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The Effectiveness of External Auditing in Detecting Financial Fraud

A review of current practices and processes, evaluation and recommendation for improvement

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Abstract

This research study explores the realm of financial fraud detection within modern auditing practices, aspiring to shed light on its significance and the implications of the evolving landscape. The study emphasizes the importance of auditors' roles in detecting financial fraud, an essential aspect of maintaining the integrity of financial reporting and safeguarding stakeholders' interests.

Methodologically, this research incorporates a comprehensive review of academic journals, industry reports, and existing literature related to auditing practices, as well as secondary data analysis, to help evaluate the effectiveness of current practices in detecting financial fraud.

Key research findings highlight the challenges and opportunities in fraud detection. While the use of external audits in fraud prevention is very common, their effectiveness as an initial detection method remains very low across the globe. For this reason, the exploration of new techniques and technologies, such as data analytics, is necessary to strengthen the accuracy and efficiency of fraud detection. Furthermore, nurturing a proactive mindset that encourages professional scepticism is critical to adapting to evolving fraudulent activities.

In conclusion, the researcher aimed to point out the critical role of auditors in financial fraud detection and prevention and advocates for an industry-wide focus on continuous education, training, and innovation to improve the efficiency of auditing practices. By addressing the limitations identified in this study, the auditing profession can enhance its capacity to detect financial fraud, promoting transparency and trust within the financial domain.

CONTENTS

1. INTRODUCTION: BACKGROUND AND RESEARCH QUESTIONS

1.1 BACKGROUND OF THE STUDY

Fiscal fraud is not a new concept it has existed throughout history as claimed by van Driel (2018) and Toms (2019) shows us how, from ancient times to the modern era, we have witnessed it in many forms, including embezzlement, insider trading, and accounting manipulations. Studying the historical development helps in understanding the changing nature of fraud schemes and the strategies employed by fraudsters.

Mboga (2017) on the other hand explores how several high-profile cases have had a significant impact on organizations and society. The Enron scandal, WorldCom, Bernie Madoff's Ponzi scheme, and the Wells Fargo accounts scandal emphasized the degree of economic losses, the erosion of public trust, and the severe consequences for the companies involved. Moreover, Li's (2010) review of the most well-known cases, such as Enron, highlighted the importance of effective fraud detection measures. Consequently, auditing practices and processes have faced increased scrutiny to improve their effectiveness in identifying and preventing financial fraud.

Financial fraud brings devastating consequences for organizations: significant financial losses, damage to reputation and brand image, legal and regulatory penalties, or bankruptcy in some cases. Additionally, fraudulent activities cause employee layoffs, investor distrust, and a loss of confidence in the financial markets.

To restore trust in external audits, the government had to act by developing legal and regulatory frameworks, such as the Sarbanes-Oxley Act in the United States and the Financial Reporting Council's Corporate Governance Code in the UK, to enhance corporate governance, reinforce internal controls, and increase accountability and transparency (ICAEW Insights, 2021b)

1.2 RATIONALE FOR THE STUDY AND OBJECTIVES

The rationale for conducting this research stems from the need to address the ongoing challenges in detecting and preventing financial fraud. Despite the existence of auditing standards and procedures, financial fraud continues to occur, indicating potential gaps in current practices. By evaluating the effectiveness of auditing in fraud detection, this research aims to contribute to the improvement of auditing processes and the development of stronger mechanisms to combat financial fraud.

The leading objective of this research is to evaluate the success of external auditing in detecting financial fraud. Specifically, the research aims to:

1. Understand the current practices and processes used by auditors to detect financial fraud and determine their level of effectiveness.
2. Identify any limitations or weaknesses in the current practices and processes.

3. Make recommendations for improvement to enhance the effectiveness of auditing in detecting financial fraud.

1.3 RESEARCH QUESTIONS

The following research questions will lead the study to fulfill the research objectives.:

- What are the current practices and processes used by auditors in detecting financial fraud?
- How effective are these practices and processes in detecting financial fraud?
- What are the limitations of these practices and processes in detecting financial fraud?
- What recommendations can be made to improve the effectiveness of auditing in detecting financial fraud?

1.4 SCOPE AND LIMITATIONS

This study will focus on the effectiveness of auditing in detecting financial fraud within the context of corporate organizations. It will consider only external auditing practices, examining the role of auditors in fraud detection. It is important to note that the study is limited to secondary data sources, such as academic journals, reports, and industry publications. Primary data collection through interviews or surveys is beyond the scope of this research.

1.5 SIGNIFICANCE OF THE STUDY

The findings of this research will have several implications for various stakeholders. Firstly, it will provide insights into the current practices and processes used by auditors to detect and prevent financial fraud, enabling organizations to identify areas for improvement. Additionally, the study will contribute to the existing literature on auditing and financial fraud detection, filling potential research gaps and serving as a foundation for future studies in this field.

By addressing the above, this research aims to contribute to the knowledge and understanding of the effectiveness of auditing in detecting financial fraud. It will reach deeper into the relevant literature, methodology, findings, and recommendations to provide a comprehensive analysis of the research topic.

