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The Financial Cost of Fraud 2015

What the latest data from around the world shows

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Centre for Counter Fraud Studies

FORENSIC & COUNTER FRAUD SERVICES

CONTENTS

“Fraud is the last great unreduced business cost, and this Report shows just how significant that cost is.”

Foreword

Fraud is a challenging problem. Its economic effects are clear – worse public services, less financially stable and profitable companies, diminished levels of disposable income for all of us, charities deprived of resources needed for charitable purposes. In every sector of every country, fraud has a pernicious impact on the quality of life.

However, historically, fraud has been described as 'difficult to cost'[1] and until relatively recently, it has not been possible to quantify these effects. However, the last 10-15 years have seen this situation change.

This Report builds on research first undertaken and published in 2009, 2011 and 2013 considering just what the financial cost of fraud really is. It represents another output of the fruitful collaboration between PKF Littlejohn, the leading accountants, and the Centre for Counter Fraud Studies at the University of Portsmouth (CCFS), Europe's leading fraud research centre.

Rapid changes have taken place in countering fraud over the last 15 years. It used to be thought that the only thing to be done was to hope that it wouldn't happen and then to react when it did (after losses had been incurred) with an investigation followed sometimes by litigation or a prosecution.

Litigation or a prosecution can still be important but in 2015, only taking a reactive approach seems rather old fashioned.

In the UK, from the late 1990s, the Department of Work and Pensions and the NHS started to accurately measure fraud (and error) losses. In 2006, the Government's 'Fraud Review' Report said, 'better measurement is crucial to a properly designed and effective strategic response to fraud and to supporting better management of fraud risks'. The National Audit Office's 2008 'Guide to Tackling External Fraud' said, 'Assessing the scale of loss from fraud is an important first step in developing a strategy for tackling external fraud'. The Government's National Fraud Authority produced an Annual Fraud Indicator each year up to 2013. In 2014, the Cabinet Office Fraud, Error and Debt Taskforce, at the behest of Ministers, asked every Government Department to undertake loss measurement exercises.

In Europe, the European Healthcare Fraud and Corruption Declaration of 2004, agreed by organisations from 28 countries, called for 'the development of a European common standard of risk measurement, with annual statistically valid follow up exercises to measure progress in reducing losses to fraud and corruption throughout the EU'.

In the United States, the Improper Payments Information Act of 2002 provided that public agencies should publish a 'statistically valid estimate' of the extent of fraud and error in their programs and activities, and this was reinforced by the Improper Payments Elimination and Recovery Act of 2010. As a result most major U.S. public sector agencies have been measuring and reporting losses for more than a decade.

As a result, many more exercises to measure losses have taken place than would otherwise be the case, and this Report documents what has been found over the period from 1997 to 2013. It also compares the cost of fraud in 2012 and 2013 with 2010 and 2011.

Of course, there are still some estimates published which are not reliable for the purpose of estimating the total cost of fraud. 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.

This Report takes the debate much further forward.

It shows that the financial cost of fraud and error can be accurately measured in the same way as other business costs; it shows that this is not unnecessarily costly or difficult; and most importantly, it shows what the financial cost is likely to be.

The volume of data, the total value of the expenditure concerned, the number of different types of expenditure and the different organisations and countries concerned are impressive.

It will take a brave Chief Executive or Director of Finance of any organisation to argue that the impact of fraud on their organisation is less than what this Report finds to be the case – more than two thirds of the exercises we reviewed showed fraud related losses of more than 3% of expenditure, with the 17 year average running at 5.6% and average losses rising in the last two years by almost 18%.

The evidence revealed in this Report that these losses can be, and have been, reduced by up to 40% within 12 months, provides a real opportunity in difficult economic circumstances. Private companies can gain a competitive advantage if the cost of fraud is reduced; public expenditure reductions can be less painful; and the charity sector can increase the resources it has available to deliver on important charitable purposes.

Fraud is the last great unreduced business cost, and this Report shows just how significant that cost is.

