

STATUTORY AUDIT MARKET INVESTIGATION

Summary of hearing with RSM Tenon Audit held on Monday 17 September 2012

Background

1. RSM Tenon Group PLC was a listed company and that RSM Tenon Audit Limited (RSM) was a separate independent statutory entity with approximately 500 staff. RSM's annual revenue was about £25 million generated from approximately 2,300 audit clients. RSM's typical client was a reasonably small, owner-managed business with an annual turnover of between £5 million and £15 million. RSM's clients, however, also included larger entities and these clients were spread out across the UK. RSM was seeking to grow its audit practice over time and the most obvious way to do this was through upscaling the average size of its client. Although not currently in a position to tender for a FTSE 100 audit, RSM was increasingly looking to provide services to AIM-listed and larger private corporates. RSM provided audit services to around 15 AIM-listed businesses and a number of larger corporates, which it planned to expand over time.

Capability

2. RSM had a good international capability with almost global coverage, due to its access to the RSM network which it acquired when it merged with the Bentley Jennison business in 2009. Through this network, RSM was linked to McGladrey, which was the fifth largest firm in the USA, and the network had strong coverage in Europe and Asia. Dealing with larger internationally-focused corporate businesses was a core area of focus. RSM considered that it had an international capability similar to the other mid-tier firms.
3. RSM had expertise in a range of sectors. Individuals within the firm might have a particular focus, but its major audit focus was the SME market which was a specialism in itself. RSM was, however, increasingly interested in internationally active clients. The RSM international network covered approximately 95 countries with 32,000 people worldwide.
4. RSM said that it recruited around 75 trainees annually for its audit work. In terms of pay scales, RSM would like to be in the median range for pay scales in its local market. On qualification, RSM estimated that around 50 to 60 per cent of trainees typically stayed with the firm. RSM was increasingly looking to leverage the trend of school leavers to forgo university in preference for scholarship programmes.
5. RSM considered that it had the capability to audit FTSE 350 companies except those in the financial services sector. A business in retail or manufacturing would be within its compass and certainly a business with UK, European, US or Asian operations. RSM considered that its capabilities were more focused on the complexity of a business rather than its size. RSM would incline towards focusing on a market and assessing whether it would make sense for it to invest in the appropriate level of resource rather than focusing on one particular business sector.

Structure and plans

6. RSM Tenon Group had decided to become a PLC as, at the time, it was considered to be an appropriate vehicle to raise finance. A number of independent firms from around the country came together to form RSM Tenon Group. Finance available from the AIM market in terms of share issues was the principal way of raising funds to enable those businesses to merge. The partners of the independent firms that formed RSM Tenon Group effectively swapped their partner capital for a partnership in share capital. As further acquisitions were made during the 2000s, the ability to issue shares and to use shares to raise funding was the major source of finance. This was mixed with bank funding, where appropriate, for example on the acquisition of RSM Bentley Jennison in 2009.
7. RSM considered that becoming a PLC had no particular effect on its relationships with existing clients. RSM had not seen a drop in the number of tenders over the last six months where it had been asked to compete but it did receive a disproportionately low level of invitations to tender, partly because it was a relatively new entrant to the larger corporate market. Its tender list would be likely to comprise one of the Big 4 and one or two mid-tier providers. This had not affected RSM's strategic direction, even though it had provided a few more challenges in the short to medium term. RSM's audit work had perhaps been less affected because so much audit work was repeat and ongoing from relationships compared with the more transactional tax or advisory work. The new management that came in to the PLC during 2012 had provided pause for thought to review RSM's strategy, but this review had only reinforced the market aims and structures of the group. RSM Tenon Audit Limited had not issued a restatement of its financial statements.

