minimising fraud and maximising results in the aviation industry

how the airlines can improve profitability by cutting the cost of fraud

Jim Gee, Dr. Mark Button and Andrew Whittaker
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The aviation industry faces numerous financial pressures that impact on its profitability, many of which are specific to the sector – the impact of Air Passenger Duty, increasing security and insurance costs, environmental levies, oil-price volatility, changes to customer business travel policies and competition from surface travel will all have had an impact on a company’s profitability during a time of unprecedented financial uncertainty. These are all costs that the industry identifies and takes into account, yet another business cost, of equal impact and significance, has never been accurately quantified by the sector – Fraud.

Fraud can lead to less financially stable and healthy companies and its reduction can also significantly improve profitability; it can result in public services which are not of the quality that citizens pay their taxes to get and its reduction can allow the maintenance and improvement of those services; it can result in the goods and services which we purchase as consumers being more expensive than they should be and its reduction can significantly improve value for money; charities can see their charitable purposes undermined by fraud and its reduction can allow additional resources to be focussed on important deserving causes. These positive outcomes arise from the financial benefits derived from the reduction of the significant cost which fraud represents.

PKF’s new report provides an unprecedented insight into the benefits to the aviation industry of reducing the cost of fraud. In uncertain macro-economic times, cutting the cost of fraud - revealed by the latest global research to represent, on average, 5.7% of expenditure - can massively boost profitability and financial health.

Developments over the last decade or so, to accurately measure the cost of fraud like any other business cost, has allowed organisations from many different sectors, and across the world, to manage and minimise that cost.

The report outlines the results of research to review data from airlines and aviation companies in the UK, as well as a range of airlines from around the world, including a number of national carriers. The effect on companies’ results is dramatic, whatever the size of the company and whichever country it is listed in.

Later in 2012, a book by Jim Gee and Mark Button - Countering Fraud for Competitive Advantage - will be published globally by John Wiley and Sons. It will expand on the themes in this report and explain what companies need to do to gain the competitive advantage. What is clear is that fraud - the last great unreduced business cost - can now be measured, managed and minimised.

Jim Gee
1 // the size of the problem
1 // the size of the problem

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 address 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 10 - 15 years this situation has changed.

1.3 In the UK, from the late 1990s, the Department of Work and Pensions and the National Health Service (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’.

1.4 The Government’s National Fraud Authority now has a specialist unit devoted to this task, and each year produces an Annual Fraud Indicator covering private, public and voluntary sectors of the UK economy.

1.5 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.”

1.6 In the United States, the Improper Payments Information Act of 2002 requires public agencies to publish a ‘statistically valid estimate’ of the extent of fraud and error in their programs and activities, and this has recently been reinforced by the Improper Payments Elimination and Recovery Act of 2010.

1.7 ‘The Financial Cost of Fraud Report 2011’ represents the latest, most extensive global research in this area. The report documents what has been found, across the world, over the period from 1997 to 2009. It also shows the impact of the recession on losses by comparing and contrasting data from 2008 and 2009 with the prior period. It focuses on presenting a credible, accurate and statistically valid picture, in a context where the quality of some information has historically been poor.

1.8 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.

1.9 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.

1.10 Surveys of opinion are also unreliable. The Association of Certified Fraud Examiners (ACFE) in the United States produces an annual survey of this type 2. Its most recent edition states that “Survey participants estimated that the typical organization loses 5% of its annual revenue to fraud.” 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. Past reports examining fraud in the airline sector have relied on survey results to measure the scale of the problem, resulting in an average figure of $2.4 million lost to fraud per airline3.

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1 ‘The Financial Cost of Fraud Report 2011’ – published by PKF (UK) LLP and the Centre for Counter Fraud Studies at University of Portsmouth – Jim Gee, Dr Mark Button and Graham Brooks

2 ACFE: ‘2010 Report to the Nations’

3 Deloitte Airline Fraud Report 2010
1 // the size of the problem

1.11 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 unnecessarily costly or difficult, and most important, an accurate, statistically valid figure can be provided for what the financial cost is estimated to be. As an example, an airline would not base its fuel consumption costs on crude estimates – it relies on accurate, reliable data. Similarly airlines and aviation companies should identify the true cost of fraud, so that an effective business plan can be adopted.

1.12 The latest global research\(^4\) indicates that losses to fraud average 5.7% of expenditure\(^5\). When measured across 32 types of expenditure with a total value of £5 trillion, and in several different countries, just under 70% of accurate and statistically valid measurement exercises revealed losses of 3% or more. This figure rose to over 75% for the period after the recession of 2008 – 2009.

1.13 So, research leaves little room for doubt that fraud represents a significant cost.

1.14 The global average loss rate of 6.1% for the period after the recession commenced (2008 - 2009), when taken as a proportion of the global Gross Domestic Product (GDP) for 2010 ($62.91 trillion or £40.66 trillion\(^6\)), equates to £2.48 trillion, a sum equivalent to more than one and a half times the UK’s entire GDP. Applying this loss rate to UK GDP (£1.45 trillion\(^7\) for 2010) equates to losses of more than £88 billion.