JIM GEE
Partner, Head of Forensic and Counter Fraud Services for PKF Littlejohn and Visiting Professor and Chair of the Centre for Counter Fraud Studies at the University of Portsmouth

1 'Counting the costs of crime in Australia: a 2005 update' – The Australian Institute of Criminology

1 // Introduction

1.1. This Report renews research first undertaken in 2009, and then in 2011 and 2013, collating accurate, statistically valid information from around the world about the real financial cost of fraud and error. Once the extent of fraud losses is known then they can be treated like any other business cost – as something to be managed and minimised in the best interest of the financial health and stability of the organisation concerned. It becomes possible to go beyond reacting to unforeseen individual instances of fraud and to embed strategies to pre-empt and minimise fraud losses in business plans.

1.2. The Report doesn't look at detected fraud or the individual cases which have come to light and been prosecuted. Because there is no crime which has a 100% detection rate, adding together detected fraud significantly underestimates the problem. If detected fraud losses go up, does that mean that there is more fraud or that there has been better detection? Equally, if detected fraud losses fall, does that mean that there is less fraud or worse detection?

1.3. The Report also doesn't rely on survey-based information where those involved are asked for their opinions about the level of fraud. These tend to vary significantly according to the perceived seriousness of the problem at the time by those surveyed. Whilst such surveys sometimes represent a valid survey of *opinion*, that is very different from a valid survey of *losses*.

1.4. Instead, this Report considers and analyses 382 exercises which have been undertaken around the world during the last 17 years, to accurately measure the financial cost resulting from fraud and error.

1.5. This is surely the worst aspect of the problem. Yes, fraud is unethical, immoral and unlawful; yes, the individuals who are proven to have been involved should be punished; yes, the sums lost to fraud need to be traced and recovered. However, these are actions which take place after the fraud losses have happened – after the resources have been diverted from where they were intended and after the economic damage has occurred.

1.6. In almost every other area of business life, organisations know what their costs are – staffing costs, accommodation costs, utility costs, procurement costs and many others. For centuries, these costs have been assessed and reviewed and measures have been developed to pre-empt them and improve efficiency. This incremental process now often delivers quite small additional improvements.

1.7. Fraud and error costs, on the other hand, have only had the same focus over the last 15 years or so. The common position has been that organisations have either denied that they had any fraud or planned only to react after fraud has taken place. Because of this, fraud is now one of the great unreduced business costs.

1.8. However, a cost can only be managed and reduced if it can be measured, and a methodology to do this accurately has only been developed and implemented over the last decade.

1.9. Now that we can measure fraud and error losses, we can make proper judgements about the level of investment to be made in reducing them. We can measure these losses and we can measure the financial benefits resulting from their reduction.

1.10. In the current macro-economic climate, reducing these losses is one of the least painful ways of reducing business costs. Fraud is an 'unnecessary' cost because much of it can be pre-empted. This Report identifies what the financial cost of fraud and error has been found to be and thus, the 'size of the prize' to be achieved from reducing that cost.

1.11. Of course, there is always more research to be done and any organisation should consider what its own fraud and error costs are likely to be; however, the volume of data which is already available from exercises covering total expenditure of over £9.76 trillion, sterling equivalent, points clearly to losses usually being found in the range of 3-10%, probably around the average of 5.6% and possibly much higher.

1.12. We will continue to monitor data as it becomes available and publish further Reports as appropriate.

2 // Overview

2.1. Our research has now reviewed 382 loss measurement exercises undertaken over the period from 1997 to 2013. The exercises took place across 40 different types of expenditure in 46 organisations from 9 countries considering losses in expenditure with a total value of £9.76 trillion. The value of the expenditure examined has not been uprated to 2013 values. The losses referred to are a percentage loss of expenditure.

2.2. This Report is based on extensive global research, building on previously established direct knowledge, to collate information about relevant exercises. The data was then analysed electronically. Exercises were collated from Europe, North America and Australasia. None were found in Asia or Africa up to 2013, although the researchers are now aware that such exercises have taken place. Relevant data will be included in our next Report.

2.3. The Report has excluded guesstimates, figures derived from detected fraud losses, and figures resulting from surveys of opinion. It has also excluded some loss measurement exercises where it is clear that they have not met the standards described below.

2.4. It has included exercises which

- have considered a statistically valid sample of income or expenditure
- have sought and examined information indicating the presence of fraud, error or correctness in each case within that sample
- have been completed and reported
- have been externally validated
- have a measurable level of statistical confidence
- have a measurable level of accuracy.

