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KPMG's Flynn Takes the Helm At a Stormy Time

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New York – In 2003, KPMG LLP executive Timothy Flynn co-wrote a book called "Risk: From the CEO and Board Perspective." A section titled "What Can Bring Your Business Down?" includes a warning: "Damage to a company's integrity can fell an organization if enough blows are sustained."

Mr. Flynn, named chairman and chief executive of KPMG last week, is the one battling such blows today, trying to minimize the damage to the nation's fourth-biggest accounting firm by revenue.

Mr. Flynn, 48 years old, succeeded Eugene O'Kelly, 53, who had led KPMG since 2002. The company said the move was tied to Mr. O'Kelly's recent diagnosis of advanced-stage cancer. It came as the company was grappling internally with another development: Federal prosecutors had told the firm that they had built a criminal case against it for alleged obstruction of justice and the sale of abusive tax shelters and were debating whether to indict the firm.

Yesterday, KPMG released a damage-control statement, rare in its directness: The firm said it "takes full responsibility for the unlawful conduct by former KPMG partners" during a 1996-2002 push to sell the tax shelters that the U.S. government maintains cheated the Treasury of billions of dollars. "We deeply regret that it occurred."

The statement detailed steps KPMG has taken over the past year or so to distance itself from the once-lucrative tax-shelter business. KPMG no longer sells "the services in question," pushed out "those responsible for wrongdoing" and put in place "reforms to ensure the highest ethical standards," it said.

But the challenges that remain for Mr. Flynn are immense. First is seeking to negotiate a settlement with the government to stave off the indictment.

Mr. Flynn also may well be busy calming some clients and shoring up staff morale, which has been worn down in the year and a half that the firm has been under investigation by the U.S. attorney's office in Manhattan. He also may have to work to avoid defections by some of the firm's most-senior executives. KPMG declined to make Mr. Flynn available to comment.

"These guys have got to wake up and get these things right," says Victor Germack, president of RateFinancials Inc., a New York firm that rates public companies on governance and financial-reporting quality. "Changing the firm's culture about tax issues while still maintaining high-quality audits is going to be the challenge."

Mr. Flynn previously served as vice chairman for audit and risk-advisory services and has been prominent in the accounting world. He joined KPMG 26 years ago, armed with an accounting degree, and has worked much of his career away from the headquarters in New York. His clients have included General Mills Inc., Pepsi Bottling Group Inc. and Aramark Corp.

As government scrutiny of tax shelters has mounted since 2002, KPMG has made a concerted effort to promote audit-side partners like Mr. Flynn, while more than two dozen executives in its tax-services unit were pushed out. Those ousted include a past deputy chairman and a chief financial officer. In April it fired an additional three tax executives.

In the past few months, KPMG has paid millions of dollars to resolve several civil lawsuits brought by entrepreneurs and other wealthy individuals who bought the now-dubious shelters. "I've seen a change in attitude in the course of these cases," says Edmundo Ramirez, an attorney for some of these former clients.

Still, in March, KPMG received a tongue-lashing from a federal judge in Florida over its attempt to seek arbitration with one tax-shelter buyer after two years of "aggressively" litigating the dispute in federal and state courts. "This court cannot condone such a mockery of the legal system," U.S. District Judge Anne Conway wrote in her order, saying KPMG's reasoning "strains credulity."

Another issue is whether the firm can keep on board its most-talented auditing partners. In Mr. Flynn's favor is that pulling out invested capital is generally difficult, says Peter Meder, a recruiter who specializes in professional-services businesses. While retiring partners can specify whether they want capital returned in a lump sum or over a period of years, those quitting sometimes have less flexibility.

If partners choose to leave, there also may be noncompete clauses in their contracts preventing them from joining rivals Deloitte & Touche LLP, Ernst & Young LLP or PricewaterhouseCoopers LLP.

On the bright side for Mr. Flynn, the move away from tax-shelter sales comes as accounting firms are enjoying strong increases in audit fees. In 2004, KPMG reported a 4% decline in revenue from its tax business to $1.37 billion, but audit revenue surged 16% and overall U.S. revenue increased 8% to $4.1 billion.