KPMG CONSULTING INC
Form 10-Q
February 12, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

[X] Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934 for quarterly period ended December 31, 2001.

[_] Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period _________ to __________

Commission File Number 000-31351

KPMG CONSULTING, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	22-3680505
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identificatio
1676 International Drive, McLean, VA	22102
(Address of principal executive office)	(Zip Code)

(703) 747-3000
(Registrant's telephone number, including area code)

(Former name, if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file reports), and (2) has been subject to such filing requirements for the past 90 days.

YES X NO _______

The number of shares of common stock of the Registrant outstanding as of January 31, 2002 was 156,697,943.

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KPMG CONSULTING, INC.

QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED DECEMBER 31, 2001

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PART I, ITEM 1. - FINANCIAL STATEMENTS

KPMG CONSULTING, INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(in thousands, except share and per share amounts)
(unaudited)

	Three Months Ended December 31, 2001	Three Months Ended December 31, 2000
Revenues	$ 593,218	$ 702,604
Costs of service:		
Professional compensation	247,746	276,208
Other direct contract expenses	155,543	196,589
Other costs of service	57,000	78,005
Total	460,289	550,802
Gross margin	132,929	151,802
Selling, general and administrative expenses	114,815	111,086

Operating income	18,114	40,716	
Interest (income) expense, net	(27)	5,560	
Loss on redemption of equity interest in affiliate and equity in losses of affiliate	-	63,310	
Income (loss) before taxes	18,141	(28,154)	
Income tax expense	11,547	9,417	
Income (loss) before cumulative effect of change in accounting principle	6,594	(37,571)	
Cumulative effect of change in accounting principle	-	-	
Net income (loss)	6,594	(37,571)	
Dividend on Series A Preferred Stock	-	15,836	
Net income (loss) applicable to common stockholders	$ 6,594	$ (53,407)	$
Earnings (loss) per share - basic and diluted:			
Income (loss) before cumulative effect of change in accounting principle applicable to common stockholders	$ 0.04	$ (0.70)	$
Cumulative effect of change in accounting principle	-	-	
Net income (loss) applicable to common stockholders	$ 0.04	$ (0.70)	$
Weighted average shares-basic and diluted	158,340,791	75,760,067	

The accompanying notes are an integral part of these financial statements.

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KPMG CONSULTING, INC.
CONSOLIDATED CONDENSED BALANCE SHEETS
(in thousands, except share and per share amounts)

	December 31, 2001 (unaudited)	June 30 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 101,008	$ 45,9
Accounts receivable, net	295,360	377,4
Unbilled revenues, net	144,451	180,3

Prepaid and other current assets	92,263	101,0
Total current assets	633,082	704,7
Property and equipment, net	65,532	66,9
Goodwill and other intangible assets, net	159,203	189,3
Other assets	32,869	38,5
Total assets	$ 890,686	$ 999,6
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of notes payable	$ 8,781	$ 11,5
Acquisition obligation	15,000	15,0
Accounts payable	53,528	65,6
Accrued payroll and related liabilities	139,881	174,8
Other current liabilities	97,709	86,9
Total current liabilities	314,899	354,1
Notes payable, less current portion	629	1,8
Other liabilities	10,208	11,5
Total liabilities	325,736	367,5
Stockholders' equity :		
Preferred Stock, $.01 par value 10,000,000 shares authorized	-	
Common Stock, $.01 par value 1,000,000,000 shares authorized, 160,018,728 shares issued on December 31, 2001 and 158,568,922 shares issued on June 30, 2001 (including 999,006 shares reserved on December 31, 2001 and June 30, 2001, and 2,330,000 treasury shares on December 31, 2001)	1,590	1,5
Additional paid-in capital	669,016	656,2
Accumulated deficit	(65,574)	(14,5
Notes receivable from stockholders	(10,094)	(7,9
Accumulated other comprehensive loss	(2,515)	(3,2
Common stock held in treasury, at cost	(27,473)	
Total stockholders' equity	564,950	632,1
Total liabilities and stockholders' equity	$ 890,686	$ 999,6

The accompanying notes are an integral part of these financial statements.