2.5. There are a number of caveats.

2.6. Some of the exercises have resulted in estimates of the fraud frequency rate, some of the percentage of expenditure lost to fraud, and some have measured both.

2.7. It is also the case that some exercises have separately identified and measured fraud and error, and some have not.

2.8. Sometimes, once such exercises have been completed, the organisations concerned have, mistakenly in the view of the authors of this Report, decided not to publish their results. Transparency about the scale of the problem is a key factor in its solution, because attention can be focussed and a proportionate investment made to address the issue.

2.9. In some cases, those directly involved in countering fraud have decided, confidentially, to provide information about unpublished exercises for wider consideration. In those cases, while the overall figures have been included in the findings of this Report, no specific reference has been made to the organisations concerned.

2.10. The authors of this Report are also aware of a very small number of other exercises which have been completed, but which have not been published and where nothing is known of the findings.

2.11. Finally, it is important to emphasise that this research will never be complete. More evidence becomes available each year. However, the preponderance of the evidence does point clearly in one direction, as is explained later.

2.12. While it is necessary to make these caveats clear, the importance of the evidence collated in this Report should not be underestimated. It shows that losses to fraud and error represent a significant, damaging and, crucially, unnecessary business cost.

3 //

Data from around the world

3.1. The nine countries in which the authors are aware that fraud loss analysis exercises have taken place are:

- the United Kingdom
- the United States of America
- France
- Belgium
- the Netherlands
- Ireland
- Canada
- Australia
- New Zealand.

3.2. By value of income or expenditure measured, the United States has undertaken the greatest amount of work in this area. This is a direct reflection of the Improper Payments Information Act of 2002 (IPIA) which requires designated major U.S. public authorities to estimate the annual amount of payments made where fraud and error are present, and to report the estimates to the President and Congress with a progress report on actions to reduce them. The Improper Payments Elimination and Recovery Act of 2010 further strengthened this requirement.

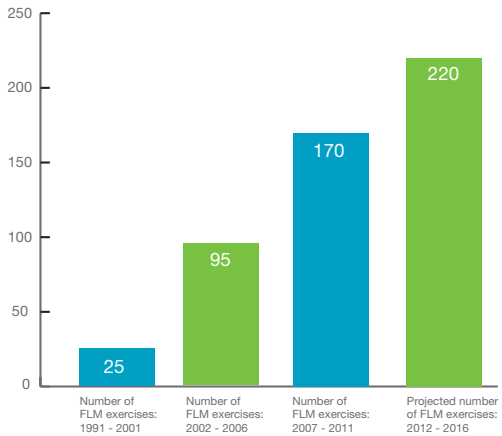
3.3. The guidance relating to the original IPIA stated 'The estimates shall be based on the equivalent of a statistical random sample with a precision requiring a sample of sufficient size to yield an estimate with a 90% confidence interval of plus or minus 2.5%'[2]. This remains the case although many U.S. agencies undertake work to the higher standard often found in the UK and Europe – 95% statistical confidence and +/- 1%.

3.4. In other countries, while there has not hitherto been any legal requirement, there is a growing understanding that the key to successful loss reduction is to understand the nature and scale of the problem. For example, in Europe, the European Healthcare Fraud and Corruption Declaration, agreed by organisations from 28 countries called for 'the development of a European common standard of risk measurement, with annual statistically valid follow up exercises to measure progress in reducing losses to fraud and corruption throughout the EU.'[3]

3.5. In the UK, the Government is on record as requiring this work to be undertaken. Indeed in late 2014, the Government's Cabinet Office Fraud, Error and Debt Taskforce, with the agreement of Ministers, asked all Government Departments to undertake 'random sampling' loss measurement exercises.

3.6. This is a major step forward to countering fraud in UK central government. The results of this work should be available in 2015 and our next Report will, hopefully, include this data.

3.7. These developments are part of a consistent trend. Over the period considered by this Report – 1997 to 2013 – the growth in the number of fraud loss measurement (FLM) exercises is marked, with a projected nine fold increase in prevalence.