2. LITERATURE REVIEW

2.1 KEYWORDS OF RESEARCH

2.1.1 Financial Fraud

There is no single definitive definition of financial fraud, as it can take many different forms and involve various types of activities. According to the European Anti-Fraud Office (OLAF, 2021), financial fraud is a deliberate act of deception that is intended to result in financial gain for the person committing the fraud.

In addition, Reurink's review (2016) analyses its many forms, including but not limited to:

1. Accounting fraud: Involves the manipulation of financial records to mislead investors and stakeholders about a company's financial performance.

2. Securities fraud: This involves making false or misleading statements about a company or its securities to influence the market and to benefit from the resulting price movements.
3. Ponzi schemes: A type of investment fraud in which returns are paid to existing investors using the capital of new investors, rather than from profit earned through legitimate business activities.
4. Embezzlement: Occurs when an individual misappropriates funds that they have been trusted to manage, such as by diverting funds from a business account into their own account.
5. Money laundering: Involves the transfer of funds obtained through illegal activities into legitimate financial channels to conceal their illegal origin.

2.1.2 Auditing

To help us understand the concept of auditing and how the audit is conducted in the modern context "Report of the Committee on Basic Auditing Concepts" (Silvoso, 1972) provides us with the definition:

"Auditing is a systematic process of objectively obtaining evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users".

In addition, the Association of Chartered Certified Accountants (ACCA Global, n.d) explains that an external audit is an independent review of an organisation's financial records financial statements are prepared in accordance with established laws and accounting standards. External audits also add value by improving efficiency within an organization and identifying areas where controls and processes can be made more effective.

The vast literature emphasizes the importance of adhering to professional auditing principles and standards, such as independence and professional scepticism (Porter, Simon and Hatherly,2014) and explores different types of audits, including financial statement, internal, operational, compliance, and forensic audits, each with its objectives and procedures (Danter, 2022).

Financial Reporting Council (2016) on the other hand, outlines the roles and responsibilities of auditors, including exercising professional judgment, maintaining independence, and providing valuable insights, which with auditor competence, ethical behaviour, technology use, effective communication, and professional development will contribute to audit quality.

2.1.3 Importance of Auditing in Fraud Detection

Not so long ago, Sir Donald Brydon (2019) performed an independent review approved by the government to enhance the audit process and its outcomes in line with user needs and the public interest. Recommendations included revising auditing standards to explicitly state auditors' duty to detect material fraud, calling for directors to report on anti-fraud measures, and emphasizing the importance of forensic accounting and fraud awareness training for auditors.

As a response, the UK Auditing Standard on Fraud (ISA (UK) 240) was updated by the FRC in May 2021 after 16 years. The changes addressed concerns raised about auditors' role in fraud detection and highlighted reasonable assurance and sufficient audit evidence. The standard recognizes challenges in detecting fraud, especially with management collusion, and emphasizes the importance of auditors' mindset, including scepticism and judgment. It promotes evaluating plausibility, seeking inconsistent evidence, and exercising professional scepticism. The FRC urged companies to enhance professional scepticism and adapt to pandemic-related challenges (ICAEW, 2021)

2.1.4 Fraud audit

Introducing a fraud audit as a response to uncovering fraud is a proactive approach and is an overall response to the risk of fraud or as a response to an internal control assessment indicating the possibility of fraud. Fraud audit is the application of audit procedures to a population of business transactions to increase the prospect of identifying fraud (Vona, 2015). The starting point is the fraud risk assessment (ICAEW Insights, 2021).

2.1.5 Other types of audits

Apart from internal and external audits, there are other types of audits that organizations can perform. These include Forensic Audit, Information Systems Audit, Compliance Audit, Operational Audit and Integrated Audit. However, this research will only focus on external audit and its usefulness.

2.2 Theoretical Frameworks and Models in Auditing for Fraud Detection

There are several theoretical frameworks and models in auditing for fraud detection.

According to Van Akkeren (2018), the most well-known and commonly accepted technique for describing how and why fraud happens is Cressey's Fraud Triangle (Donald Ray Cressey, 1973). The theory, which has its origins in sociology literature, identifies three conditions—pressure, opportunity, and rationalisation **(Fig. 1)** —that must be met before a crime may be committed. In his 2012 article, Chong stresses the value of understanding the fraud triangle and how to apply it to spot and stop fraud (Chong, 2012).