KPMG CONSULTING, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	S
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Cash flows from operating activities:	
Net income (loss)	$ (5
Adjustments to reconcile to net cash provided by (used in) operating activities:	
Cumulative effect of change in accounting principle	7
Loss on redemption of equity interest in affiliate and equity in losses of affiliate	
Depreciation and amortization	2
Deferred income taxes and other	(
Changes in assets and liabilities:	
Accounts receivable	8
Unbilled revenues	3
Prepaid expenses and other current assets	(
Other assets	1
Accrued payroll and related liabilities	(3
Accounts payable and other current liabilities	
Distribution payable to managing directors	
Net cash provided by operating activities	14
Cash flows from investing activities:	
Purchases of property and equipment	(1
Businesses acquired, net of cash acquired	(3
Purchases of other intangible assets	(1
Investment in affiliate	
Purchases of equity investments	(
Net cash used in investing activities	(6
Cash flows from financing activities:	
Proceeds from issuance of common stock	1
Repurchases of common stock	(2
Proceeds from notes payable	
Repayment of notes payable	(
Repayment of acquisition obligations	
Repurchase of minority interest in subsidiary	(
Notes receivable from stockholders	(
Dividends paid on Series A Preferred Stock	
Net cash used in financing activities	(2
Net increase (decrease) in cash and cash equivalents	5
Cash and cash equivalents - beginning of period	4
Cash and cash equivalents - end of period	$ 10
Supplementary cash flow information:	
Interest paid	$
Taxes paid	$ 2

The accompanying notes are an integral part of these financial statements.

KPMG Consulting, Inc.
Notes to Consolidated Condensed Financial Statements
(in thousands, except shares and per share amounts)
(Unaudited)

Note 1. Basis of Presentation

The accompanying unaudited interim consolidated condensed financial statements of KPMG Consulting, Inc. (the "Company") have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") for quarterly reports on Form 10-Q. These statements do not include all of the information and note disclosures required by generally accepted accounting principles, and should be read in conjunction with our consolidated financial statements and notes thereto for the fiscal year ended June 30, 2001, included in the Company's Annual Report on Form 10-K filed with the SEC. The accompanying consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States and reflect all adjustments (consisting solely of normal, recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of results for these interim periods. The results of operations for the three and six months ended December 31, 2001 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2002. Certain prior period amounts have been reclassified to conform with the current period presentation.

On August 29, 2001, the Board of Directors of the Company adopted a shareholder rights plan. Under the plan, a dividend of one preferred share purchase right (a "Right") was declared for each outstanding share of common stock of the Company that was outstanding on October 2, 2001. Each Right entitles the holder to purchase from the Company one one-thousandth of a share of a new series of Series A Junior Participating Preferred Stock (the "Preferred Shares") at a price of $90 per one one-thousandth of a Preferred Share, subject to adjustment. The Rights are traded with the common stock and are not exercisable until the occurrence of certain specified events (relating to certain actual or prospective changes in ownership interests in the Company's common stock of 15 percent or more). Until such specified events occur, the Board of Directors may redeem the Rights for $0.01 per Right. The Rights will expire on October 2, 2011.

Note 2. Segment Reporting

The Company discloses business segments under Statement of Financial Accounting Standard ("SFAS") No. 131, "Disclosures About Segments of an Enterprise and Related Information." SFAS No. 131 established standards for the way public business enterprises report information about operating segments in annual financial statements and required those enterprises to report selected information about operating segments in interim financial statements.

Through fiscal 2001 the Company provided consulting services through six major industry groups in which it has significant industry-specific knowledge. Effective July 1, 2001, the Company transferred the health care group's businesses into high technology and public services; accordingly the company now provides services through five major industry groups. Additionally, Canada was transferred from International to the five industry groups, resulting in a North American region. Prior year information has been reclassified to reflect these changes.

Industry Results

	Three Months Ended December 31, 2001 Revenue	Three Months Ended December 31, 2001 Operating Income	2000 Revenue
Public Services	$ 236,621	$ 76,381	$ 193,639
Financial Services	53,734	4,016	133,420
Communications & Content	132,201	31,473	142,561
High Tech	50,122	7,269	111,636
Consumer & Industrial Markets	73,973	13,572	88,380
International / Corporate (1)	46,567	(114,597)	32,968
Total	$ 593,218	$ 18,114	$ 702,604

	Six Months Ended December 31, 2001 Revenue	Six Months Ended December 31, 2001 Operating Income	2000 Revenue
Public Services	$ 455,341	$ 147,030	$ 391,687
Financial Services	121,439	12,152	272,121
Communications & Content	265,548	72,760	262,328
High Tech	112,710	19,765	211,081
Consumer & Industrial Markets	158,328	35,722	179,704
International / Corporate (1)	88,743	(225,284)	65,119
Total	$ 1,202,109	$ 62,145	$ 1,382,040

(1) International/ Corporate revenues are primarily attributable to international regions (Latin America, Asia Pacific and Ireland) for all periods. International/ Corporate operating loss is principally due to infrastructure and shared services costs, as well as operating results of international regions.