Barriers to entry/expansion

8. RSM explained that it would seek to service larger SMEs in the medium term. RSM did not expect to move out of the SME market, which was its core expertise.
9. RSM did not consider AIM listed or small cap businesses to be in a different market from large private businesses in terms of the relative complexity of the work. It did, however, consider them to be in a different market in terms of their ownership structure, ie whether it was an owner-managed business as opposed to having executive management. RSM noted that there were additional governance or reporting requirements around a listed business and these control structures were important. Size, however, brought complexity, for example an AIM client with a £4 million turnover involved additional issues regarding the way the culture and Audit Committees ran, that created a different approach when compared with an owner-managed business turning over £25 million. Both clients, however, could be very similar in terms of the business, leaving only the entrepreneurial or AIM-listed variations as requiring a different level of technical input for their audits.
10. RSM perceived some barriers to entry in providing audit services way below FTSE 350 clients or large private corporations. It regularly came across private-equity-owned businesses where there was not a Big 4 clause but rather a Big 4 mentality. There were at least three or four occasions where RSM had been the preferred choice of executive management, but RSM had not been acceptable to the private equity house which would prefer to remain with one of the Big 4. This had not been written down anywhere. RSM had achieved success in growing its practice in the larger privately-owned businesses and AIM-listed market.
11. Working with AIM clients required RSM to establish additional relationships with the brokers. The brokers might influence management away from RSM for a different

perspective, such as their own reciprocity opportunities, whereas RSM's relationship for the SME clients was just with the executives. This added an additional layer of complexity when working with AIM-listed businesses.

12. Other than specialized industries, there were not any specific features either in the FTSE 350 or other market segments of regulatory environments preventing it from auditing entities or trying to enter the market. RSM could upscale the technical input to provide audit services to larger manufacturing or retail businesses and complexity usually related to group structure and other issues. RSM had a number of people who had previously worked for the Big 4 and had the relevant skills to audit FTSE 350 businesses. There were not any regulatory barriers to auditing FTSE 350 and AIM-listed businesses.
13. RSM had to consider whether to make an investment to audit FTSE 350 and AIM-listed companies effectively. It would not be an issue to obtain adequate insurance cover to audit a FTSE 350 business. RSM had not been invited recently to tender for a FTSE 350 client. It said that the FTSE 350 market for audit services was a chicken-and-egg situation, because when bidding in that market an auditor needed the credentials and the CV to demonstrate competence, even when they already had competence. Where it had a close working relationship with a client, it had generally retained the client when it had become a listed company or grown over time.
14. Where RSM saw opportunities in the market, it would invest to bring in the right people who could broaden out skills, rather than bringing people in who had the same skills as the existing team.
15. By way of example, RSM provided advisory services to a small number of Fortune 500 businesses, one of which was a FTSE 100 company. RSM was not currently in a position to tender for the audit of those businesses but it was working with its international network to increase its other services into these businesses. RSM was willing to engage with mid-tier companies in terms of advisory services but it was quite a long lead-in time between that and being able to provide fuller services including audit.
16. It was RSM Tenon's experience that staff often moved from the Big 4 as they preferred being directly engaged with the decision-makers in the business and having more time to be able to do so. The lifestyles were not different between working for the Big 4 or RSM in terms of hours: RSM could not be said to entail longer hours. The main difference was that RSM's trainees received a slightly less deep technical grounding due to the nature of their clients but a broader experience in terms of involvement in business and tax issues and so forth. They therefore had a slightly different mindset than the trainees coming out of a contract with one of the Big 4.
17. RSM did encounter the Big 4 when tendering for services for their larger corporate clients and its AIM-listed clients. This occurred several times a year and these businesses were very much at the smaller end of the Big 4's client base. The challenge was for RSM Tenon to be perceived as a quality alternative rather than competing on price. RSM was a better option for those SME clients as it specialized in that market. RSM did not come across the Big 4 on a daily basis yet it came across them as frequently as the larger mid-tier firms such as BDO, Baker Tilly or Grant Thornton.
18. In the education sector, RSM was strong and it would see both the Big 4 and Grant Thornton and Baker Tilly as its main competitors. RSM said that nine times out of ten, it would compete against at least one of the Big 4 in most of those public sector tenders. RSM competed against the Big 4 firms more in the current economic

environment than it had done previously, ie the Big 4 firms were chasing work in RSM's sphere that they would not have chased five years ago.

