Countering Fraud For Competitive Advantage

How UK FTSE listed companies can reduce the cost of fraud and maximise profitability

Jim Gee and Professor Mark Button
“Fraud can lead to less financially stable and healthy companies and its reduction can significantly improve profitability.”
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Managing cost is an important discipline for any organisation. Operating an efficient and streamlined business and avoiding unnecessary cost is essential but, of equal impact and significance, and which has rarely been accurately quantified by the sector, is the cost of fraud.

Until the last 15 years or so the best it was thought you could do concerning fraud was to hope that it wouldn’t happen. If it did, you reacted after it had taken place, when irrecoverable losses had often already been incurred. It was seen as a series of low volume, high value incidents which required further expense to investigate. That approach has been changing for some time. It is now recognised that the total cost of fraud can be accurately measured and that, because of this, it can be managed and minimised like any other cost.

Fraud can lead to less financially stable and healthy companies and its reduction can significantly improve profitability. These positive outcomes arise from the financial benefits which are delivered by that reduction.

PKF Littlejohn’s new report provides an unprecedented insight into the benefits to UK listed companies of reducing the cost of fraud. In competitive times, cutting the cost of fraud - revealed by the latest global research to represent, on average, 5.6% of expenditure - can significantly boost profitability and financial health.

Developments over the last decade or so, to accurately measure the cost of fraud like any other business cost, have allowed organisations from across the world to manage and minimise that cost. PKF Littlejohn has worked with such organisations to help them do this and, as a result of that work, they are already benefitting.

This report outlines the results of research to review the latest results and data from 1709 UK FTSE listed companies with total revenues of more than £1.84 trillion. The effect of cutting the cost of fraud on companies’ results is dramatic whatever their size.

A book by the authors of this report - Countering Fraud for Competitive Advantage - was published globally by John Wiley and Sons in 2013. It expands on the themes in this report and explains what companies need to do to gain a competitive advantage. What is clear is that fraud - the last great uncontrolled business cost - can now be measured, managed and minimised - both in the UK FTSE listed sector and beyond.

JIM GEE
Partner and Head of Forensic & Counter Fraud Services at PKF Littlejohn and Visiting Professor and Chair of the Centre for Counter Fraud Studies at University of Portsmouth
1.1. If you don’t understand the nature and scale of the problem, how can you apply the right solution? Over the last decade or so it has become possible to accurately measure the nature and scale of fraud – and then to design an informed strategy to reduce it.

1.2. Fraud is a challenging problem. Its economic effects are clear. In every sector of every country, fraud has a pernicious impact. However, historically fraud has been described as ‘difficult to cost’ and until relatively recently, it has not been possible to quantify these effects. In the last 15 years or so this situation has changed.

1.3. ‘The Financial Cost of Fraud Report 2015’ represents the latest, most extensive global research in this area. The report documents what has been found across the world, over the 17 year period from 1997 to 2013. It also shows the impact of the recession on losses by comparing and contrasting data from 2008 to 2011 with the period before and after it. It focuses on presenting a credible, accurate and statistically valid picture, in a context where the quality of some information has historically been poor.

1.4. There are still some estimates published which are simply not reliable. Counting only those losses which are detected or prosecuted, or surveying those working in the area for their opinion, will never be accepted as a reliable indicator of the real economic cost of fraud.

1.5. Unless one imagines that all fraud can be detected – and research tends to indicate that, at best, organisations can only detect in the region of 1/30th of it – then a measure of fraud based on detected losses will always represent a serious underestimate. Bearing in mind that even the crime of murder doesn’t have a 100% detection rate and that the essence of fraud is about concealment, it is unlikely ever to be the case that what is detected will represent the totality of the cost.

1.6. Surveys of opinion are also unreliable. The Association of Certified Fraud Examiners (ACFE) in the United States produces an annual survey of this type. Its most recent edition states that “Survey participants estimated that the typical organization loses 5% of its revenues to fraud each year.” Such surveys can represent a reliable reflection of the opinion of those surveyed (if the sample is representative) but, in the absence of an examination of actual items of expenditure, and the collation of evidence of correctness, error and fraud, they are not grounded in fact.

1.7. It is now possible to do much better than this. The financial cost of fraud and error can be accurately measured in the same way as other business costs. This is not necessarily costly or difficult and, most important, an accurate, statistically valid figure can be provided for what the financial cost is estimated to be.

1.8. The latest global research again indicates that losses average 5.6% of expenditure. 17 years of data derived from 382 loss measurement exercises across 40 types of expenditure with a total value of £9.76 trillion, and in several different countries underpins this figure. Over 69% of accurate and statistically valid measurement exercises revealed losses of 3% or more.