2. Appendix C to Office of Management and Budget Circular A-123
3. European Healthcare Fraud and Corruption Declaration 2004

4 //

Types of income and expenditure and the nature of the figures

4.1. The types of income and expenditure where losses have been measured include:

- payroll
- procurement
- housing
- education
- social security
- healthcare
- insurance
- tax credits
- pensions
- agriculture
- construction
- compensation

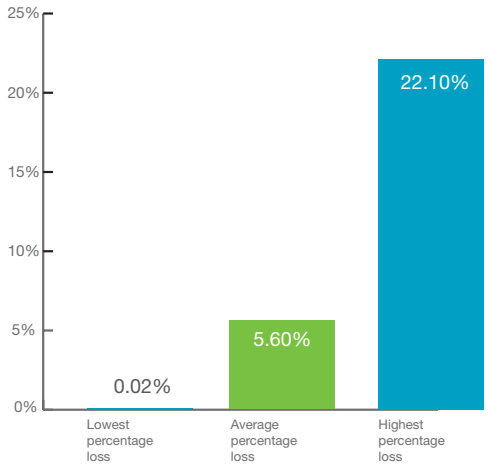
4.2. The key figures which have been produced concern the percentage loss rate (PLR - i.e. the proportion of expenditure lost to fraud and error).

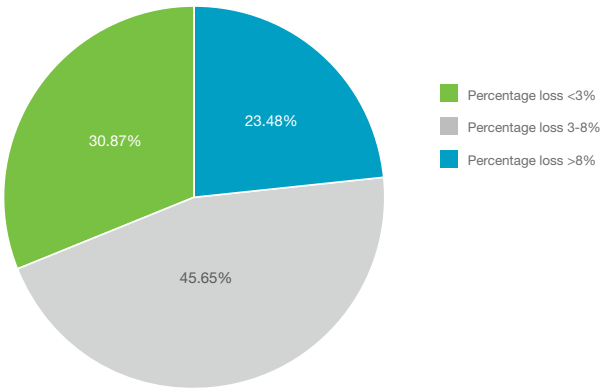
4.3. There is more research still to be done and it is intended that this Report will be updated on a regular basis.

5 //

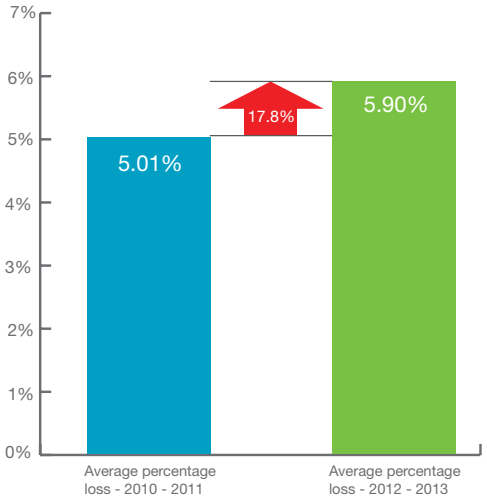
Fraud and error losses

5.1. The range of percentage losses across all the exercises reviewed between 1997 and 2013 was found to be between 0.02 and 22.1%, with average losses of 5.6% (69% of the exercises showed loss figures of more than 3%).





5.2. Just considering those exercises undertaken between 2010 and 2013 shows average losses increasing from 5.01% in 2010 and 2011 to 5.9% in 2012 and 2013 – an increase of 17.8% in 2010 and 2011 to 5.9% in 2012 and 2013 – an increase of 17.8%.



5.3. Over the whole period of the research the cost of fraud for the last two years reviewed (2012 and 2013) is 5.9%. This is 29% higher than for the period prior to the recent recession from 1997 to 2007.

5.4. The reasons for these increases – whether over the last two years or over the longer period since 2007 - seem to go beyond the economic cycle. Previous research has shown an apparent trend where fraud increases during recessions and plateaus or decreases slightly during periods of economic growth.

5.5. This does not seem to explain why the cost of fraud has risen in 2012-2013. Further research will be needed but it may be that longer term social and technological factors are an underlying cause of the growth of fraud, in addition to the effect of the economic cycle.

5.6. Such factors might include:

- greater individualisation (less adherence to collective moral and ethical 'norms')
- greater complexity of processes and systems (it becoming easier to disguise fraud amidst this complexity)
- more transactions by computer / less face to face transactions (fraudsters feeling more distant from the victims of their dishonesty and thus less concerned about any response)
- the differences between pre and post-recession economies
- more people under financial pressure during the financial crisis
- the increasing pace of change in business (with controls struggling to keep up).