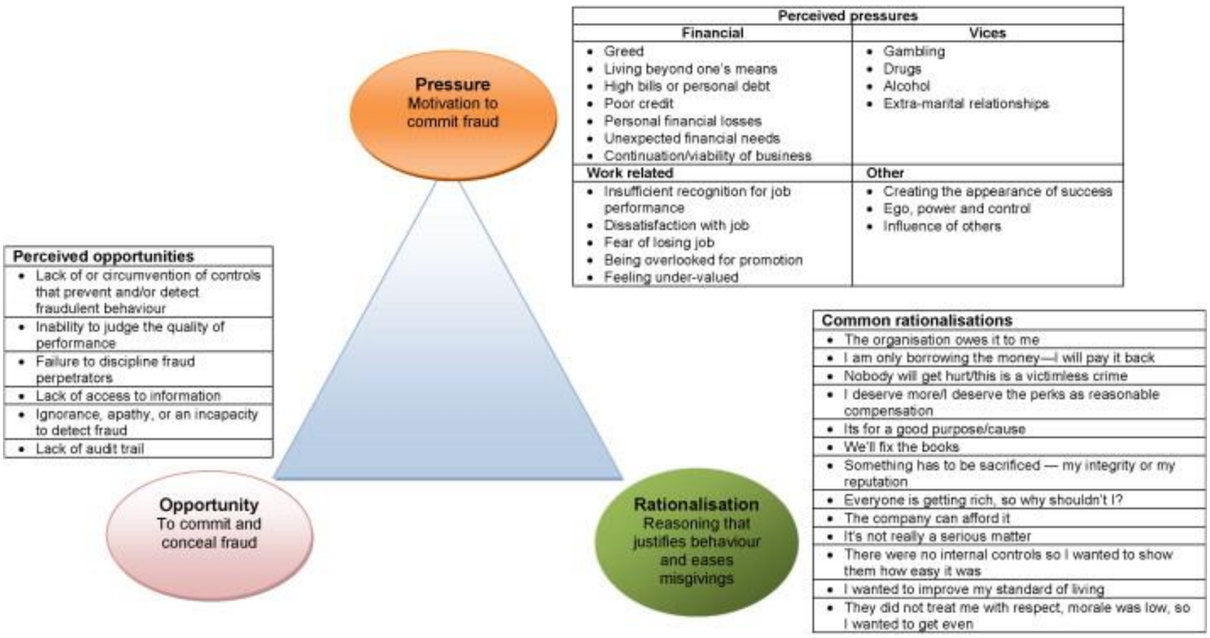

Fig. 1 *Conversations with inmate accountants: Motivation, opportunity and the fraud triangle* (Dellaportas, 2008).

However, not everyone fully agreed with Cressey's idea, Wolfe and Hermanson (2004) indicated that it was missing a very important element, capability, and called it a "fraud diamond". There would later be several more extensions to Cressy's theory, such as the fraud scale, the ABC, the MICE and the SCORE model (Puspasari, 2015)

On the other hand, Donegan and Ganon (2008) claim that the abrupt adoption of the fraud triangle in Statement on Auditing Standards (SAS) No. 99, as an explanatory model for financial fraud, was premature, due to a lack of scientific research, as well as an incapacity to identify cooperation or the societal causes of crime.

In addition to the frameworks, tools, techniques and models can help detect anomalies in data and records to prevent fraud, as organizations sometimes have gaps in their business and financial processes that allow fraudsters within the organization to exploit them. Tarjo and Herawati's (2015) analysis shows the efficiency of the Beneish Model (Beneish, 1999), a mathematical tool that uses financial ratios and eight variables to determine whether an organization's stated revenues and profits have been manipulated. Other models such as the Altman Z-model, the modified Jones model, the Dechow F-score, Benford's law, and Zipf's law have also been shown to help detect fraud (Mohammad et al., 2021)

2.3 Previous Studies on Auditing Effectiveness in Detecting Fraud

External audit plays a crucial role as a governance mechanism and has a significant impact on the quality of financial reporting. Amina (2021) emphasizes this importance and highlights the function and key responsibility of external auditors in ensuring high-quality financial reporting. They act as independent evaluators, who verify the accuracy and reliability of financial statements.

In defining audit quality, DeAngelo (1981) states that it incorporates two essential elements: competence and independence. Competence refers to the ability of auditors to identify errors in financial statements, while independence refers to their impartiality in revealing those errors. The combination of these factors determines the probability of auditors successfully detecting and disclosing inaccuracies.

However, Sun, Jia, and Liu (2021) express concerns regarding the potential negative impact of increased professional scepticism on auditors' ability to navigate the growing complexity and unpredictability of the audit process. While professional scepticism is essential for identifying potential misstatements or irregularities, an excessive level of scepticism may hinder auditors' adaptability to the evolving auditing landscape.

There are many aspects, that can influence the outcome quality of an audit. Ettredge et al. (2014) conducted a study on the effects of fee pressure on audit quality and discovered that auditors may sacrifice their independence and professional scepticism when confronted with fee pressure.
DeFond and Zhang (2014) discovered that competencies more than auditor independence is a crucial factor that positively influences audit quality, especially in cases where auditors have long-standing relationships with their clients.
However according to Carey and Simnett's research in 2006, when an audit partner has been working with a client for a long time, they are less likely to issue a going concern opinion and there is some evidence that the client is more probable to meet or miss earnings benchmarks. This suggests that audit quality may decline over time.

