005)

As part of the settlement, KPMG also agreed to allow an independent monitor to oversee KPMG's operations for the next 3 years. Former SEC chairman Richard Breeden was the one selected to monitor KPMG's compliance. He was also the corporate monitor for WorldCom Inc. on behalf of the US district court. The settlement also bans KPMG from offering prepackaged tax products and restricts KPMG from charging fees not based on hourly rates. They were also required to make a public admission of wrongdoing which caused a number their partners to be sued. (Glater, 2005)

The fines and restrictions resulted in KPMG being at a marked disadvantage to other firms in the industry. Not only was the loss of so much revenue a significant burden to maintaining future performance the company had to contend with numerous weaknesses due indirectly to the incident. These included:

-Reduced ability to offer discounts

With a smaller size, profits from certain segments could not be used as effectively to offset losses in another segment. Since firms frequently offer discounts to attractive clients in order to secure business in the future, KPMG was at a disadvantage. It did not have as much profits that it could use to cut prices in other areas.

-Increased fixed cost hurdles

With KPMG's revenues in decline, the company was left with a large amount of idle capacity, including buildings and computers that went unused. Since these items still incurred fixed costs, the company was stuck with paying down costs that were not generating revenue for the company. The company also had less ability to take advantage of economies of scale.

-Reduced breadth and depth

The sheer reduction in size meant that KPMG could not offer as large a network of experts as its competitors. The company would have difficulty convincing its customers that it could offer solutions to any problem a client might have. Many partners were also indicted after the settlement, which caused some of KPMG's best talent to move to other firms.

-Reduced opportunities for advancement

Many talented accountants also were afraid to work at KPMG, because they perceived the smaller size would offer them less opportunity for advancement.

-Reduced bargaining power

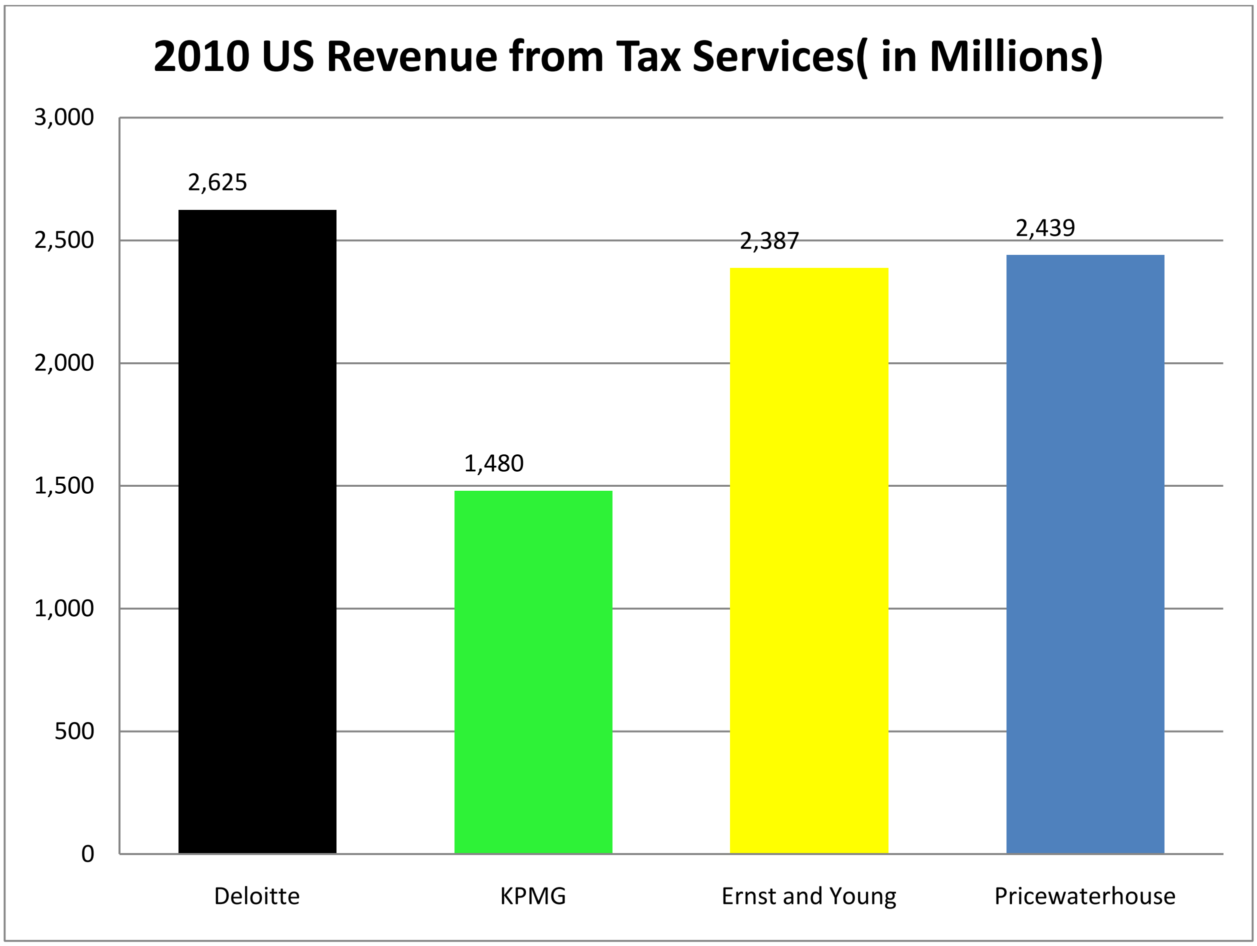
The "Big Four" relied heavily on their extensive abilities to charge top dollar for their services.