5.7. Where organisations have undertaken repeated exercises to measure their losses in the same areas of expenditure, then the evidence also shows that this has helped to reduce them.

5.8. The global average loss rate for the entire period of the research (5.6%), when taken as a proportion of the global Gross Domestic Product (GDP) for 2013 ($75.59 trillion or £49.68 trillion)[4], equates to £2.78 trillion ($4.23 trillion), a sum more than 50% greater than the UK's entire GDP. Even reducing such losses by 40%, which individual organisations have achieved, would free up more than £1.1 trillion – a sum greater than the GDP of 175 countries.

5.9. In the UK, applying that global average loss rate to GDP[5] would imply total losses of £98.6 billion each year. Reducing such losses by 40% would free up more than £39 billion each year. This sum is equivalent to more than the UK Government spent on education in 2013 and only slightly less than it spent on military defence.

5.10. On the basis of the evidence, it is clear that fraud and error losses in any organisation should currently be expected to be at least 3%, probably almost 6% and possibly more than 10%. It would be wrong to go too much further in terms of predicting where in this range losses for an individual organisation will be, without some organisation-specific information about the strength of arrangements to protect it against fraud (its 'fraud resilience').

5.11. PKF Littlejohn and the Centre for Counter Fraud Studies (CCFS), in parallel research, have developed Europe's most comprehensive database of fraud resilience information, with data recorded concerning more than 700 organisations from almost every economic sector. By combining the data which underpins this Report and organisation-specific information about fraud resilience, we are able to predict:

- the likely scale of losses
- the key improvements which would reduce them, and
- the related cost.

5.12. We can also accurately measure losses or train client organisations to do this if engaged to do so. The practical experience of PKF Littlejohn specialists, combined with the academic rigour of CCFS researchers, provides an unparalleled expert resource.

4 World Bank figures
5 World Bank figures indicate UK GDP for 2013 was $2.678 trillion or £1.76 trillion

6 //

Conclusion and recommendations

6.1 This is the fourth Report in an area where, for too long, the accurate measurement of losses was considered either impossible or too difficult. It no longer is. In many areas loss measurement has become routine. Losses to fraud and error can now be treated as a business cost like any other – to be measured, managed and minimised.

6.2. It is also the case that work to measure losses can be highly cost-effective. The extent to which efforts to reduce losses are helped by greater knowledge about the problem is shown by the significantly lower average level of losses where they have been re-measured over a period of time, in the same area of expenditure.

6.3. Where losses have been measured, and the organisations concerned have accurate information about their nature and extent, there are examples, especially in the UK and U.S., where losses have been substantially reduced. The best examples over the 17 year period covered by this Report include:

- the UK's National Health Service (the second largest organisation in the world) between 1999 and 2006 where losses were reduced by up to 60%, and by up to 40% over a shorter period[6]
- the U.S. Department of Education, which reduced its losses across a $12 billion grant program by 35% between 2001 and 2005[7]
- the U.S. Department of Agriculture, which reduced its losses across a $12 billion program by 28% between 2002 and 2004[8]
- the UK's Department of Work and Pensions which successfully reduced its losses in Income Support and Job Seekers Allowance by 50% between 1997/98 and 2005/06[9]
- the U.S. Department of Veterans Affairs which successfully reduced its losses across a $4 billion program by more than 46% in 2010 and 2011[10]
- the U.S. Department of Agriculture (again) successfully reduced its losses across an $8 billion program by more than 22%[11]
- the UK's Department of Work and Pensions (again) achieved a significant reduction of more than 24% in losses in respect of Job Seekers Allowance[12].

6.4. Even during the two years after the start of the recession in 2008, when losses generally were increasing rapidly, two of the organisations included in our research reported very significant reductions in their losses – one by 33% and the other by 19% - within a single year in each case.

6.5. Three things are clear:

- Losses to fraud and error can be measured – and cost effectively
- On the basis of the evidence it is likely that losses in any organisation and any area of expenditure will be at least 3%, probably near to 6% and possibly more than 10%, and
- With the benefit of accurate information about their nature and extent, they can be reduced significantly.