On the other hand, Wilks and Zimbelman (2004) conducted a study on how auditors process fraud risk assessment information and the cues they use to assess fraud risk. The results showed that auditors were more sensitive to fraud cues when the components indicated a high risk of fraud, weak internal controls, a low likelihood of detection, and a high potential loss.
The study implies that auditors should consider the interdependence of these components when conducting fraud risk assessments to effectively assess fraud risk.
This may suggest that heuristic and cognitive biases may predispose auditors' judgments, and reports influenced by bias can be extremely costly to investors (Karpoff, Lee, and Martin, 2008).

According to Psychology Today (2019), bias refers to a tendency, inclination, or prejudice towards or against something or someone. It can manifest as a preconceived notion, a particular perspective, or a preference that affects the way one thinks, feels, or behaves towards a particular group or individual. Several qualitative biases can influence the outcome of an audit, causing auditors to overlook critical information or misinterpret data, which can affect the accuracy of the audit and the conclusions drawn from it (Knechel et al., 2012). Some of the most prevalent qualitative biases in auditing include jumping to conclusions, representativeness, groupthink, availability, and anchoring bias (Maradona, 2020).

2.4 Impact of financial fraud on organizations (case of Carillion)

The collapse of Carillion, one of the largest UK-based construction and facilities management companies, in January 2018 had far-reaching consequences. With over 19,000 employees and involvement in key government infrastructure projects, such as schools and hospitals, its liquidation had a profound effect on the industry and resulted in substantial job losses.

The role of auditors, specifically KPMG, came under scrutiny as they were responsible for auditing Carillion's financial statements. A parliamentary inquiry (House of Commons, 2018) revealed that KPMG failed to challenge the company's management and reveal the extent of its financial difficulties. This highlighted concerns regarding the quality and independence of the audit process. It also suggested that strengthening auditing practices and ensuring greater independence could have helped identify and address the issues plaguing Carillion earlier, potentially mitigating the fallout from its collapse.

On 25 July 2022, KPMG was fined 14.4 million pounds after admitting to providing fabricated and misleading information to its regulator during spot checks on audits of construction firm Carillion (Jones, 2022)

2.5 Gaps in the Existing Literature

The literature on fraud detection in auditing may have limitations in terms of the focus on specific fraud detection techniques, consideration of emerging technologies, examination of auditor scepticism, understanding of organizational factors, and lack of comparative studies.

Further research is needed to explore the value of different auditing methods, the impact of emerging technologies, fostering auditor scepticism, the influence of organizational factors, and conducting comparative studies across different contexts.

Addressing these gaps can enhance the understanding of auditing effectiveness in detecting financial fraud and lead to improved fraud detection processes and procedures.

3. METHODOLOGY

3.1 Research Philosophy

The research philosophy for this study adopts a combination of interpretivism and positivism. As per Junjie and Yingxin (2022), interpretivism, also known as constructivism or qualitative research, focuses on understanding and interpreting the subjective meanings and experiences of individuals, emphasizing the social and cultural contexts that shape human behaviour.

Interpretivism is evident in this study in the focus on understanding and interpreting the experiences, perspectives, and behaviours of auditors, as well as the exploration of cognitive biases and subjective judgments in fraud detection (Byrne, 1998).

On the other hand, according to Maksimović and Evtimov (2023), positivism, otherwise known as quantitative research, emphasizes the application of scientific principles and objective measurements to study phenomena.

The choice between them depends on the research questions, objectives, and the nature of the phenomenon under study. As per Shorten and Smith (2017), researchers often adopt a mixed-methods approach to incorporate elements of interpretivism and positivism to gain a comprehensive understanding of the research topic, in this case, auditors' experiences and perspectives, while drawing on existing knowledge and empirical evidence to support the research questions and provide a well-rounded analysis of the effectiveness of auditing in detecting financial fraud.

3.2 Research Approach

As claimed by Saunders, Lewis and Thornhill (2009) there are three types of research approaches: abductive, inductive and deductive.

The inductive method involves collecting facts and the study and examining data to generate conclusions and theories. Therefore, in the context of this study, this approach is used to investigate and comprehend the current practices and processes used by auditors in detecting financial fraud.

The deductive method requires putting well-established theories, hypotheses, or frameworks to the test through the gathering and examination of data. In this research, the deductive approach will help evaluate the effectiveness of the current practices and processes in detecting financial fraud.

Hence, by incorporating both approaches, this research can benefit from a thorough investigation.

3.3 Research Design and Data Collection Methods

The research design will be a literature review-based study and will primarily involve the use of secondary data. As explained by Johnston (2014), secondary data refers to existing data that has been collected by others for purposes other than the current research. In the context of this research, secondary data includes information from academic journals, books, reports, industry publications and regulatory filings. The researcher will not use primary data collection methods, such as interviews or surveys, in this study.