A junior accountant with 0-2 years of experience bills $120-$250 per hour.
A senior accountant with 3-5 years of experience bills $250-$350 per hour.
A manager with at least 5 years of experience bills anywhere from $350 to $600 per hour.
The partner's time is typically billed for at least $600 per hour. (Robillard, 2009)

Knowing that KPMG is in dire need of added revenue, clients may intentionally offer below market rates. This dilutes the value of KPMG's services over times and defeats its ability to be considered a premium firm.

-Increased government oversight

KPMG was banned from a number of practices which other firms were still allowed to perform, such as offering prepackaged tax products. They also had to contend with increased reporting requirements and a government overseer. This limited the ability of KPMG to expand and wasted time and resources. (DataMonitor, 2010)



The practice is now roughly 60% the size of the other firms. (KPMG, 2011) (Kautter, 2011) (Hoovers Inc, 2011) (Hoovers Inc., 2011) (Deloitte, 2011)

KPMG's Response

After being set at such a market disadvantage after the crisis, KPMG struggled to retain its reputation for integrity. Its strategy was basically, to the best of its abilities, converting its new weaknesses to strengths in the eyes of its clients.

Seeing that it was substantially smaller than its competitors, the company offered a more personalized service that could better address the needs of individuals. The new restrictions imposed by the federal government actually helped with this assertion. Since KPMG was forced to only charge for hourly work, they were able to gain a competitive advantage in more personalized services that accountants would bill for the hour with.

The increased government oversight became an advantage to KPMG, since it was able to say it was in closer compliance with regulations than any other firm that was not being monitored. As long as there were no further issues that came up, KPMG was able to argue that its service was more reliable than anyone else's. (Kautter, 2011)

Finally, KPMG was able to counteract the flight of many of its best people by creating a corporate culture that was warmer and more familiar than other firms. They emphasized work-life balance, boasting the shortest number of hours worked. They had many successes in keeping employee satisfaction high, including a 2009 initiative in London which reduced the number of work days for some London offices to four days as an alternative to laying off people when the market turned for the worse. The initiative was widely accepted, as many of the associates preferred taking a little time off with reduced pay to being completely laid off. (KPMG, 2011)

The firm also reasserted a commitment to corporate social responsibility by sponsoring employees to take time off to help with community service initiatives and by undertaking several green initiatives, including tracking each employee's carbon footprint and looking for ways to reduce carbon emissions. In 2010, Yvo Deboer, one of the leading experts on climate change, left his post at the UN to work with KPMG. (DataMonitor, 2010)

The company was able to outrank many of the other "Big Four" firms in its commitment to corporate social responsibility, and thus restored some of the goodwill it had previously lost.