Note 3. Comprehensive Income

The Company accounts for comprehensive income under SFAS No. 130, "Reporting Comprehensive Income." SFAS No. 130 established standards for reporting and displaying comprehensive income and its components in a financial statement that is displayed with the same prominence as other financial statements. The components of comprehensive income are as follows:

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Comprehensive Income

	Three Months Ended December 31, 2001	Three Months Ended December 31, 2000	Six Month Decembe 2001
Income (loss) before cumulative effect of change in acccounting principle	$ 6,594	$ (37,571)	$ 28,909
Cumulative effect of change in accounting principle	-	-	(79,960)
Net income (loss)	6,594	(37,571)	(51,051)
Foreign currency translation adjustment, net of tax	129	274	769
Comprehensive income (loss)	$ 6,723	$ (37,297)	$ (50,282)

Note 4. Business Combinations

On August 2, 2001, the Company acquired a regional consulting practice in Southeast Asia, consisting of businesses and marketing rights of KPMG International member firms in Hong Kong, Malaysia, Singapore and Taiwan for $16.9 million ($6.8 million cash was paid at closing). The allocation of the purchase price to acquired assets and liabilities, determined in accordance with SFAS No. 141, "Business Combinations," resulted in the allocation of $14.8 million to goodwill and $2.3 million to finite-lived intangibles.

On October 3, 2001, the Company acquired the consulting practice of the KPMG International member firm in Australia for approximately $29.0 million (of which $26.2 million was paid in cash at closing). The allocation of the purchase price to acquired assets and liabilities, determined in accordance with SFAS No.141, resulted in the allocation of $18.9 million to goodwill and $10.8 million to finite lived intangibles.

These acquisitions have been accounted for as purchases, in accordance with SFAS No. 141. The pro forma effects on operations were not material.

Note 5. Adoption of SFAS No. 142, "Goodwill and Other Intangible Assets"

Effective July 1, 2001, the Company elected to early-adopt SFAS No. 142, "Goodwill and Other Intangible Assets," which establishes financial accounting and reporting for acquired goodwill and other intangible assets and supersedes Accounting Principles Board Opinion No. 17, "Intangible Assets." Under SFAS No. 142, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed at least annually for impairment. Separable intangible assets that have finite useful lives, will continue to be amortized over their useful lives.

SFAS No. 142 requires that goodwill be tested for impairment at the reporting unit level at adoption and at least annually thereafter, utilizing a two step methodology. The initial step requires the Company to determine the fair value of each reporting unit and compare it to the carrying value, including goodwill, of such unit. If the fair value exceeds the carrying value, no impairment loss would be recognized. However, if the carrying value of the reporting unit exceeds its fair value, the

goodwill of this unit may be impaired. The amount, if any, of the impairment would then be measured in the second step.

In connection with adopting this standard as of July 1, 2001, during the first quarter the Company completed step one of the test for impairment, which indicated that the carrying values of certain reporting units exceeded their estimated fair values, as determined utilizing various valuation techniques including discounted cash flow and comparative market analysis. Thereafter, given the indication of a potential impairment, the Company completed step two of the test. Based on that analysis, a transitional impairment loss of $80.0 million, or $0.50 per basic and diluted earnings per share, was recognized as the cumulative effect of an accounting change. The transitional impairment charge resulted from a change in the criteria for the measurement of the impairment loss from undiscounted cash flows, a method required by SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," to discounted cash flows as required by SFAS No. 142.

Net income (loss), and basic and diluted net earnings (loss) per share for the three and six months ended December 31, 2000 are set forth below as if accounting for goodwill and other intangible assets had been accounted for in the same manner for all periods presented. The adjustment of previously reported net income (loss) and earnings (loss) per share represents the recorded amortization of goodwill and other purchased intangibles (assembled workforce).

Reconciliation of Net Income (Loss) and Earnings (Loss) Per Share

	Three Months Ended December 31,		
	2001	2000	
Reported income (loss) before cumulative effect of change in accounting principle	$ 6,594	$ (37,571)	$
Add back goodwill amortization, net of tax	--	3,614	
Adjusted income (loss) before cumulative effect of change in accounting principle	6,594	(33,957)	
Cumulative effect of change in accounting principle	--	--	
Adjusted net income (loss)	6,594	(33,957)	
Series A Preferred Stock dividends	--	15,836	
Adjusted income (loss) applicable to common stockholders	$ 6,594	$ (49,793)	$
Earnings (loss) per share - basic and diluted:			
Reported income (loss) before cumulative effect of change in accounting principle applicable to common stockholders	$ 0.04	$ (0.70)	$

Add back goodwill amortization, net of tax	--	0.05
Adjusted income (loss) before cumulative effect of change in accounting principle applicable to common stockholders	0.04	(0.65)
Cumulative effect of change in accounting principle	--	--
Adjusted income (loss) applicable to common stockholders	$ 0.04	$ (0.65)
Weighted average shares - basic and diluted	158,340,791	75,760,067

At December 31, 2001 the Company has $12.1 million of finite-lived intangible assets consisting primarily of purchased market rights, which are being amortized over a weighted average useful life of 4.4 years. The cost and accumulated amortization of these assets at December 31, 2001 are $13.1 million and $1.0 million, respectively.