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1 ‘The Financial Cost of Fraud Report 2015’ – published by PKF Littlejohn and the Centre for Counter Fraud Studies at University of Portsmouth – Jim Gee and Professor Mark Button
2 ACFE: ‘2014 Report to the Nations’
3 Losses to fraud and error
1.9. Losses are shown to have increased by just under 18% since 2010 and 29% since the start of the recession in 2008.

1.10. The global average loss rate of 5.6% for the 17 year period which the data covers, when taken as a proportion of the global Gross Domestic Product (GDP) for 2013 (£49.68 trillion or $75.59 trillion\(^4\)), equates to £2.78 trillion ($4.23 trillion), a sum more than 50% greater than the UK’s entire GDP. In the UK, applying that global average loss rate to GDP would imply total losses of £98.6 billion each year. Reducing such losses by 40% would free up more than £39 billion each year.

1.11. So, research leaves little room for doubt that fraud represents a significant cost and that it can be, and has been, measured in many different types of organisation. What you can measure, you can manage. The next logical question concerns the extent of the competitive advantage to be gained from managing and minimising this cost for UK FTSE listed companies.

\(^4\) World Bank figures
2.1. Organisations have been measuring and reducing other types of business cost for decades – usually with progressively smaller reductions as time has gone by – but they have mostly not been doing this in respect of the cost of fraud. Indeed, it is still possible to hear those leading sizeable private or public sector organisations comment that ‘there is no fraud in my organisation’. Such comments show a lack of understanding that the first step to solving a problem is to stop being in denial about it. Even where such attitudes are not prevalent, it is still common that organisations have a reactive approach, acting primarily after fraud has taken place and after the losses have been incurred.

2.2. The Financial Cost of Fraud Report 2015 refers to examples where losses have been reduced. Where losses have been measured, and the organisations concerned have accurate information about their nature and extent, they have been substantially reduced.

2.3. The best examples from the UK over the 17 year period covered by this report include:

2.3.1. where one organisation reduced its losses by up to 60%, and by up to 40% within 12 months;

2.3.2. where another organisation successfully reduced its losses by 50% over an eight year period.

2.4. The best examples from the U.S. over the 17 year period covered by this report include:

2.4.1. where one organisation reduced its losses across a $12 billion program by 35% over a four year period;

2.4.2. where another organisation reduced its losses across a $12 billion program by 28% over a three year period.

2.5. Even during the two years after the start of the recession, and in the middle of a period during which fraud losses increased by over 30%\(^5\), two of the organisations included in this research reported very significant reductions in their losses – one by 33% and the other by 19% - within a single year in each case. As can be seen, the speed of reduction of losses will vary from organisation to organisation, but it is not unreasonable to assert that losses can be reduced by 40% over a two year period – this is what the data shows.

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\(^5\) “The Financial Cost of Fraud Report 2015” - Jim Gee and Professor Mark Button
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What would such a reduction in fraud losses mean?

3.1. This section of the report reviews data from FTSE listed companies to provide an answer.

1709 FTSE listed companies

3.2. In the commercial sector, fraud has a significant effect on profitability. A summary of 1709 FTSE listed companies for 2013 - 2014 shows that they had total annual revenues of £1.84 trillion, with pre-tax profits of £137.03 billion, representing 7.43% of revenues. Applying the global average loss rate (5.6%), derived from where losses have been accurately measured, would imply that fraud losses total £103.23 billion, equivalent to 75.33% of the total profits of these companies.

3.3. What would such a reduction in the cost of fraud mean in financial terms? If we apply the 5.6% loss rate and the 40% reduction figure cited in Section 2 of this report the aggregate pre-tax profitability of the companies would be boosted by £35.27 billion or over 22%.

3.4. The financial benefits to companies are potentially impressive. Of the 974 companies which made profits:

- 194 would increase their pre-tax profitability by between 0 - 9%;
- 262 would do so by between 10 - 24%;
- 191 by between 25 – 49%;
- 123 by between 50 – 99%;
- 88 by between 100 – 499%; and
- with 27 companies increasing their pre-tax profitability by over 500%.

This would represent a significant boost to corporate health.

3.5. Of the 732 companies which made losses:

- 29 would make a pre-tax profit not a loss;
- 307 would reduce their losses by 9% or less;
- 74 would reduce them by between 10 – 24%;
- 45 by between 25 – 49%;
- 22 by between 50 – 74%; and
- 9 by between 75 – 99%.

85 FTSE 100 companies

6 89 companies recorded profits but no turnover
7 246 companies reported losses but no turnover
3.6. A summary of 85 of the FTSE 100 listed companies for which data was available for 2013 - 2014 shows that those which were profitable had:

- total annual revenues of £1.24 trillion;
- with pre-tax profits of £126.82 billion;
- representing 10.24% of revenues.

Applying the global average loss rate (5.6%), derived from where losses have been measured, would imply that:

- losses total £67.75 billion;
- equivalent to 54% of the total pre-tax profits of these companies.