Looking forward

Although KPMG has had some significant successes in reducing the impact of its tarnished reputation, the company's tax segment revenue still lags behind its competitors and may be at a disadvantage for a number of years. Considering there are only 10,000 individuals with incomes more than $20 million per year in the United States, it can be safely said that KPMG has already completely alienated at least 2% of the lucrative potential market for tax shelters merely because of that one incident. Considering that many of these wealthy individuals probably either control public corporations that do substantial business with accounting firms or are able to influence others who do, this will have a substantial impact on business for a long time. (Smith, 2011) (KONIGSBERG, 2006) The settlement that KPMG paid to its former clients did not serve to completely cover the losses that they incurred from the collapse of their tax shelters and it can certainly be expected that there will be hard feelings from this. (Browning, 2005)

However, KPMG has the opportunity to significantly expand its tax business in the US at this time. Congress appears set to perform a major overhaul of the tax code in order to rein in spending and increase revenues. There is talk of increasing tax brackets to put a higher tax burden on the super rich which means the demand for tax shelters and other services will increase. (Emanuel, 2011) There can also be expected to be a higher demand for auxiliary services whenever there is a significant change in the tax code. "Big

Four" accounting firms saw huge revenue increases after the enactment of the Sarbanes-Oxley Act in response to the Enron scandal, which put tighter restrictions on firms. (Niederjohn, 2006)

In order for KPMG to expand its business back up to pre-2005 levels, there are a number of actions KPMG International could take:

1. Concentrating resources on a few high profile segments that can help KPMG expand its reputation.
2. Widening recruitment efforts to obtain the best people.
3. Performing a nationwide audit of the tax practice to ensure there are no questionable practices taking place.

With KPMG's limited resources, they are at a distinct disadvantage to larger firms, who can subsidize certain products to increase their market share or achieve some other strategic objective, for a longer time than KPMG can afford to. This risk can be mitigated, however, if KPMG stays away from trying to compete across the board and identifying key opportunities that will allow the company to expand its reputation. KPMG International should authorize funds for use in subsidizing KPMG's projects in the amount of several million dollars. The use of these funds will be justified by the use of a decision matrix, which will assign a point value to each characteristic of the deal based on a predefined set of criteria. The higher the score on the decision matrix, the more funds should be authorized to secure the deal and subsidize the firm's profits. In this way, KPMG can choose the best jobs to offer discounts for and focus its resources on the best jobs out there.

KPMG should also expand its recruitment efforts to attract the highest quality talent to its organization. KPMG has many notable advantages over other firms and yet the number of applications it receives for job openings pale in comparison to other firms. While KPMG admits more than 30% of applicants, Deloitte admits a mere 2%. Deloitte receives over 5 times as many applications per year as KPMG does, while PwC received over 3 times as many. (Businessweek, 2007)

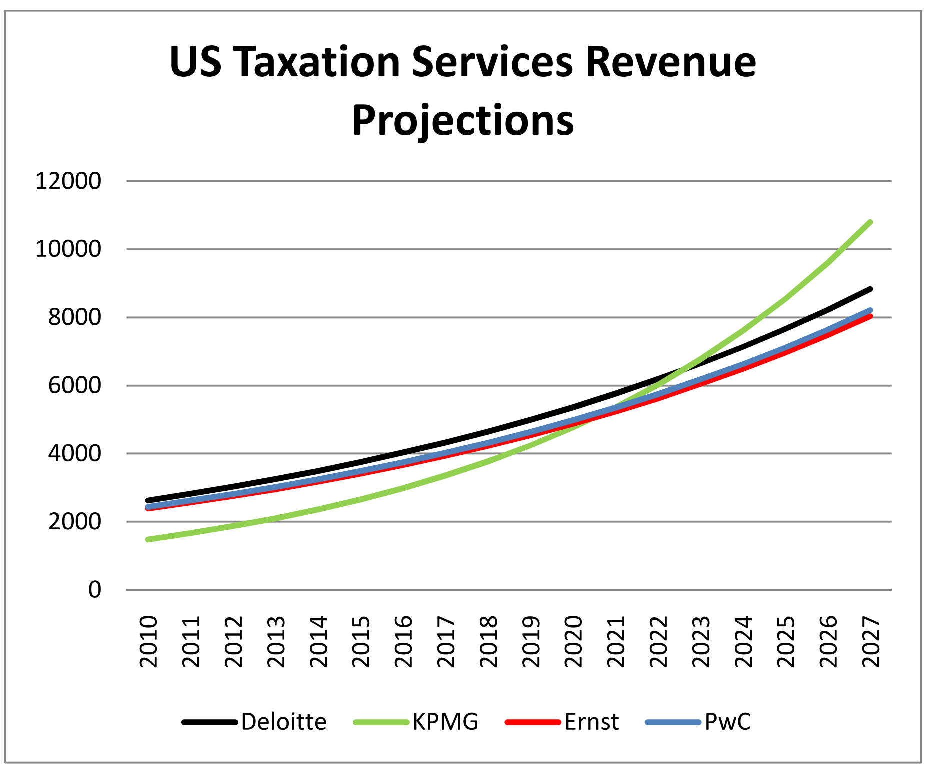
With compensation packages that are virtually indistinguishable from one another, this should not be the case. KPMG has more employees who make over 70k a year than any other firm, it also boasts the best work life balance, with the fewest number of hours worked per week. (Businessweek, 2007) I believe the problem is in how KPMG markets itself to potential employees that causes the bulk of its problems. Although KPMG recruits at more Universities than any other "Big Four" firm, its operations are relatively low key and personal. Take American University as an example, KPMG has no job postings on the Career Website and the only events that they sponsor are mock interviews that take place in a one on one setting. KPMG has a limited opportunity to interact with a large number of students at once.

