

### INVESTIGATION INSIGHTS



## Using Discovery Sampling to Find Fraud

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**T**o decide to proceed with a fraud investigation, an investigator should always have predication—reasonable belief and/or minimal evidence that fraud has occurred and can be detected through investigation.

One way to get predication is by performing an audit-related exercise known as discovery sampling (also sometimes referred to as "stop-and-go sampling").

**Also helpful:** An understanding of how anti-fraud controls were breached, and who stood to gain from the breach.

### WHAT IT IS/HOW IT WORKS

Discovery sampling is an audit tool that assumes that a minimal sample would suffice, unless proven otherwise.

**Key:** In auditing, the minimal sample is selected (example: 25 invoices), and if no suspicious exceptions are noted, the auditor concludes that his or her assumption that internal controls over invoicing are working well, is proven.

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**Contrast:** If there are exceptions, the auditor then expands the sample, until the deviation rate is acceptable. For example, an internal auditor wants to see if large checks are being signed by two signers, as required. She selects 25 checks that fit the profile and is expecting a 6% error rate.

**Results:** For two of the 30 checks, the controls failed. The auditor has a deviation rate of 2:30, or 7%. The auditor expands the sample by 10 more units for each exception found, and inspects an additional 10 checks. One exception is noted from the second group of 10 checks, and the deviation rate is now 3:40, or 7.5%. The auditor selects a third group of 15 checks and tests them. Now they all pass the test and the overall deviation rate is 3:55 or 5.5%, and the control can be deemed effective.

Test	Sample	Result	Stop or Go?
Initial	0	2 Exception, 7% deviation	Go
Expansion #1	10	3 Exception, 7% deviation	Go
Expansion #2	15	3 Exception, 5.5% deviation	Stop

However, in fraud investigations, when we don't know how the fraud happened, we perform the minimal selection in order to detect a pattern of fraud. As in auditing, we start with a minimal sample (example, again 30) and if we see a pattern of fraud, we have a basis to expand the selection. Most likely, we will then try to turn to data-driven methods (saves money), or at least be able to plan the investigation further.

#### SIZE MATTERS

A good minimal number for a sample in a fraud audit or investigation is 25. If we find no suspicious patterns after we sampled at least 10% of the population (in internal controls testing, and in fraud, this is usually the number of transactions regardless of their amount) then we can have some comfort that we did not detect a pattern of fraud. The main difference between fraud and audit is that in a discovery sampling in fraud, we are selecting our sample with a bias.

**Example:** If we suspect that the checks are being replaced, we will select only checks that fit the initial suspicion (out-of-sequence check numbers would be one such characteristic). The sample is not a statistical sample per-se, because it is intended to provide us knowledge of a pattern, but not necessarily project on the whole population.

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## WHERE DO WE BEGIN?

Unlike auditing, fraud investigations require bias samples in "discovery sampling". That is because of efficiency (eg. A single vendor is identified as related to a kickback scheme) ... or working theory, or predication (a single employee has booked unauthorized expenses).

So in discovery sampling for fraud the sample can and should be biased, to the extent that the investigator knows or suspects the areas experiencing fraud.

**Example:** A bias sample can exist when we are tipped off that invoices for a particular vendor are inflated for labor and materials that were not delivered—as part of a kickback scheme. We don't know if this is really going on, and interviewing would be both disruptive and expensive.

Discovery sampling of invoices of this particular vendor could give us an idea of the pattern. We select only the invoices for this vendor, and look only for labor and materials that may not have been delivered. Once we discover that the vendor's method is to provide such invoices by hand to the project manager on site, we not only have an insight into how often this is done, we may also have a suspect.

By contrast, if we perform a random sample of the invoices without a biased selection, the chances of discovering the fraud only grow marginally with the increased sample size – as would have been the case in an audit. 🚫

### **White-Collar Crime Fighter source:**

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## ANTI-FRAUD TECHNOLOGY



# How to Protect Your Organization From Wire Transfer and ACH Fraud

SECURE YOUR COMPUTER, SMARTPHONE AND NETWORK.

### **Steps to take:**

- ✓ Install –or upgrade –a firewall on your computer and/or network to prevent unauthorized access.
- ✓ Install and run anti-virus, anti-spyware, and anti-malware software on your computer and keep them updated.
- ✓ Change all default passwords on your computer, smartphone and network and create complex passwords.
- ✓ Beware of any changes in the performance of your computer such as a significant loss of speed ... changes in the way print and images appear on your screen ..., the computer freezes ... unexpected rebooting... or anything else out of the ordinary.