Collection of data comprised:

1. Conducting a comprehensive review of existing literature on auditing, fraud detection, and related topics to gather relevant information, theories, and empirical findings.
2. Analysing documents such as financial statements, audit reports, regulatory guidelines, and industry reports to understand current auditing processes, fraud detection techniques, and their effectiveness.
3. Studying real-world cases of financial fraud and auditing failures to gain insights into the challenges, deficiencies, and lessons learned in fraud detection.
4. Conducting a systematic review and synthesis of existing studies and data to conclude, identify trends, and assess the overall effectiveness of auditing in detecting financial fraud.

3.4 Data Analysis Techniques

The secondary data will be systematically reviewed and synthesised as part of the data analysis. According to Lame (2019), this technique is appropriate for reviewing prior research on a subject to highlight knowledge gaps, research strengths and weaknesses, and offer suggestions for more research. Therefore, a thorough search and selection procedure, a critical evaluation of the chosen literature, and a synthesis of the results are all components of a systematic literature review for this research.

3.5 Limitations and Ethical Considerations

It is important to acknowledge the limitations and ethical considerations associated with this study.

The use of a quantitative approach in research can be constrained in several ways. One constraint is the need for a substantial sample size to achieve statistical significance and generalisability. Therefore, the accessibility of data and the focus on auditors' techniques in detecting financial fraud may limit the sample size, potentially affecting the reliability of the results. Another constraint, as analysed by Schneider (2013) is the objectivity of quantitative methodologies, which rely on numerical data and may overlook the nuanced and subjective aspects of auditors' experiences and perceptions.

Additionally, financial fraud is a complex phenomenon that may not be fully captured by quantitative approaches, as certain aspects of fraud can be challenging to quantify. On the other hand, utilizing a qualitative methodology also presents limitations, such as subjectivity and limited generalisability (Almeida, Faria and Queirós, 2017).

Conducting extensive qualitative research can be time-consuming, which may not be feasible given the constraints of the dissertation. To address these constraints, a mixed-methods approach was applied, enabling a more comprehensive examination of auditors' practices in detecting financial fraud while mitigating their respective limitations.

Ethical considerations will be addressed by ensuring proper citation and referencing of all sources used and maintaining academic integrity throughout the research process as well as maintaining objectivity and impartiality in data collection, analysis, and interpretation to avoid any biased or skewed results. Additionally, the researcher will present the research findings accurately and truthfully, even if they do not align with their initial expectations.

4. PRESENTATION AND ANALYSIS OF RESEARCH FINDINGS

4.1 Introduction

This chapter presents a detailed discussion of the findings from the literature review and the analysis of secondary data, including academic journals, industry reports, and relevant literature related to auditors' practices in detecting financial fraud. The primary objective of this discussion is to tackle the core research questions and objectives, shedding light on the effectiveness of modern auditing practices and procedures in the realm of fraud detection.

4.2 Current Practices and Processes in Detecting Financial Fraud

When it comes to traditional ways of auditing, the Association of Chartered Certified Accountants (ACCA, 2015) provides us with efficient audit process stages, which are planning, risk assessment, evidence evaluation, testing controls, substantive testing, and issuing the audit report.

4.2.1 Fraud Risk Assessment

Risk assessment methodologies have become more sophisticated to address the dynamic nature of financial fraud. As per Financial Conduct Authority (FCA, 2023) auditors are now required to perform fraud risk assessments as part of the audit process to identify areas of heightened fraud risk and tailor their audit procedures accordingly. This proactive approach allows auditors to focus their efforts on high-risk areas and increase the likelihood of detecting fraudulent activities.

4.2.2 Data Analytics

The field of auditing has experienced notable transformation in recent times, propelled by technological advancements and the ever-shifting realm of financial deception (Jackson, 2023). With the arrival of data analytics as a forceful instrument, auditors now own the means to investigate vast volumes of financial data, enabling them to recognise patterns, irregularities, and suspicious transactions with greater efficiency (Mohamed, 2021).

4.2.3 Fraud Prevention Training

As per Financial Reporting Council (FRC, 2020b), the repercussions of recent financial scandals, the digitization of business processes, and ongoing innovations have been profound, requiring audit practices to continually adapt and enhance their approaches. Training in fraud prevention has emerged as a necessary factor, with auditors placing greater emphasis on cultivating their proficiency in the expertise of artificial intelligence (AI) applications.

4.2.4 New technologies

According to the Institute of Chartered Accountants in England and Wales (ICAEW, 2022) AI has become the new norm within the industry, prompting audit firms to allocate millions towards fortifying their personnel and technology to improve audit quality, particularly in fraud prevention and detection.

As shown in **Figure 2**, the adoption of these technologies is reshaping the auditing profession, compelling auditors to forge ahead in an increasingly data-driven and technologically oriented world.