KPMG needs to do something different to attract attention and address a large group of potential employees. The best way that KPMG could do this is host debates on accounting topics in which students or professionals are invited to participate. The recent 60 minutes cover story on foreign taxes being trapped overseas shows how tax issues penetrate into mainstream society. Colleges, already known as being forums for the discussion of government policy, would be excellent places to host debates on taxation. In return, KPMG would be able to get its name out to the next generation of leaders and identify some of the strongest students at the University with a particular passion for their field of interest. KPMG should take similar initiatives at other accounting organizations such as the AICPA, where KPMG has developed relationships and frequently identifies talent. By encouraging member firms to host such debates, KPMG can not only learn about accounting and identify talented individuals; it can also increase awareness of the firm to an unprecedented level.

Finally performing an audit of the tax practice to identify any questionable activities, including tax shelters, would increase KPMG's credibility in the United States. The audit could be performed by the umbrella organization, KPMG International so that some degree of independence could be maintained. The audit would most likely be to affirm that "no illegal or potentially illegal tax shelters are being sold by KPMG." Although public information is not available on what KPMG's tax products are, they almost undoubtedly still include some tax shelters. Tax shelters are not necessarily an unethical product, as a matter of fact, some tax shelters, including passive losses generated from low-income housing, are encouraged in the tax code. (Higgins, 2011) It is unrealistic to expect KPMG LLP to eliminate tax shelters completely from its portfolio, however, KPMG should be especially on the safe side when it comes to these tax shelters, and should set of goal of "reasonably assured" rather than "more likely than not" that the IRS will accept the tax shelter when deciding whether to market it or not. The audit should also ensure that the "tone at the top" matches the corporate culture in general.

Before any of these measures are implemented, a survey of all US partners should be taken to see whether they agree on the proposed changes. Partners may be unwilling to take advantage of the opportunities which KPMG offers if they do not give their "buy-in" before hand, especially because partners are legally each part owners of the firm.

If KPMG can achieve a growth rate that is 5% above that of the other "Big Four" it could surpass the other firms in 10 years. KPMG is in an excellent position to capture market share with its global advantage over other firms and its experience in providing highly personalized services.



During the mid-200's most of the "Big Four's" resources were focused on gearing up for Sarbanes-Oxley. As a result, some of their smaller and medium sized clients left to smaller firms which offered more personalized services. The "Big Four" have alienated many of their smaller clients by their distancing of the people who seal the deal with the people who actually do the work. KPMG has now positioned itself as the most "personal" of the "Big Four" accounting firms and is, therefore, in a good position to obtain new business from these smaller clients who may need the services which a larger firm can provide. (Accounting, Auditing, and Bookkeeping services, 2011)

At the same time, as US firms are increasing their exports there is more of a need for a firm with global operations. KPMG boasts more firms in more countries than any other accounting firm in the world. Services such as Global Transfer Pricing and Global Tax Outsourcing should be able to increase their US market share dramatically over the coming years.

By making short-term investments in internal audits and discounts, KPMG can capture these promising new markets and bring in new opportunities for growth. KPMG International should sponsor this initiative, since it will be one of the largest beneficiaries. As long as KPMG is smaller than its competitors, it suffers from numerous disadvantages that limit its profitability. But by providing the resources to level the playing field, KPMG can again rise above the competition and become a US market leader once again.

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