3.7. If we apply the 5.6% loss rate and the 40% reduction figure cited in Section 2 of this report the aggregate pre-tax profitability of FTSE 100 companies would be boosted by £27.1 billion or over 21%.

3.8. A summary of 182 of the FTSE 250 listed companies for which data was available for 2013 - 2014 shows that those which were profitable had:

- total annual revenues of £223.05 billion;
- with pre-tax profits of £20.68 billion;
- representing 9.27% of revenues.

Applying the global average loss rate (5.6%), derived from where losses have been accurately measured, would imply that:

- losses total £12.2 billion;
- equivalent to 59% of the total pre-tax profits of these companies.

3.9. If we apply the 5.6% loss rate and the 40% reduction figure cited in Section 2 of this report the aggregate pre-tax profitability of FTSE 250 companies would be boosted by £4.88 billion or over 23%.

3.10. A summary of 327 of the FTSE AIM listed companies for which data was available for 2013 - 2014 shows that those which were profitable had:

- total annual revenues of £27.13 billion;
- with pre-tax profits of £3.39 billion;
- representing 12.52% of revenues.

Applying the global average loss rate (5.6%), derived from where losses have been accurately measured, would imply that:

- losses total £1.48 billion;
- equivalent to 45% of the total pre-tax profits of these companies.

3.11. If we apply the 5.6% loss rate and the 40% reduction figure cited in Section 2 of this report the pre-tax profitability of FTSE AIM listed companies would be boosted by £593.55 million or over 14%.
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Three simple first steps to achieving this

4.1. There are three simple first steps to reduce the cost of fraud:

(1) Find out how well protected overall your company is against fraud

(2) Find out how much fraud may cost your company

Go to www.pkf-safr.com. This free tool is the front end to the largest databases in the world concerning the measured cost of fraud and protection against it (“fraud resilience”). It considers 29 different factors but will take only 5 – 10 minutes to complete.

You will get:

• A fraud resilience rating (the scale is 0 – 50);

• A ranking by percentile against the 1100 plus organisations whose data is held; and

• An indicative figure for the percentage cost of fraud in your company (based on data from more than 380 statistically valid and accurate loss measurement exercises undertaken over 17 years and across 40 sectors in different countries. The total value of the expenditure measured is over £9.7 trillion).

(3) Contact PKF to find out more about where your protection against fraud is strong and where it could be strengthened – call Jim Gee on +44 (0)20 7516 2288 or email jgee@pkf-littlejohn.com for a free insight to your data.
The competitive advantage to be derived from the measurement and reduction of the cost of fraud could not be clearer. By ensuring that resources are not diverted from where it is intended they be applied, there are real competitive and financial advantages to be obtained.

We now have the tools to accurately measure fraud as a business cost, and to focus our skills and resources on reducing that cost. Rapid reductions have been shown to be possible and there are very significant financial benefits which can be delivered. As with any new way of doing things, the question initially is ‘Why would we do that?’ – it is now becoming ‘Why wouldn’t we do that?”.

This report highlights why and how companies can start to manage their fraud costs, just as they routinely manage other costs. Companies have much to gain from this approach. In such a highly competitive market any opportunity to reduce costs must be an attractive proposition.

As with other significant developments in business, the new approach is simply a result of looking at a problem in a different way, and then developing the related methodologies. The barriers to progress are often in the mind, not in reality. If you consider fraud just to be a crime, then you police it; if you think of it as a business cost like any other, then you manage and reduce it. The new approach has been applied in organisations from across the world and has delivered proven results. And, as ever, now that this has happened, those who follow next will secure the greatest competitive advantage.
Jim Gee is a Partner and head of Forensic and Counter Fraud Services at PKF Littlejohn, the major accountancy and business services firm and Visiting Professor and Chair of the Centre for Counter Fraud Studies at University of Portsmouth.

During more than 25 years as a counter fraud specialist, he led the team which cleaned up one of the most corrupt local authorities in the UK - London Borough of Lambeth - in the late 1990s; he advised the House of Commons Social Security Select Committee on fraud and the Rt. Hon. Frank Field M.P. during his time as Minister of State for Welfare Reform; between 1998 and 2006 he was Director of Counter Fraud Services for the Department of Health and CEO of the NHS Counter Fraud Service, achieving reductions in losses of up to 60% and financial benefits equivalent to a 12:1 return on the costs of the work.

Between 2004 and 2006 he was the founding Director-General of the European Healthcare Fraud and Corruption Network; and he has since worked as a senior advisor to the UK Attorney-General on the UK Government’s Fraud Review as well as delivering counter fraud and regulatory services to public bodies and private companies both in this country and internationally. He has worked with organisations from 38 countries to counter fraud in Europe, the Americas, Asia, Australasia and Africa. He has also advised the Chinese Government about how to measure, pre-empt and reduce the financial cost of fraud.

