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Effective Methods for Detecting Fraudulent Financial Reporting: Practical Insights from Big 4 Auditors

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Abstract*: Purpose: Using a qualitative grounded theory approach, this study explores the methods experienced external auditors use to detect fraudulent financial reporting (FFR) during standard audits.*
Methodology: Semi-structured interviews were conducted with twenty-four experienced external auditors to explore the methods they used to detect FFR successfully during standard external audits. Results: We find 58 methods used for FFR detection, out of which the following methods are frequently used and helped in detecting more than one type of FFR: (i) specific analytical procedures, (ii) positive confirmation, (iii) understanding of the client's business and industry, (iv) the inspection of specific documents, (v) a detailed analysis of the audit client's anti-fraud controls; and (vi) investigating tip-offs from suppliers, employees, and customers. Additionally, we observed that technology is not one of the reported methods, implying that auditors might not feel the need for sophisticated technology to detect fraud.
Theoretical Implications: Based on our grounded theory approach, we theorise that although auditors may not need technology to detect fraud, they must return to the basics and focus on specific audit procedures highlighted in this study for effective fraud detection.
Practical Implications: The study provides practical guidance, including fifty-eight methods used in audit practice to detect FFR. This knowledge can improve auditors' skills in detecting material misstatements due to fraud. Besides, analytical procedures and positive confirmation helped external auditors in this study detect all forms of FFR, yet they are overlooked in the external audit practice. Therefore, audit firms should emphasise the significance of these audit procedures in their professional audit training programmes. Given the significance of modern technology in auditing, auditors may need training on how technology could help counter fraud.
Policy Implications: Audit regulators should advise auditors to consider positive confirmation instead of negative confirmation in financial audits to increase the likelihood of FFR detection. Moreover, audit standards (ISA 240 and SAS 99) should explicitly require auditors to conduct a detailed analysis of the client's anti-fraud controls.
Originality: This is the first study to identify actual, effective methods used by external auditors in detecting FFR during the ordinary course of an audit.

Keywords: Grounded theory; fraudulent financial reporting; fraud risk assessment; fraud detection methods; external auditors