The changes in the carrying amount of goodwill for the six months ended December 31, 2001 are as follows:

	Balance June 30, 2001	Additions (a)	Transitional Impairment Charge	Other (b)	Balanc December 2001
Public Services	$ 12,616	$ --	$ --	$ (681)	$ 11,9
Financial Services	3,028	--	--	(142)	2,8
Communications & Content	9,349	--	--	(1,107)	8,2
High Tech	2,488	--	--	(562)	1,9
Consumer & Industrial Markets	9,178			(908)	8,2
International / Corporate	99,118	33,668	(79,960)	(518)	52,3
Total (c)	$135,777	$ 33,668	$ (79,960)	$ (3,918)	$ 85,5

(a) Additions related to the acquisition of the regional consulting practices in Southeast Asia and Australia (see Note 4).

(b) Other relates primarily to the reversal of deferred taxes no longer required due to adoption of SFAS No. 142.

(c) After adopting SFAS No. 142, on July 1, 2001, goodwill had gross and net carrying values of $89,166 and $52,417, respectively, all of which was no longer subject to amortization.

Note 6. Reduction in Workforce

In November 2001, the Company recorded a $17.7 million charge for severance and termination benefits related to a worldwide reduction in workforce and a $2.5 million charge related to the impairment of third-party software licenses. The reduction in workforce affected approximately 325 employees and was the result of aligning the Company's workforce with market demand for certain types of services. All of the affected employees have been terminated and are no longer employed by the Company.

A summary of the movements in the Company's accrual for severance and termination benefits from June 30, 2001 to December 31, 2001 is as follows:

	Severance Accrual
Balance at June 30, 2001(a)	$ 4,236
November charge	17,729
Payments	(15,200)
Balance at December 31, 2001(b)	$ 6,765

(a) Balance relates to the Company's reduction in force in April 2001.
(b) The remaining payments will be made in cash by February 2003.

Note 7. Subsequent Events

On February 1, 2002 the Company filed with the SEC a Schedule TO relating to a self tender offer for employee stock options with an exercise price of $55.50. Under the offering, holders of such options (other than executive officers and directors of the Company) have the opportunity to surrender their options as of March 1, 2002 and, in exchange, receive an equal number of options to be issued in September 2002 (or at a later date if the exchange offer is extended) with an exercise price equal to 110% of the then fair market value of the Company's common stock. The replacement options will vest equally over three years. As of the date of the tender offer there were approximately 6 million options outstanding with an exercise price of $55.50. Consummation of this offer will result in additional compensation expense of approximately $1 million to be recognized by the Company over the vesting period of the replacement options.

* * * * *

PART I, ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following information should be read in conjunction with the information contained in the Consolidated Condensed Financial Statements and notes thereto appearing elsewhere in this Quarterly Report on Form 10-Q. This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. See the discussion relating to "Forward-Looking Statements" below.

Accounting polices that management believes are most critical to the Company's financial condition and operating results pertain to revenue recognition and valuation of unbilled revenues (including estimates of costs to complete engagements); collectibility of accounts receivable; valuation of goodwill; and judgments about discretionary compensation costs and effective income tax rates. In deriving accounting estimates, management considered available information and exercised reasonable judgment. However, actual results could differ from these estimates.

Company Overview

We are one of the world's largest consulting firms with nearly 10,000 employees. We serve over 2,500 clients, including Global 2000 companies, Fortune 1000 companies, small and medium-sized businesses, government agencies and other organizations. We provide our clients with a range of service offerings that combine industry specific business strategy and operational improvements, technology selection and implementation. Our service offerings are designed to help our clients generate revenues, improve efficiency and contain costs.

These services include:

- business and technology strategy;
- process design and operations improvement;
- systems integration;
- network integration and infrastructure; and
- outsourcing.

Through June 30, 2001 we provided consulting services through six industry groups in which we have specific industry knowledge. Effective July 1, 2001, we transferred the health care group's businesses into high technology and public services; accordingly, we now provide our services

through five industry groups. These groups are public services, financial services, communications and content, high technology, and consumer and industrial markets. These groups comprise the North American region. In addition, we have multi-national operations covering Latin America, Asia Pacific, Ireland and Israel.

HISTORICAL RESULTS OF OPERATIONS OVERVIEW

The Company realized net income applicable to common stockholders for the three months ended December 31, 2001 of $6.6 million, or $0.04 per share, compared to a net loss of $53.4 million, or $0.70 per share for the three months ended December 31, 2000. Included in operating results for the quarter ended December 31, 2001, was a $20.2 million charge ($12.8 million net of tax) predominantly related to a reduction in workforce. Included in operating results for the quarter ended December 31, 2000, was a $63.3 million non-operating loss on redemption of an equity interest in affiliate ($58.5 million net of tax). Excluding the after-tax effects of the aforementioned charges, operating net income for the three months ended December 31, 2001, was $19.4 million compared to $20.9 million in the quarter ended December 31, 2000. The slight decrease in profitability was driven by a decline in revenue of $109.4 million, partially offset by lower levels of operating expenses.

