# External Audit with a View to Detecting Financial Fraud

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***Author's contribution***

*The sole author designed, analysed, interpreted and prepared the manuscript.*

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## ABSTRACT

Recently, the problem of financial fraud and its adverse effects on the quality of information disclosed and on the financial system in general has gained increasing attention from the media, the general public and regulators. Thus, the detection of financial fraud remains essential for the stability and continuity of companies. The role of the external auditor in the detection of financial fraud has been widely demonstrated in theoretical and empirical research. The purpose of this paper is to emphasize the responsibility of auditors in detecting and preventing fraud and the effectiveness of current audit procedures. Through a review of the literature, we have revealed the important role of external auditors in the detection and prevention of financial fraud. We have further explored the main models of financial fraud detection most used in previous studies.

## 1. INTRODUCTION

Today, many controversies with audit firms and the importance of the cost for investors highlight the current interest in the concept of fraud. A non-recent problem, financial fraud is gaining increasing attention from the media, the general public and regulators [1-4]. In fact, theoretical and empirical research in this area did not proliferate until the 1980s. However, academic research on the analysis of financial fraud began as early as the founding work of Sutherland [5] and Cressey [6]. Although, the cases of fraud studied were not limited to recent cases alone, since the work dates back to the analysis of the British East India Company at the end of the 17th century [7,8]. In fact, it was Sutherland [9] who coined the term white-collar crime. He used the

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term to define the criminal act of companies and individuals operating in a professional environment. Since that date, the term has been more widely used to define all economic and financial offenses, from the mail service to the board of directors.

Fraud is defined as any form of malicious or criminal deception aimed at obtaining personal or financial gain. The various faces of fraud make it difficult to measure; This is how large companies firmly believe that they are not the victims of deception or seriously underestimate the extent of the problem. What they recognize is a problem of bad debt or increased collection activity, not realizing that many of the affected borrowers have no intention of paying their debts.

Moreover, recent research has demonstrated the responsibility of auditors in detecting financial fraud. Although, several studies, carried out in Anglo-Saxon countries, show that only 5% of fraud cases are discovered by external auditors, despite the presence of inaccuracies in the financial statements in 65% of these cases. Carassus and Cormier state that this inability of auditors to detect numerous cases of fraud, and this despite the changes made in terms of professional standards, thus calls into question a legal audit model centered on the more global objective. faithful image and on a risk-based approach. Therefore, it is necessary to know to what extent the current approach of the auditor is effective and what are the benefits of this approach the analysis and detects the possible presence of fraud.

The objective of this paper is therefore to understand the role of external audit in the prevention and detection of financial fraud and the effectiveness of the audit procedures in force through a review of the literature.

This paper will be organized as follows: in a first section we will present the external audit as a crucial external governance mechanism. The second section is devoted to the literature review of the main studies that have shown the role of external audit in the detection and prevention of financial fraud. Finally, the final section will be devoted to reviewing the main models for financial fraud detection cited in previous research.

## 2. EXTERNAL AUDIT: AN EXTERNAL GOVERNANCE MECHANISM

Referring to agency theory, Fan and Wong (2005) assert that external audit has long been considered a full-fledged governance mechanism with information and control missions in order to regulate relationships between the various holders of interests in the company. In the same sense, Charreaux (1997) considers external audit as one of the governance mechanisms whose mission is to resolve agency problems between the different actors of the organization.

O'Sullivan and Diacon [10] and Yeoh and Jubb (2001) define external audit as an important governance mechanism that participates in and helps ensure the reliability and relevance of accounting data. It is a mechanism which serves to control the relations between the partners of the company. For their part, Jensen and Meckling [11] consider that external audit serves to align the interests of managers with those of shareholders. Indeed, the external audit can be used as a means of justification or obligation (bonding). Thus, to supervise and control managers (monitoring), shareholders and creditors engage financial statements and an independent external auditor. This helps, according to Omrod and Cleaver [12] to reduce and break the informational asymmetry that exists between managers and other stakeholders.

Chemingui and Pigé, (and Hay D. et al. (2008), for their part, criticize the effectiveness of this mechanism, starting from the many financial crises that have taken place over the past two decades and the fall of the largest audit firms (such as the Arthur Andersen network …). They stress the need to take into account certain criteria such as independence and competence.