\(^4\) ‘The Financial Cost of Fraud Report 2011’ – published by PKF (UK) LLP and the Centre for Counter Fraud Studies at University of Portsmouth – Jim Gee, Dr Mark Button and Graham Brooks

\(^5\) Losses to fraud and error

\(^6\) IMF Data - Nominal GDP list of countries for the year 2010. World Economic Outlook Database-September 2011

\(^7\) IMF Data - Nominal GDP list of countries for the year 2010. World Economic Outlook Database-September 2011

\(^8\) ‘The Financial Cost of Healthcare Fraud Report 2011’ – published by PKF (UK) LLP, the Centre for Counter Fraud
1 // the size of the problem

1.15 In the global healthcare sector, the average percentage of expenditure lost, across such a wide range of healthcare expenditure, was found to be 7.29% \(^8\). The World Health Organisation’s latest estimate of global healthcare expenditure is US $5.7 trillion. Thus, it is likely that around US $415 billion is lost globally to fraud (and error). This is the equivalent of more than twice the budget for the entire UK NHS or enough to build more than 2,300 new hospitals (at developed world prices) and more than the entire national GDP of all but 29 of more than 190 countries across the world. Countering fraud effectively would reduce these losses and free up massive resources for better patient care.

1.16 In the UK, the Government’s National Fraud Authority (NFA), in its Annual Fraud Indicator for 2012, estimates that £73 billion is lost to fraud, with £20.2 billion lost in the public sector.

1.17 IATA estimates that global aviation revenues grew to $554 billion on 2010, yet no one knows how much of that is lost to fraud. Using the average fraud loss of 5.7%, this would represent losses to aviation of over $31.5 billion.

1.18 So it is clear that the cost of fraud is significant and can and has been measured in many different types of organisation. The next logical question concerns the extent of the competitive advantage to be gained from reducing this cost and how quickly it can be realised.

\(^8\) ‘The Financial Cost of Healthcare Fraud Report 2011’ – published by PKF (UK) LLP, the Centre for Counter Fraud
how quickly can losses be reduced and by how much?
2 // how quickly can losses be reduced and by how much?

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 2011 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. The best examples over the 12 year period covered by this Report include:

2.2.1 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% within 12 months;

2.2.2 the US Department for Education, which reduced its losses across a $12 billion dollar grant program by 35% between 2001 and 2005;

2.2.3 the US Department of Agriculture, which reduced its losses across a $12 billion dollar program by 28% between 2002 and 2004; and

2.2.4 the UK’s Department of Work and Pensions which has successfully reduced its losses in Income Support and Job Seekers Allowance by 50% between 1997/98 and 2005/06.

2.3 These are published public sector examples because of the transparency requirements concerning public expenditure. However, there are unpublished private sector examples, which the authors of this report are aware of, showing a comparable position.

2.4 In fact, research shows that the position concerning losses does not vary significantly according to what part of the economy an organisation comes from.

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%9, 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.

9 “The Financial Cost of Fraud Report 2011” - Jim Gee, Dr Mark Button and Graham Brooks
3 //
what would such a reduction in fraud losses mean?
3.1 This section of the Report reviews data from across the world to provide an answer.

40 of the World’s Leading Aviation Companies

3.2 In the global commercial sector, fraud has a significant effect on profitability. A summary of 40 of the world’s leading aviation companies for 2011 shows that they had total annual revenues exceeding $340 billion, with profits of just under $10 billion, representing 2.88% of revenues. Applying the global average loss rate (5.7%), derived from where losses have been accurately measured, would imply that losses total $19.55 billion, almost twice times the total profits of these top companies.

3.3 What would such a reduction in the cost of fraud mean in financial terms? The beneficial effects to the aviation sector are impressive. Nearly 50% of the leading aviation companies would increase their profitability by between 10 – 99%; 20% would do so by between 100 – 1000%; 15% would be making profits not losses and 13% would have their losses significantly reduced. This would represent a massive boost to corporate health and would point the way out of one of the worst global recessions ever for a sector that has more than its share of financial burdens.

3.4 The average increase in profitability (excluding one outlier), across the firms who were already profitable to some extent, would be almost 128%. Among the 11 firms that were making losses (of $1.4 billion), those losses would be reduced by an average of over $73 million.

3.5 The proportion of companies that would increase their profitability is indicated below:

67% would increase their profitability by 10% or much more; two out of every three of these airlines would more than double their profitability, with one increasing its profitability by over 2000%. And of course, the beneficial effects do not stop there. Greater profitability can enable greater investment, more competitiveness, an increase in employment and a general economic stimulus within the sector.

Regional variations

3.7 The positive picture of profitability increasing due to reduced losses to fraud is replicated around the world. In North America profitability would increase on average by over 100%, in Europe by over 60% and in Asia/Pacific by just under an average of 50%. Although the figure for Asia is less than that for Europe and North America, the range is much narrower, indicating that most companies could achieve an increase in profitability close to the average.