After deducting an $80.0 million after-tax charge representing the cumulative effect of a change in accounting principle, the Company realized a net loss applicable to common stockholders of $51.0 million, or $0.32 per share for the six months ended December 31, 2001, compared to a net loss of $48.7 million, or $0.64 per share for the six months ended December 31, 2000. Included in operating results for the six months ended December 31, 2001, was the $20.2 million charge referred to above. Included in results for the six months ended

December 31, 2000, was $76.0 million charge representing equity in losses of affiliate and loss on redemption of equity interest in affiliate ($71.2 million net of tax). Excluding the after-tax effects of the aforementioned charges, operating net income for the six months ended December 31, 2001, was $41.7 million compared to $54.2 million for the six months ended December 31, 2000. This decrease in profitability was driven by a decline in revenue of $179.9 million, partially offset by lower levels of operating expenses.

Three Months Ended December 31, 2001 Compared to Three Months Ended December 31, 2000

Revenues. Revenues decreased $109.4 million, or 15.6%, from $702.6 million in the three months ended December 31, 2000, to $593.2 million in the three months ended December 31, 2001.

This overall decrease is primarily attributable to a slower economy than that of the same quarter last year. Public Services remained strong with growth of 22.2%, however, this growth was more than offset by declines in Financial Services and High Tech of 59.7% and 55.1%, respectively. International revenue also grew by 41.2%, which is largely due to the acquisitions of the Australia and Southeast Asia consulting practices.

The Company expects this period of economic uncertainty may continue to impact revenue growth for at least another quarter.

Gross Margin. Gross margin as a percentage of revenues was 22.4% for the three months ended December 31, 2001. This reflects an increase from 21.6% for the three months ended December 31, 2000. The increase in gross margin percentage was primarily due to a reduction in the Company's expenses as a result of a continued focus on expense control.

In dollar terms, gross margin decreased by $18.9 million, or 12.4%, from $151.8 million for the three months ended December 31, 2000, to $132.9 million for the three months ended December 31, 2001. Included in gross margin for the quarter ended December 31, 2001, was a $20.2 million charge primarily related to a reduction in workforce. The decrease in gross margin was due to a decline in revenue of $109.4 million described above, offset by:

- A net decrease in professional compensation of $46.2 million, or 16.7%, excluding the $17.7 million charge recorded in the current quarter. This decrease was predominantly due to the Company's reduction in workforce actions taken in the current quarter and the fourth quarter of fiscal 2001. The $17.7 million charge taken in the current quarter pertains to the reduction in workforce of approximately 325 employees, primarily in North America and Latin America, in order to balance workforce capacity with market demand for services. In addition, incentive compensation accruals were also lower.

- A net decrease in other direct contract expenses of $41.0 million, or 20.9%, to $155.5 million, representing 26.2% of revenue, compared to $196.6 million, or 28.0% of revenue in the prior year's quarter. The decrease is attributable to lower revenue levels combined with a decline in travel-related expenses resulting, in part, from the events of September 11th. Subcontractor usage as a percentage of revenue has also declined as the Company continued its efforts to strategically utilize subcontractors to supplement its workforce.

- A net decrease in other costs of service of $21.0 million, or 26.9%, from $78.0 million to $57.0 million, was primarily due to tighter controls on discretionary expenses and reduced headcount, offset by a $2.5 million charge related to the impairment of third-party software licenses. Additionally, bad debt expense decreased $7.5 million due to greater emphasis on credit reviews and strengthened cash collections.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were $114.8 million for the three months ended December 31, 2001. This reflects an increase of $3.7 million, or 3.4%, from $111.1 million for the three month period ended December 31, 2000. This increase is primarily due to increased infrastructure costs as the Company continues its infrastructure build-out in order to lessen its reliance on its former parent company, KPMG LLP, as well as an incremental $2.7 million of expenses for the Australia and Southeast Asia consulting practices.

Interest (Income) Expense, Net. Interest (income) expense, net, decreased $5.6 million, or 100.5%, from $5.6 million of net interest expense to $0.03 million of net interest income for the three months ended December 31, 2000 and 2001, respectively. This decrease was due to a repayment of all outstanding borrowings under our credit facility of $100 million at December 31, 2000, resulting from the use of proceeds from our initial public offering, and improvements made in our management of client billings and collections. This improvement is evidenced by the reduction in our days sales outstanding from 76 days at December 31, 2000, to 56 days at December 31, 2001.