In addition, the evolution of legislative texts in terms of accounting audit standards follows the succession of financial scandals. Fassal (2016) stipulate that: "Cases of fraud are not mere accidents on the long road to finance, but foundational events, in that they cause change and innovation". In this regard, international texts have been put in place over the past two decades, including in particular: the Sarbanes-Oxley and Dodd-Frank laws in the United States, the financial security law in France, the 8th Union Directive European Union and the 2014 audit reform in Europe. the SOX law (2002) was introduced following a succession of scandals in the American capital market, mainly: Enron, Tyco International and WorldCom; these large companies committed fraud and corruption causing an uproar in the American market. The 8th Council Directive 84/253 / EEC of April 10,

1984 on the approval of persons responsible for statutory audit provided for the professional qualifications required by auditors, their integrity and their independence.

## 3. EXTERNAL AUDIT AND THE DETECTION OF FINANCIAL FRAUD

The literature review showed the importance of governance mechanisms in the detection of financial fraud [13-16]. In fact, following the set of successive and multiple financial crises, the quality of external audit has become increasingly important on the academic level but also on that of the media as well as regulatory bodies. The audit is therefore at the heart of the control system in any type of business. It is seen as an important way to examine the actions of leaders, reduce information asymmetry, and learn about performance. The external audit, considered to be primarily responsible for the quality of the information disseminated. In fact, the responsibility of auditors in detecting fraud in financial statements is set out in ISA 240 Frauds. Basically, the auditor is not and cannot be held responsible for fraud prevention because the fact that an annual audit is performed can have a deterrent effect. When planning the audit, the auditor should assess the risk that fraud and error will cause the financial statements to contain material misstatement.

In this regard, Mrad (2004) certifies that the auditor is supposed to monitor the application of accounting rules and express an opinion on the company's accounts. Carassus and Cormier (2003) indicate that spectacular and unexpected bankruptcies as well as fraud and false financial statements are a strong reminder that managers always have the possibility and the imagination to show in the accounts a very profitable financial situation.

However, the quality of the audit service provided, reflected in the quality of the certified information, is difficult to observe. DeAngelo, [17] defines audit quality as "the joint probability that an auditor can discover an error in the financial statements (competence) and reveal it (independence)". Indeed, the competence and independence of the auditors are two essential prerequisites to guarantee the credibility of this mechanism. These two determining criteria for the quality of the audit can be understood through the size of the audit firm (membership of international group BIG, fees), the reputation of the external auditor, the duration of the auditor's

mandate, the existence of Co-auditor. This assumes according to DeAngelo, [17] that he is able to discover the anomaly (competence), and reveal the anomaly knowing it has been discovered (independence). Various indicators have been used in the literature to measure these two criteria, such as the size of the audit firm (Emby, Etherington, 1996), reputation (Richard, 2000) and membership of a large international group "BIG. As such, [18] ensures that the Big 4 auditors or international accounting firms are more capable of detecting fraud more precisely than the non-Big 4 or local auditors because they have sufficient funds and resources. to do so, and on top of that, they deserve to protect their reputation.

As such, Kinney and Martin (1994) ensure that the contribution of an independent auditor in the control of social accounts greatly limits the inadequacies in the information disclosed. Likewise, Francis and Krishnan (1999) have shown that "Big 6" auditors are more conservative towards financial statements produced by firms with high levels of accruals. Chen et al. [14] who examined the effect of audit quality on earnings management in Chinese companies found a significantly lower level of earnings management in companies audited by Top Eight. In this same context, Francis, Michas and Yu (2013) predict that the size of the external audit office can affect the quality of the services offered. They have shown that small audit firms produce a lower quality of results than that of large audit firms. Indeed, large firms are associated with greater acquired expertise, in the sense that auditors have a better understanding of their clients' business. As for Becker et al. [19] they found that companies that are not audited by BIG 6 firms reported more discretionary adjustments than those audited by a BIG 6 auditor.