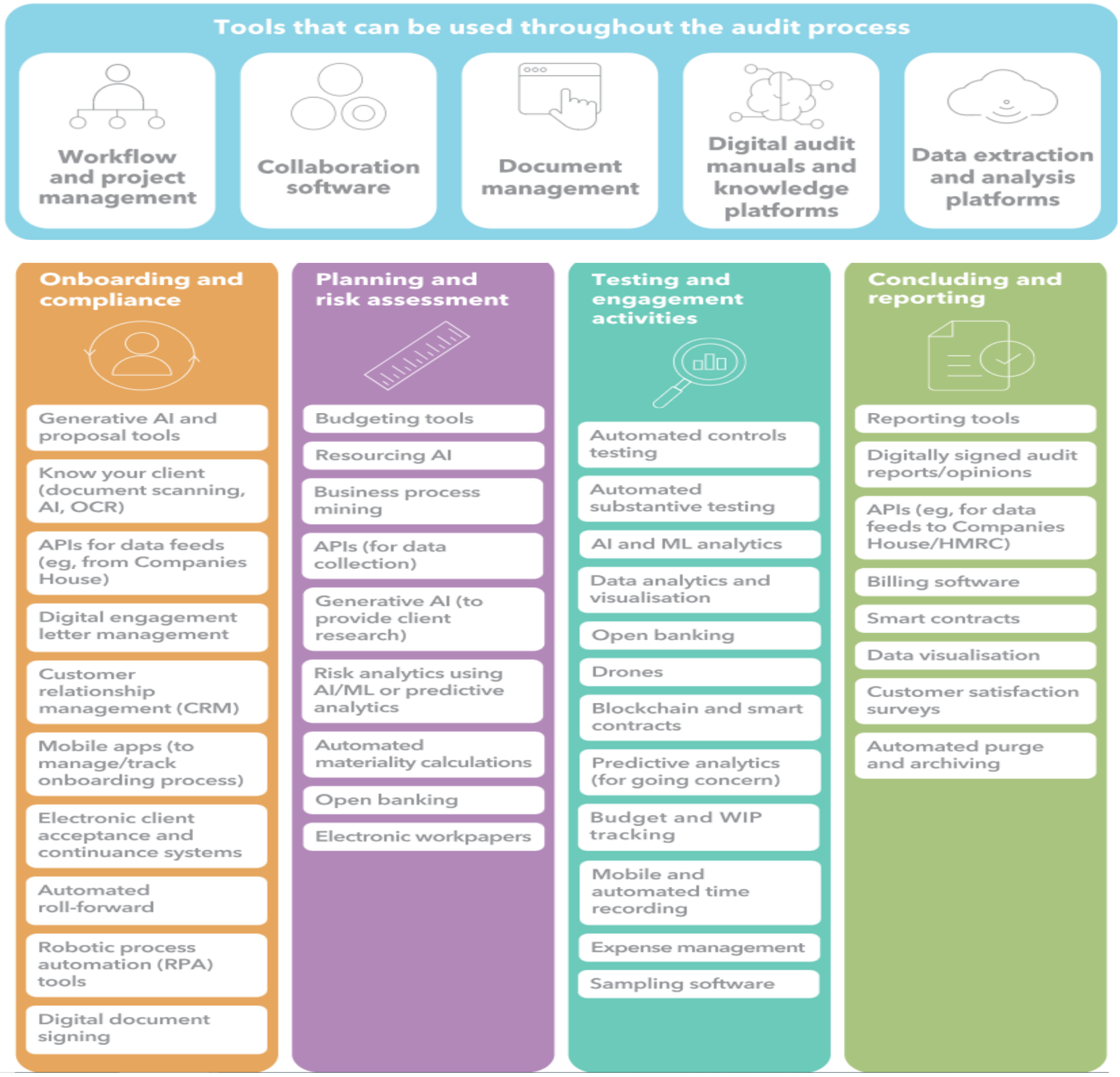

Fig. 2 *How to use technology throughout the audit process.* (ICAEW, 2023)

Apart from the constantly evolving digital methods of committing fraud, the mindset of auditors plays a crucial role in detecting fraudulent activities. While technology and data analytics have become valuable tools in identifying unusual transactions and patterns that may indicate fraud, it is the auditor's mindset that provides the critical human element in the process.

4.3 Effectiveness of Current Practices and Processes

4.3.1 Reports to the Nations

In this part of the research, the effectiveness of the current practices and processes in detecting financial fraud is critically analysed. The research findings are compared with existing literature and industry best practices to assess the strengths and limitations of auditors' fraud detection efforts.

It should be prefaced, that detecting and preventing fraud is not a primary objective of an external audit.

Nevertheless, as per **Table 1**, it has been a leading form of fraud prevention chosen by companies in the last 5 years, even though initial detection of fraud through this method has remained stagnant at a very low 4% globally. However, in Western Europe, after a slight drop in 2020, fraud detection by external audit increased to 5% in the latest report from the Association of Certified Fraud Examiners (ACFE, 2022).

Fraud has caused immense losses internationally, In Western Europe where the UK had 14%-26% of all cases, reported median loss was between $173,000 - $200,000, since 2018.

Apart from a decrease in median loss, where compared data relates to having control versus not having control in place, there is also a noticeable reduction in the duration of fraud with a decrease from 18 to 12 months, based on 82% of cases - a decrease in comparison with previous reports.