Loss on Redemption of Equity Interest in Affiliate and Equity in Losses of Affiliate. On December 27, 2000, the Company redeemed its equity interest in Qwest Cyber.Solutions ("QCS") for a nominal amount which resulted in a non-cash charge to earnings of $63.3 million ($58.5 million net of tax) during the three month period ended December 31, 2000.

Income Tax Expense. For the three month period ended December 31, 2001, the Company earned income before taxes of $18.1 million and provided income taxes of $11.5 million resulting in an effective tax rate for the quarter of 63.7%.

For the three months ended December 31, 2000, the Company incurred a loss before taxes of $28.2 million and provided income taxes of $9.4 million. The tax rates have been significantly impacted by the non-deductibility of losses incurred in certain international operations and related to the loss on redemption of equity interest in affiliate.

Preferred Stock Dividends. Series A Preferred Stock dividends totaling $15.8 million were recorded in the three months ended December 31, 2000. After December 31, 2000, the Company was no longer required to pay dividends on our Series A Preferred Stock because it was redeemed and converted in connection with our initial public offering.

Net Income (Loss) Applicable to Common Stockholders. For the three months ended December 31, 2001, the Company realized net income applicable to common stockholders of $6.6 million, or $0.04 per share. For the three months ended December 31, 2000, the Company realized a net loss applicable to common stockholders of $53.4 million, or $0.70 per share. Improvement in net income applicable to common stockholders is due to the December 2000 redemption of an equity interest in affiliate (thereby eliminating further investment in this start-up venture), the February 2001 conversion of Series A Preferred Stock to common stock (thereby eliminating preferred stock dividends), partially offset by the previously-mentioned $20.2 million charge recognized in the quarter ended

December 31, 2001. The per share amounts of the income (loss) were further affected by the completion of our initial public offering on February 8, 2001, which increased the number of average common shares outstanding by 82 million.

Six Months Ended December 31, 2001 Compared to Six Months Ended December 31, 2000

Revenues. Revenues decreased $179.9 million, or 13.0%, from $1,382.0 million in the six months ended December 31, 2000, to $1,202.1 million in the six months ended December 31, 2001.

This overall decrease is primarily attributable to a slower economy than that of the same period last year. Public Services remained strong with growth of 16.3%, however, this growth was more than offset by declines in Financial Services and High Tech of 55.4% and 46.6%, respectively. These decreases are a result of weakening market demand in these industries coupled with the postponement and cancellation of client projects. Additionally, International revenue grew by 36.3%, which is largely due to the acquisitions of the Australia and Southeast Asia consulting practices.

Gross Margin. Gross margin as a percentage of revenues was 24.7% for the six months ended December 31, 2001. This reflects an increase from 23.9% for the six months ended December 31, 2000. The increase in gross margin percentage was primarily due to a reduction in the Company's expenses as a result of an increased focus on expense control.

In dollar terms, gross margin decreased by $33.7 million, or 10.2%, from $330.6 million for the six months ended December 31, 2000, to $296.9 million for the six months ended December 31, 2001. Included in gross margin for the quarter ended December 31, 2001, was the $20.2 million charge primarily related to the reduction in workforce. The decrease in gross margin was due to a decline in revenues of $179.9 million described above, offset by:

- A net decrease in professional compensation of $83.7 million, or 15.0%, excluding the previously-mentioned $17.7 million charge recorded in the six months ended December 31, 2001. This decrease was predominantly due to the reduction in workforce actions taken in the

current quarter and the fourth quarter of fiscal 2001. In addition, incentive compensation accruals were also lower.

- A net decrease in other direct contract expense of $46.8 million, or 13.5%, to $299.7 million, representing 24.9% of revenue, compared to $346.6 million, or 25.1% of revenue in the prior year's comparable period. The $46.8 million decrease is attributable to lower revenue levels combined with a decline in travel-related expenses resulting in part from the events of September 11th. Subcontractor usage as a percentage of revenue also declined as the Company continued its efforts to strategically utilize subcontractors to supplement its workforce.

- A net decrease in other costs of service of $33.5 million, or 22.9%, from $146.1 million to $112.6 million, primarily due to tighter controls on discretionary expenses including training and recruiting costs and reduced headcount, offset by a $2.5 million charge related to the impairment of third-party software licenses. Additionally, bad debt expense decreased $9.2 million due to greater emphasis on credit reviews and strengthened cash collections.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were $234.7 million for the six months ended December 31, 2001. This reflects an increase of $5.9 million, or 2.6%, from $228.9 million, which is primarily due to increased infrastructure costs of $15.7 million as a result of the Company's infrastructure build out in order to lessen its reliance on its former parent company, KPMG LLP, as well as, an incremental $2.8 million of expenses for the Australia and Southeast Asia consulting practices. This increase is partially offset by a decrease in amortization expense of $6.9 million as a result of the Company electing to early-adopt SFAS No. 142, "Goodwill and Other Intangible Assets", and decreases in other expenses reflecting tighter controls over discretionary spending.