However, certain other studies have shown that belonging to international group BIG4 does not guarantee the effectiveness of external audit. Taktak and Mbarki [20] have shown in their study of a sample of Tunisian banks over the period from 2003 to 2007, that the membership of the Co-auditors in BIG 4 favored the management of results in the banks. Likewise, Piot et al. [21] studied the effect of audit quality on results management on a sample of French companies. They confirmed that the companies audited by the Big 5 in France do not have a lower level of results management. Likewise, Zgarni and Fedhila [22] have shown that audit

quality measured by auditors' membership of the BIG4 group favors accounting manipulations in a sample of Tunisian banks. Also, Ittonen et al. [23] in their sample of American banks having proved the non-significant negative relationship between the BIG4 variable and discretionary provisions. Similarly, Wright, et al. [24] who, on a sample of US and UK companies, find that external auditors cannot mitigate self-interest-driven managerial behavior.

## 4. EFFECTIVENESS OF THE CURRENT APPROACH TO EXTERNAL AUDIT

Based on the risk assessment, the auditor should plan good audit procedures to ensure that they detect any inaccuracies resulting from fraud or error on the financial statements. In addition, according to Krambia-Kapardis [25] auditors are required to communicate to management in writing whenever they suspect fraud and are also legally required to report to an oversight body whenever material fraud occurs. detected. External auditors can now be carried out both actively and passively, depending on the situation of the company. Hence, it can be one of the main audit features when detecting financial fraud. Therefore, the quality of the auditor is essential to detect fraud.

In fact, in previous studies, financial fraud detection models such as Beneish M-Score, Dechow-F-Score, and Altman-Z-Score are very accurate and important indicators for fraud detection (Omar et al. 2014, Hung et al. 2017 McCarthy 2017). Moreover, Chan and Vasarhelyi (2018), have shown that conventional audit methods used by external auditors may be ineffective in detecting financial statement fraud due to a lack of knowledge and experience of accounting fraud of the auditors. Also, Fanning & Cogger [26] indicate that the infrequent nature of fraudulent manipulation also makes it difficult for external auditors to detect falsified accounting information, particularly when perpetrated by senior management. Thus, external auditors can rely on the detection of fraud detection patterns to identify cases that require attention. It is therefore crucial for auditors to verify the accuracy of financial statements to reveal any manipulation by adopting various fraud detection tools and models, which can help them detect fraud.

In fact, the fraud is hidden from the eyes of observers, so no fraud is detected. It can be a smart operation which is not easily found by old or normal methods. This can be seen in many fraud cases that occur in many organizations. However, various models have been developed by experts to help auditors analyze financial statements and assess potential fraud. According to Aghghaleh et al. [27], these tools are mature and consist of financial indicators and are ideal for fraud detection. These models were developed by accounting research to detect fraud, bankruptcy, earnings management, etc. Although the Altman Z model is primarily used to predict a company's bankruptcy, its use as an essential part of every audit while complementing other models such as Beneish M-Model is recommended due to the association between bankruptcy and financial fraud. In this context, Hakami et al. [28] explored the fraud detection gap (FDG) of an auditor in the companies of the Gulf Cooperation Council (GCC) by comparing the result of fraud detection models (to namely the Beneish M-score, Dechow F-score and Altman Z-score) with an actual audit opinion given by the auditors. They showed, based on a sample of 365 companies operated in the CCG for the period 2015 to 2017, that the success rate of financial statement fraud detection for the Dechow F model is much higher than for the Beneish M or Altman Z models. They have also shown In addition, the results are supported by a gap analysis based on the detection gap between the auditors and each of the other three models and indicate that the fraud detection rate obtained by auditors differs from the rate obtained by the Dechow F-score which proved that the Dechow F-score is capable of detecting higher cases of fraud. On the other hand, the rate obtained by Beneish M-score confirmed that this model can better detect fraud of companies with local audit firms than companies with international audit firms. Therefore, this study supports the superiority of the Dechow F-score in fraud detection over auditors, Beneish M-score and Altman Z-score [29].

## 5. CONCLUSION

This paper has been devoted to analyzing the role of external audit in financial fraud detection and subsequently in its prevention. Addressing such a subject was motivated by the increase in the number of financial scandals throughout the last three decades, mainly due to frauds and significant irregularities recorded in the published financial statements. We have emphasized the importance of external audit as a crucial governance mechanism and subsequently its role and primary responsibility in financial

reporting quality. Likewise, we explored the various fraud detection models most used in previous studies as well as the current methods used by external auditors.

This research contributes to theoretical research dealing with governance and financial fraud detection. However, this study is not without limitations. An empirical study would have supported the results of our theoretical research.

## COMPETING INTERESTS

Author has declared that no competing interests exist.

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