19. RSM's competitive advantage when competing with the Big 4 was that it specialized in the mid-tier corporate market, which comprised a large majority of its work. RSM therefore had a clear insight into this sector and could provide more cost-effective advice. The client was also more likely to have access to more senior people in order to help them with the business. RSM was less highly leveraged in terms of the number of staff per partner and clients were more likely to get access to the relationship holder on a more frequent basis.
20. A Big 4 brand occasionally resonated in RSM's sector as they were well known and perceived to be high quality but also high priced. At the moment, there was quite a lot of price uncertainty in the market. Typically, when RSM was competing with three or four other firms, there was someone who did something left-field in terms of pricing which was quite unhelpful—this was not always one of the Big 4 firms. That created quite a lot of uncertainty. One of RSM's larger clients went out to tender on a rotational basis last year and one of the Big 4 firms' proposals came in 20 per cent cheaper than RSM's. This was unusual given that RSM did not consider the tender it submitted to be expensive. RSM did retain the audit and came down a little in its price.
21. The Big 4 firms were active in targeting their newly-qualified staff to 18 months post-qualified staff. RSM Tenon said that if one of the Big 4 issued an instruction to a recruitment agency that involved paying above market rates, then this put uncertainty in the market. People often tended to take a longer-term view of their career, so if RSM could demonstrate that it was providing the training, expertise and career development staff were interested in, their decision was not all about money.

Non-audit services

22. The FTSE 350 was not a significant purchaser of RSM's non-audit services but it did provide several million pounds' worth of services to this sector. In particular, RSM provided corporate finance advice to a large FTSE 350 business that was probably worth £1 million a year and it also provided a range of other advisory work. The work was useful to it as learning and development and to building RSM's credentials. This helped RSM secure work from other large corporates. RSM would like FTSE 350 companies to be a larger part of its wider business, not necessarily audit. Providing advisory services to FTSE 350 companies was a stepping stone to gaining access to the market and it intended to work to develop relationships and ensure that RSM could demonstrate its expertise. RSM was particularly working to develop its services in risk management to corporates, which was growing fast, but it noted that risk management was a separate division in RSM Tenon Group PLC from audit practice.
23. Building credentials was one of RSM's primary strategies. In order to enter the FTSE 350 market in the medium term, it would need to consider bringing people in from the outside and also develop relationships at a non-audit level to develop its CV. Apart from areas that were outside RSM's current specialism such as banks, it was a matter of scale, ie the work was not necessarily more complex but something that RSM was capable of doing and had the skills and resources to be able to do. However, it was very difficult to persuade people that RSM could do the work if it had not done so previously.
24. RSM Tenon Group PLC's risk advisory services division actively targeted the FTSE 350. There were a limited number of partners in the firm who were focused on the FTSE 350 and it was not currently a core strategy across the business. However, this

was expected to evolve over time and in response to the openness of the market. The financial management division would also target the FTSE 350 but it was not a major focus for its business either.

25. The work RSM currently carried out was largely generated from relationships that people had upon joining RSM, ie relationships staff had in previous work at different firms and/or formed through alumni networks. Work had not been forthcoming from cold tendering.