Interest (Income) Expense, Net. Interest (income) expense, net, decreased $10.4 million, or 101.7%, from $10.2 million of net interest expense to $0.2 million of net interest income for the six months ended December 31, 2000 and 2001, respectively. This decrease was due to a repayment of all outstanding borrowings under our credit facility of $100 million at December 31, 2000, resulting from the use of proceeds from our initial public offering, and improvements made in our management of client billings and collections. This improvement is evidenced by the reduction in our days sales outstanding from 76 days at December 31, 2000 to 56 days at December 31, 2001.

Loss on Redemption of Equity Interest in Affiliate and Equity in Losses of Affiliate. For the six months ended December 31, 2000 loss on redemption of equity interest in affiliate and equity losses of affiliate of $76.0 million related to our equity investment in Qwest Cyber.Solutions ("QCS"). On December 27, 2000, the Company redeemed its equity interest in QCS for a nominal amount which resulted in a non-cash charge to earnings of $63.3 million ($58.5 million net of tax) during the six month period ended December 31, 2000.

Income Tax Expense. For the six months ended December 31, 2001, the Company earned income before taxes and cumulative effect of change in accounting principle of $62.3 million and provided income taxes of $33.4 million, resulting in an effective tax rate of 53.6%. This rate was impacted by the non-deductibility of losses incurred by certain international operations. For the six months ended December 31, 2000, the Company earned income before taxes of $15.5 million and provided income taxes of $32.6 million, resulting in an effective tax rate of 209.6%. This rate was significantly impacted by the non-deductibility of the loss on redemption of equity interest in affiliate coupled by non-deductible losses in certain international operations.

Cumulative Effect of Change in Accounting Principle. The Company elected to early-adopt SFAS No. 142 as of July 1, 2001. This standard eliminates goodwill amortization upon adoption and requires an assessment for goodwill impairment upon adoption and at least annually thereafter. As a result of adoption of this standard, the Company did not amortize goodwill during the six months ended December 31, 2001, and incurred a non-cash transitional impairment charge of $80.0 million. This transitional impairment charge is a result of the change in accounting principles to measuring impairments on a discounted versus an undiscounted cash flow basis.

Preferred Stock Dividends. Series A Preferred Stock dividends totaling $31.7 million were recorded in the six months ended December 31, 2000. After December 31, 2000, the Company was no longer required to pay dividends on our Series A Preferred Stock because it was redeemed and converted in connection with our initial public offering.

Net Income (Loss) Applicable to Common Stockholders. For the six months ended December 31, 2001, the Company realized a net loss applicable to common stockholders of $51.0 million, or $0.32 per share. For the six months ended December 31, 2000, the Company realized a net loss applicable to common stockholders of $48.7 million, or $0.64 per share. Period over period, net losses applicable to common stockholders increased primarily due to decreased levels of revenue, partially offset by decreased levels of costs and expenses. Losses per share were further affected by the completion of our initial public offering on February 8, 2001, which increased the number of average common shares outstanding by 82 million.

LIQUIDITY AND CAPITAL RESOURCES

The Company has funded its operations through cash generated from operations. While the Company expects this period of economic uncertainty may continue to impact revenue growth for at least another quarter, we will continue to actively manage client billings and collections and maintain tight controls over discretionary expenses, and expect operations to continue to generate cash. Additionally, the Company has borrowing arrangements available including a revolving credit facility with no outstanding balance at December 31, 2001 (not to exceed $100 million), a revolving line of credit facility with no outstanding balance at December 31, 2001 (not to exceed $100 million), as well as a note payable related to an accounts receivable financing facility with no outstanding balance at December 31, 2001 (not to exceed $200 million). The revolving credit facility and revolving line of credit facility expire on May 24, 2004 and May 20, 2002, respectively, while the accounts receivable purchase agreement permits "sales" of accounts receivable through May 21, 2003, subject to annual renewal. The accounts receivable purchase agreement is accounted for as a financing transaction; accordingly, it is not an off-balance sheet financing arrangement. The credit facilities described above include covenants relating to the maintenance of certain financial ratios and restrictions on the Company's ability to pay dividends.

Under the transition services agreement with KPMG LLP, the Company contracted to receive certain infrastructure support services from KPMG LLP until the Company completes the build-out of its own infrastructure (for a period not to exceed four years from the date of our IPO). If the Company terminates any services prior to the end of the term for such services, the Company may be obligated to pay to KPMG LLP any termination costs incurred as a result of KPMG LLP having made investments in systems, personnel and other assets that were used in provisioning of shared services. It is the intent of the parties, that during the term of the agreement, the Company will work with KPMG LLP to minimize any termination costs arising at the end of the term of the agreement, and the Company will wind down its receipt of services from KPMG LLP by developing its own infrastructure and support capabilities.