6.6. **In the current economic climate, not to consider the financial benefits of making relatively painless reductions in losses to fraud and error seems foolhardy.**

6 UK NHS Counter Fraud and Security Management Service – 1999 – 2006 Performance Statistics
7 U.S. Department of Education Performance and Accountability Reports 2001 – 2005
8 U.S. Department of Agriculture Performance and Accountability Reports 2002 - 2004
9 UK Department of Work and Pensions - Fraud and Error in the Benefit System April 2005 to March 2006
10 Department of Veterans Affairs – Performance and Accountability Report 2012
11 Department of Agriculture – Performance and Accountability Report 2011
12 Department of Work and Pensions – Fraud and Error in the Benefit System – 2011/2012 Estimates (Revised Edition)

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What is the financial cost of fraud to your organisation?

Fraud is a challenging problem. Its economic effects are clear – worse public services, less financially stable and profitable companies and diminished levels of disposable income for all of us except the fraudsters.

However, fraud has historically been described as 'difficult to cost' and, until relatively recently, it has not been possible to quantify these effects. Over the last decade the situation has changed.

The most recent global study, undertaken by Jim Gee, PKF Littlejohn's Head of Forensic and Counter Fraud Services, with the University of Portsmouth, reported the latest accurate and statistically valid information from around the world about the real financial cost of fraud and error. It reviewed 290 exercises to accurately measure fraud and error losses, covering 40 different types of expenditure over 15 years and with a total expenditure valued at over £7.2 trillion sterling equivalent. It found, across this massively representative sample, average losses were 5.47% of expenditure.

Financial benefits of 2% of expenditure within 12 months

Once the extent of fraud losses is known, then they can be treated like any other business cost – something to be reduced and minimised in the best interest of the financial health and stability of the organisation concerned. PKF Littlejohn offers a service to do just that – to measure and to recommend how to reduce such losses, with reductions of up to 40% within 12 months possible and up to a 12:1 return on the cost of the work. It becomes possible to go beyond reacting to unforeseen individual instances of fraud and to include plans to pre-empt and minimise fraud losses in business plans.

In almost every other area of business life, organisations know what their costs are – staffing costs, accommodation costs, utility costs, procurement costs and many others. Fraud and error costs, on the other hand, have only rarely had the same focus. Because of this, fraud is now one of the great unreduced business costs.

We can provide the answers

Now that we can measure fraud and error losses, we can make proper judgements about the level of investment to be made in reducing them. Because we can measure these losses, we can then measure the financial benefits resulting from their reduction. In the current tough business climate, reducing these losses is one of the least painful ways of reducing business costs. We can help client organisations to do that as well as providing specialist training for staff to allow ongoing in-house measurement of the problem.

Find out more

The cost of PKF Littlejohn's fraud loss measurement service varies. We provide a comprehensive report indicating the level of cost of fraud (and error) in your organisation, so that you can make an informed judgement on how much to invest to reduce this cost. We can complete this work within as little as three months.

To find out more please call **+44 (0)20 7516 2288** or email **jgee@pkf-littlejohn.com**

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About the authors

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 the 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 Jim 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 more than 35 countries to counter fraud including companies, public sector bodies and charities. He has also advised the Chinese Government about how to measure, pre-empt and reduce the financial cost of fraud.

Professor Mark Button is Director of the Centre for Counter Fraud Studies at the Institute of Criminal Justice Studies, University of Portsmouth. Mark has written extensively on counter fraud and private policing issues, publishing many articles, chapters and completing eight books with one forthcoming.

His latest book (co-authored with Martin Tunley, Andrew Whittaker and Jim Gee) is titled 'The Accredited Counter Fraud Specialist's Handbook' and published by Wiley. Some of his most significant research projects include leading the research on behalf of the National Fraud Authority and ACPO on fraud victims; the Department for International Development on fraud measurement, Acromas (AA and Saga) on 'Cash-for-Crash fraudsters', the Midlands Fraud Forum and Eversheds on 'Sanctioning Fraudsters'.

Mark has also acted as a consultant for the United Nations Office on Drugs and Crime and on Civilian Private Security Services. Mark also holds the position of Head of Secretariat of the Counter Fraud Professional Accreditation Board. He is a former director of the Security Institute. Before joining the University of Portsmouth he was a Research Assistant to the Rt. Hon. Bruce George MP specialising in policing, security and home affairs issues. Mark 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.

About the publishing organisations

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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.

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University of Portsmouth
Centre for Counter Fraud Studies

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

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