External audit of financial statements in statistics	2018	2020	2022
How is occupational fraud initially detected? (method)	4%	4%	4%
How does detection method relate to fraud duration and loss?	$250,000, 3 months	$150,000 24 months	$219,000 20 months
What anti-fraud controls are most common?	80%	83%	82%
How does the presence of anti-fraud controls relate to median loss?	29% reduction	46% reduction	33% reduction
How does the presence of anti-fraud controls relate to the duration of fraud?	38% reduction	46% reduction	33% reduction
What anti-fraud controls are the most common in Western Europe?	88%	89%	90%
How is occupational fraud initially detected in Western Europe?	4%	3%	5%
Total cases in UK in comparison with Western Europe	34/130 cases (26%)	24/128 cases (18%)	21/145 cases (14%)
Median Loss	$200,000	$139,000	$173,000

Table 1 - Author's work based on the Association of Certified Fraud Examiners' "*Report to the Nations*".

(ACFE, 2018; ACFE, 2020; ACFE, 2022)

4.3.2 Big 4

The term "Big 4" implies the four largest multinational accounting firms: Deloitte, PwC (PricewaterhouseCoopers), EY (Ernst & Young), and KPMG. As shown in **Figure 3**, from the latest Financial Reporting Council report, these firms hold significant dominance in the global auditing market and handle a substantial portion of audits for the world's largest companies.

	Big Four Firms (%)					Next Five Firms (%)					Other Firms (%)				
	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
FTSE 100	99.0	99.0	100.0	100.0	100.0	1.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FTSE 250	96.4	96.8	96.0	94.8	91.2	3.6	3.2	4.0	4.8	7.6	0.0	0.0	0.0	0.4	0.8
Other UK Main Market	74.8	74.2	77.8	73.7	67.2	18.4	16.0	15.3	16.8	22.8	6.8	9.8	6.9	9.5	10.0
All Main Market	81.0	80.0	81.8	79.0	74.1	13.3	12.6	12.7	13.6	18.4	5.7	7.4	5.5	7.4	7.6

Figure 3: *Listed company audits concentrations, 2016 to 2020*

Source: Financial Reporting Council (FRC, 2021a)

According to Che, Hope, and Langli (2019), Big 4 auditors and international accounting firms possess superior capabilities for detecting fraud with greater precision compared to non-Big 4 or local auditors. Their extensive resources, experience, and expertise enable them to conduct audits for complex multinational corporations with greater precision. Additionally, the authors highlight that Big 4 auditors have a vested interest in safeguarding their reputation and upholding their credibility in the market., which further motivates them to perform their duties effectively.

Despite all these advantages, in 2019, the prominent Big came under significant scrutiny and faced disciplinary actions due to various audit failures and instances of misconduct. As reported by Moyer (2019), none of these firms were able to meet the Competition and Markets Authority's target of achieving 90% 'good quality audit,' raising concerns about the effectiveness of external audits.

Deloitte faced £6.5m in fines and tribunal proceedings related to past errors in auditing Autonomy and Serco's Geografix division (McCormick and Beioley, 2019).

KPMG was fined for a £1.5m accounting error in the Co-Op Bank's accounts (Withers, 2019), leading the bank to switch auditors and PwC admitted to errors in its Redcentric audits and received a substantial fine (Sweet, 2019).

The industry witnessed too many scandals involving well-known companies such as Thomas Cook, Eddie Stobart, Ted Baker, and M&C Saatchi. These companies had significant accounting errors, due to a lack of scrutiny from the auditors of Big Four (Moyer, 2019).

These scandals have drawn greater attention to the entire accountancy industry and emphasized the importance of maintaining public reputation and client trust. They have also created opportunities for smaller audit firms to showcase their capabilities to potential clients.

4.4. Limitations of Current Practices and Processes

4.4.1 Lack of Independence

One of the limitations of current auditing practices and processes is the challenge of maintaining complete independence. Auditors are often hired by the companies they are meant to audit, creating a potential conflict of interest. Contrary to the DeFond and Zhang (2014) findings, Sunder and Yoon, (2023) analyse how such a close relationship can compromise objectivity and lead to biased assessments. The pressure to retain clients and secure future business may discourage auditors from raising red flags or thoroughly scrutinizing financial statements. Such dependence on the client for revenue can hinder auditors from making impartial judgments and identifying irregularities or fraud.

4.4.2 Insufficient training and education

The methods and procedures currently used to identify financial fraud have several drawbacks. As per KPMG report (KPMG, 2013), one of the major difficulties is that fraud techniques are constantly changing. New strategies and methods are constantly being developed to trick auditors and exploit weaknesses in control systems. As a result, it is challenging for auditors to stay abreast of fraud trends and adjust their detection techniques as needed.

In their empirical research, Asare, Wright and Zimbelman (Asare, Wright and Zimbelman, 2015) show that the staggering lack of fraud expertise among auditors is a problem for curricula and training. This warrants the inclusion of forensic accounting courses in academic programmes and professional settings.