Based on information currently available, the Company anticipates paying KPMG LLP approximately $40 to $60 million for the net book value of capital assets (such as software licenses, computer equipment and leasehold improvements) that will be transferred to our Company on or before the termination of the agreement; upon transfer, such capital assets will continue to be used in our business. Until the Company takes ownership of these capital assets, the transition services agreement is an off-balance sheet financing arrangement. The Company expects to take ownership of approximately $35 million of these capital assets by the end of fiscal 2002.

Cash provided by operating activities during the six months ended December 31, 2001 was $142.3 million, principally due to cash operating results of $49.4 million and collections of accounts receivable of $83.5 million.

Cash used in investing activities during the six months ended December 31, 2001 was $62.5 million principally due to $12.5 million in purchases of property and equipment, $33.2 million paid for acquisitions, and $14.6 million paid for other intangible assets.

Cash used in financing activities for the six months ended December 31, 2001 was $24.7 million, principally due to the purchase of 2.3 million treasury shares for $27.5 million and repayment of notes payable of $5.9 million, offset by proceeds of $12.7 million from the issuance of common stock primarily from the Company's employee stock purchase plan.

The Company believes that the cash provided from operations, borrowings available under the various facilities described above and existing cash and cash equivalents should be sufficient to meet working capital and ongoing capital expenditure needs.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In August 2001, the FASB issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long Lived Assets". This statement is effective for fiscal years beginning after December 15, 2001 and supersedes SFAS No. 121, while retaining many of the requirements of such statement. The Company is currently evaluating the impact of the statement.

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements relating to our operations that are based on our current expectations, estimates and projections. Words such as "expects," "intends," "plans," "projects," "believes," "estimates," and similar expressions are used to identify these forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Forward-looking statements are based upon assumptions as to future events that may not prove to be accurate. Actual outcomes and results may differ materially from what is expressed or forecast in these forward-looking statements. As a result, these statements speak only as of the date they were made, and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Our actual results may differ from the forward-looking statements for many reasons, including:

- the business decisions of our clients regarding the use of our services;

- the timing of projects and their termination;
- the availability of talented professionals to provide our services;
- the pace of technological change;
- the strength of our joint marketing relationships;
- continuing limitations following our separation from KPMG LLP; and
- the actions of our competitors.

In addition, these statements could be affected by general domestic and international economic and political conditions including slowdowns in the economy, uncertainty as to the future direction of the economy and vulnerability of the economy to domestic or international incidents. (For a more detailed discussion of certain of these factors, see Exhibit 99.1 to this Form 10-Q.)

PART I, ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We are exposed to a number of market risks in the ordinary course of business. These risks, which include interest rate risk and foreign currency exchange risk, arise in the normal course of business rather than from trading activities. Our exposure to changes in interest rates arises primarily because our indebtedness under our bank credit facilities carries variable interest rates. Foreign currency exchange risk is not significant as foreign currency transactions have not been significant and are not concentrated in a single foreign currency.

In connection with our borrowings and as a result of continual monitoring of interest rates, we may in the future enter into interest rate swap agreements for purposes of managing our borrowing costs.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are from time to time the subject of lawsuits and other claims and regulatory proceedings arising in the ordinary course of our business. We do not expect that any of these matters, individually or in the aggregate, will have a material impact on our financial condition or results of operations.

ITEMS 2-5. NONE

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits -- Reference is made to the Exhibit Index.

(b) The Company filed one report on Form 8-K during the period of July 1, 2001 through the date of this report. The Form 8-K was filed on October 3, 2001 and related to the adoption of a shareholder rights plan.

Exhibit Index

4.1 Rights Agreement, dated as of October 2, 2001, between KPMG Consulting, Inc. and EquiServe Trust Company, N.A., incorporated by reference from Exhibit 1.1 to the Company's Registration Statement on Form 8-A dated October 3, 2001.

4.2 Certificate of Designation of Series A Junior Participating Preferred Stock, incorporated by reference to Exhibit 1.2 to the Company's Registration Statement on Form 8-A dated October 3, 2001.

10.1 Form of Special Termination Agreement, made as of November 7, 2001, between KPMG Consulting, Inc. and Certain Executive Officers.

10.2 Form of Special Termination Agreement, made as of November 7, 2001, between KPMG Consulting, Inc. and Certain Executive Officers and Other Key Executives

99.1 Factors Affecting Future Financial Results

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KPMG Consulting, Inc.

DATE: February 12, 2002

By: /s/ Randolph C. Blazer

Randolph C. Blazer,
Chairman of the Board, Chief Executive Officer, and President

Principal Financial and Accounting Officer

DATE: February 12, 2002

By: /s/ Robert C. Lamb, Jr.

Robert C. Lamb, Jr.,
Executive Vice President
and Chief Financial Officer

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