3.8 Of the EU companies currently making a loss, 40% would return to profitability and 40% would reduce their losses by more than 25%. In North America, those companies making a loss would reduce these by between 10 and 40%. What would reductions of these magnitudes have on market confidence? It is difficult to speculate but traditional cost-cutting measures often attract poor publicity and put a strain on employee relations.
conclusion
4 // conclusion

4.1 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 reaped.

4.2 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?’.

4.3 This report highlights why and how airlines and other companies operating in the sector can start to manage their fraud costs, just as they routinely manage other costs. The statistics revealed indicate that this sector probably has the most to gain from this approach, due to the plethora of external forces acting against it. In a difficult macro-economic climate, the benefits of cutting the cost of fraud could provide a real economic stimulus in a sector that has always been difficult to trade in. In such a highly competitive market any opportunity to reduce costs, rather than to increase passenger charges, must be an attractive proposition.

4.4 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 now been tested in organisations from across the world and has delivered proven results. And, as ever, now that this has happened, those who follow next will reap the greatest competitive advantage.

4.5 A first step may be to use PKF’s free Fraud Resilience Self-Assessment Tool, which draws on data from the two largest databases in the world concerning fraud losses and fraud resilience, to rate and rank organisations and to provide an indicative figure for the financial cost of fraud. The UK Government has endorsed this methodology and the tool can be accessed at www.pkfapps.co.uk/fraud.
Fraud is a problem that undermines the stability and financial health of aviation companies from across the world. It is not a victimless crime, but one which undermines their profitability and the cost effectiveness of air travel.

Global research shows that fraud costs organisations an average of 5.7% of expenditure but also that this figure varies considerably according to how resilient to fraud they are.

PKF (UK) LLP 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 experience. Together we offer a confidential Fraud Resilience Review service which rates and benchmarks mining companies operations 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. We have delivered this service on-site in different countries around the world.

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. Our work results in the provision of a clear and concise Report detailing our findings with recommendations for improvements based on a wealth of experience drawn from more that 30 countries around the world.

find out more

The cost of the Fraud 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.

To find out more please ring 020 7065 0557 or email jim.gee@uk.pkf.com
about
the authors
Jim Gee is Director of Counter Fraud Services at PKF (UK) LLP, the leading accountancy and business services firm 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 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 more than 30 countries to counter fraud including recently in Zambia and Indonesia. He has also recently finished advising the Chinese Government about how to measure, pre-empt and reduce the financial cost of fraud.

Dr Mark Button is a Reader at University of Portsmouth and Director of the Centre for Counter Fraud Studies. Mark Button is a Reader in Criminology and Associate Head Curriculum at the Institute of Criminal Justice Studies, University of Portsmouth. He has also recently founded the Centre for Counter Fraud Studies of which he is Director. 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. Mark has recently been working on a research project funded by the National Fraud Authority and ACPO looking at victims of fraud.

Andrew Whittaker is a Senior Manager at PKF (UK) LLP and has over 35 years experience of investigating wrongdoing, 20 of them countering fraud. He is chairman of the Counter Fraud Professional Accreditation Board's Training and Education Committee and is both an Accredited Counter Fraud Specialist and Accredited Counter Fraud Trainer, as well as being an Accredited Security Management Specialist. Andrew has worked with a number of global companies to help counter fraud, with engagements in Hong Kong, Europe and Africa. He holds a Commercial Pilots Licence and has worked for an FBO in the UK.
about the publishing organisations

PKF Forensic Services
PKF (UK) LLP is one of the leading firms of accountants and business advisers in the UK offering counter fraud, forensic accounting, expert witness and litigation support services on a national and international basis including:

- fraud resilience checks
- fraud loss measurement and reduction
- asset tracing and confiscations
- forensic IT, including data mining, data imaging and recovery
- fraud and financial investigations

www.pkf.co.uk

The Centre for Counter Fraud Studies at University of Portsmouth
The University of Portsmouth's Centre for Counter Fraud Studies (CCFS) was founded in June 2009 and is one of the specialist research centres in the University's Institute of Criminal Justice Studies. It was founded to establish better understanding of fraud and how to combat it through rigorous research. The Institute of Criminal Justice Studies is home to researchers from a wide cross-section of disciplines and provides a clear focus for research, knowledge transfer and educational provision to the counter fraud community. The Centre for Counter Fraud Studies makes its independent research findings available to support those working in counter fraud by providing the latest and best information on the effectiveness of counter fraud strategies.

www.port.ac.uk/departments/academic/icjs/CentreforCounterFraudStudies
// notes
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PKF (UK) LLP is one of the UK’s leading firms of accountants and business advisers and specialises in advising the management of developing private and public businesses. We pride ourselves on creating and sustaining supportive relationships where objective and timely advice enables our clients to thrive and develop.

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- Pensions
- Professional practices
- Public sector
- Real estate & construction

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