4.4.3 Inadequate professional scepticism

To meet the objectives of the financial statement audit it is vital to maintain professional scepticism throughout the examination. According to the FRC report (FRC,2022), a sceptical and alert mindset allows auditors to question and challenge the information presented by management, assess the plausibility of explanations, and seek out contradictory evidence.

Moreover, Fang, Huang and Wang (2017) and Brewster, Butler and Watkins (2019) report that by maintaining a mindset that is open to the possibility of fraud and willing to dig deeper, auditors can improve their ability to detect and prevent fraudulent activities, thus safeguarding the integrity of financial reporting and protecting the interests of stakeholders. Herron and Cornell (2021) go even further and imply that auditors need to be more creative in their approach to detecting fraud and that this can be achieved by adopting a more holistic, strategic, and proactive approach.

4.4.4 Insufficient focus on fraud risk assessment

The method of evaluating fraud risks in organisations ought to be improved, as suggested by ICAEW (ICAEW Insights, 2021). The detection of potential fraud schemes and weaknesses in internal controls should be given more attention by auditors to better understand the unique fraud risks that the organisation being audited faces.

4.4.5 Limited use of advanced technologies

According to the National Audit Office (NAO, 2020), while data analytics and technology have shown potential in detecting fraud, their implementation in auditing processes is not widespread. FRC (FRC, 2020b) also suggests, that there is a need for auditors to leverage advanced technologies, such as data mining and artificial intelligence, to enhance their ability to identify unusual patterns, anomalies, and potential fraud indicators in financial data.

5. CONCLUSION AND RECOMMENDATION

5.1 CONCLUSION

In conclusion, this research aimed to evaluate the effectiveness of external auditing in detecting financial fraud by diving into the realm of financial fraud detection, emphasizing its complexities and the evolving practices in modern auditing. Financial fraud takes various forms and is driven by factors such as opportunity, pressure, and rationalization, as highlighted by the fraud triangle theory. Auditing, as a systematic process, plays a vital role in evaluating evidence and ensuring the accuracy of financial assertions. However, the effectiveness of current practices and processes in detecting financial fraud warrants further investigation and improvement.

The importance of auditors' role in detecting financial fraud cannot be overstated. External audits, while not primarily designed for fraud detection, are chosen as a leading form of fraud prevention by companies. However, the initial detection of fraud through external audits remains low globally, underlining the need for improved approaches. The impact of financial fraud on organizations, such as the case of Carillion, underscores the significance of accurate and rigorous audit processes.

The adoption of data analytics and new technologies offers promising avenues for improving fraud detection. As the auditing landscape shifts, auditors must embrace these tools to identify irregularities and patterns in vast volumes of financial data. Additionally, the cultivation of a proactive mindset that promotes professional scepticism is crucial in navigating the complexities of modern auditing and adapting to the evolving landscape.

While auditors possess valuable expertise, there are limitations to their current practices. Insufficient training and education in fraud detection pose challenges in keeping up with evolving fraud techniques. Inadequate professional scepticism, lack of independence, and limited utilization of advanced technologies further hinder the effectiveness of fraud detection efforts.

5.2 Recommendations

To summarise, the following recommendations are proposed:

1. **Comprehensive Training:** Auditors should receive comprehensive training in fraud detection techniques, including forensic accounting courses. Continuous education programs should be developed to keep auditors updated on evolving fraud methods and trends.

2. **Enhanced Independence:** Stricter guidelines on auditor-client relationships and client selection can reduce conflicts of interest, enhancing auditor independence and objectivity.

3. **Enhanced Professional Scepticism:** Auditors should maintain a high level of professional scepticism throughout the audit process. This mindset will empower them to question information, assess explanations, and seek out contradictory evidence, thereby improving fraud detection capabilities.

4. **Robust Fraud Risk Assessment:** Auditors should give more attention to evaluating fraud risks specific to each organization being audited. Tailored risk assessments will enable auditors to identify potential fraud schemes and weaknesses in internal controls more effectively.

5. **Leveraging Advanced Technologies:** Auditors should embrace data analytics and advanced technologies such as artificial intelligence to enhance their ability to detect unusual patterns and anomalies in financial data. Integrating these tools into auditing processes will enhance fraud detection accuracy.

6. **Cross-Industry Collaboration:** Collaboration between auditing firms, regulatory bodies, and industry experts will facilitate knowledge sharing and the development of best practices in fraud detection. Learning from successful strategies across industries can lead to innovative approaches.

7. **Regular Auditing Standard Review:** Regulatory bodies should regularly review auditing standards to ensure they are aligned with emerging fraud detection practices and technologies. Updates should emphasize the importance of fraud prevention training and the integration of advanced tools.

Incorporating these recommendations into audit practices will contribute to more robust and effective methods of detecting financial fraud, ensuring the integrity of financial reporting, and strengthening stakeholder confidence in the audit process.

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