Professor Mark Button is a Director of the Centre for Counter Fraud Studies at University of Portsmouth

He has written extensively on counter fraud and private policing issues, publishing many articles, chapters and completing four books with one forthcoming: Private Security (published by Perpetuity Press and co-authored with the Rt. Hon. Bruce George MP), Private Policing (published by Willan), Security Officers and Policing (Published by Ashgate), Doing Security (Published by Palgrave), and Understanding Fraud: Issues in White Collar Crime (to be published by Palgrave in early 2010 and co-authored). He is also a Director of the Security Institute, and Chairs its Academic Board, and a member of the editorial advisory board of “Security Journal”.

Mark founded the BSc (Hons) in Risk and Security Management, the BSc (Hons) in Counter Fraud and Criminal Justice Studies and the MSc in Counter Fraud and Counter Corruption Studies at Portsmouth University and is Head of Secretariat of the Counter Fraud Professional Accreditation Board (CFPAB). Before joining the University of Portsmouth he worked as a Research Assistant to the Rt. Hon. Bruce George MP specialising in policing, security and home affairs issues.

He completed his undergraduate studies at the University of Exeter, his Masters at the University of Warwick and his Doctorate at the London School of Economics.
Fraud is a problem that undermines the financial health of companies of all sizes. It is not a victimless crime, but one which undermines their profitability and capacity for a beneficial impact.

Global research shows that fraud costs organisations an average of 5.6% of expenditure but also that this figure varies considerably according to how resilient to fraud they are.

PKF Littlejohn and the Centre for Counter Fraud Studies (CCFS) at University of Portsmouth have jointly undertaken the most extensive and most comprehensive research yet in this area and now have the world's largest databases concerning measured fraud losses and fraud resilience.

One affects the other - the more resilient to fraud that a company is, the lower its losses will be. By increasing levels of fraud resilience, losses have been cut by up to 40% within 12 months.

By combining specialist experience and academic rigour …

PKF and the CCFS represent a unique combination of specialist hands on experience, academic knowledge and rigour, and mining sector expertise. Together we offer a confidential Fraud Cost and Resilience Review service which rates and benchmarks companies against both best practice and their peers. This service reviews counter fraud arrangements against 29 measures of resilience and 170 different criteria derived from the best professional standards.

The review covers

- the extent to which an organisation understands the nature and cost of fraud to it as a business problem;
- the extent to which it has an effective strategy in place which is tailored to address this problem;
- the extent to which organisations maintain a counter fraud structure which can implement this strategy successfully;
- the extent to which the structure efficiently undertakes a range of pre-emptive and reactive action; and
- the extent to which results are properly measured, identified and delivered.

… We can provide the answers

We let the data speak for itself to identify weaknesses in counter fraud arrangements and we calibrate our findings to estimate the cost of fraud. Our work results in the provision of a clear and concise report detailing our findings with recommendations for action to reduce the extent and cost of fraud.

Find out more

The cost of the Fraud Cost and Resilience Review service varies according to the nature, size and complexity of the company concerned. However, it is designed to be a cost-effective response to fraud which provides information and evidence to allow further decisions to be made.
About the publishing organisations

PKF Littlejohn Counter Fraud and Forensic Services
PKF Littlejohn is one of the leading firms of accountants and business advisers in the UK and the London member of PKF International. We offer a full range of forensic services on a national and international basis including:

• Counter fraud services which focus on measuring, managing and minimising fraud as a business cost
• Expert investigation and litigation support
• Professional counter fraud training
• Business intelligence services – undertaking due diligence work across the world
• Advice on combating bribery and corruption
• Advanced data analytics.

About PKF
In the UK and Ireland, PKF International is represented by six PKF member firms - PKF Littlejohn, PKF Cooper Parry, KLSA, Johnston Carmichael and PKF-FPM and PKF O’Connor, Leddy & Holmes. They have a combined fee income of £78m, with services delivered by 1,000 partners and staff.

The PKF International network has close to 300 member firms and correspondents in 440 locations in 125 countries providing accounting and business advisory services. PKFI member firms have around 2,270 partners and nearly 22,000 staff.

www.pkf-littlejohn.com

The Centre for Counter Fraud Studies (CCFS) is one of the specialist research centres of the Institute of Criminal Justice Studies, formed in 2009 to accommodate the growing interest in counter fraud that has occurred within the Institute over the last ten years. The Centre aims to collate and present the widest possible range of information regarding fraud and the solutions applied to it, and to undertake and publish further research where needed. Additionally, the Centre’s Fraud and Corruption Hub gathers the latest thinking, publications, news and research in one central resource for counter fraud professionals.

www.port.ac.uk/centre-for-counter-fraud-studies