Adverse outcomes

26. RSM thought that the current market for audit services was often price competitive. One representative said that during his career with the Big 4 he had seen a high degree of price competition, particularly when work was put out to tender. There were, however, a lot of barriers to entry for RSM, some of which had no easy solution because they were factors such as scale, investment and resource. RSM was perfectly capable of doing a lot of the work but it was difficult to demonstrate that it could do so. RSM thought that there were a lot of inherent barriers such as alumni networks, ie the majority of Finance Directors and/or Managing Directors of large corporates were probably alumni of the Big 4 and had formed relationships and close networks in this way. These networks did not work in the favour of a firm like RSM Tenon that had only been established for 10 or 11 years. These networks were particularly true for Audit Committees. A lot of the Chairs on Audit Committees were comprised of ex Big 4 staff and that perpetuated a certain approach.
27. RSM thought the market for FTSE 350 audit services not to be particularly open to competition from firms like RSM Tenon, but that structural issues were not necessarily the cause. Some of the issues were historic and due to Big 4 alumni networks, and it was difficult to gain entry in the first place.
28. RSM had worked with the university sector in its risk advisory services division and it would have liked to provide external audit services to that market. RSM could provide a good service to universities but it was yet to see a tender specification for a university that did not include the question near the beginning: 'Name your top five university clients'. RSM was a similar situation in the PLC sector as in certain sectors a firm needed to have a certain amount of critical mass in that sector. This made it very difficult to win the first, second or third clients.
29. Last year RSM tendered against two Big 4 firms for a £100 million turnover group of companies. RSM was the recommendation of the Chief Executive and the Finance Director. However, the private equity house said that it would feel more comfortable dealing with the Big 4. There was a large element of 'You never got fired for buying IBM', which was a prevalent attitude and one that was self-perpetuating.
30. RSM said that quality was not a differentiator between it and the Big 4 and that it did not consider itself to be incapable of auditing larger corporates. If RSM felt that it did not have the expertise to do the work, it would not try to win it in the first place. If RSM put in a proposal for work, it would not be on the grounds of being cheaper and of lower quality. RSM was less leveraged in terms of its model so it would typically have more senior involvement in engagements. The issue was the perception of quality rather than quality itself. RSM had lost many qualified staff to the Big 4 firms so it was not concerned about the quality of its people.
31. RSM did not think quality in the market would increase if there was more competition, but it would depend on the terms of competition, for example whether competition was in terms of brand names, quality or relationships. There were lots of different

factors in a competitive situation which influenced the outcome and the decision-making process. RSM also thought there was a balance between experience and understanding the client, its market, its processes and its systems that came from being involved with the client over time and offset by a fresh pair of eyes being able to challenge accepted truths. There was some benefit in having a fresh approach, which did not necessarily happen on a regular basis. There was rotation within the team in terms of the person responsible for signing off an audit but the approach remained the same.

32. Competition would encourage more innovation in the market for statutory audits. If there were more people involved in the market, they would introduce new ideas so even incumbents would need to think carefully about the best means of approaching the business, getting the assurance required and meeting the stakeholders' needs.
33. RSM's customers depended on the ownership structure of a business. These were typically the owners of an owner-managed business albeit there were other stakeholders, for example HMRC. The AIM-listed business involved a wider range of stakeholders including the non-executives, the shareholders and the market. Different stakeholders were interested in different things ranging from institutional investors to the shareholder on the street and the executives. There needed to be a wider engagement in terms of what people were looking for, especially as quality was to some extent in the eye of the beholder.
34. RSM's engagement with clients was much more via the management route than with shareholders or investors. In the AIM market it was quite difficult to reach a disparate shareholder group, so it would start by engaging with management but then it became conscious of the broker, the nomad, the shareholders and the other people who had invested in that business. RSM had never been asked by a shareholder to tender for an audit; it always came through management. This seemed a bit odd as the demand for audits came from the shareholders and the purpose of audits was to protect shareholders from management, but that was not how it worked in practice. RSM said that the Company Director and Finance Director could take comfort in agreeing decisions with auditors, but there was some risk in someone else looking at these.
35. It was uncertain that the changes to the audit thresholds that were issued by BIS over the last few weeks increased competition in audit, although it was grateful for reducing red tape and the administrative burden on companies. There would be a number of smaller accounting firms whose audit client base would drop away almost entirely as a result of the new thresholds which would increase market concentration. The threshold affected a reasonable proportion of its clients and a number of those businesses would either choose to continue having an audit for various reasons or would need to have some other form of assurance. However, some of RSM's clients that fell below the thresholds would still ask for a statutory audit due to demand from their stakeholders, including banks, shareholders and customers. These companies wanted to be able to put audited accounts into tenders and to deal with customers who expected them to have audited accounts.
36. The various parcels of work from the Audit Commission were not structured in a way that made it easy for firms like RSM to take on the required level of risk and investment. This was particularly the case where someone was building a business from scratch with the risk of losing work to tender after three or five years.