

How Auditors Detect and Prevent Financial Statement FraudAuthor: **Ella Maria Challita¹***Affiliation:*

1. *Business School, Holy Spirit University of Kaslik, P.O. Box 446, Jounieh, Lebanon*
2. *CIRAME Research Center, Holy Spirit University of Kaslik, P.O. Box 446, Jounieh, Lebanon*

Abstract:

This study examines how external auditors detect risks of financial statement fraud and how audit work can contribute to fraud prevention. Financial statement fraud can involve intentional manipulation of accounting records, omission of important information, improper revenue recognition, biased estimates, or unusual transactions designed to mislead users. Auditing standards require auditors to obtain reasonable assurance that financial statements are free from material misstatement due to fraud or error, while recognizing that an audit cannot provide absolute assurance. The study reviews professional skepticism, fraud-risk assessment, analytical procedures, journal-entry testing, examination of accounting estimates, confirmation and inspection procedures, and communication with management and those charged with governance. To present the method in the same practical format as the project model, an illustrative audit case is used to show how five common red flags could be investigated. The case figures are simulated for academic demonstration and are not presented as observations from a real company. The analysis shows how combining risk assessment, evidence testing, internal-control evaluation, and professional skepticism can improve the likelihood of identifying suspicious financial reporting and can also encourage stronger preventive controls.

Keywords:

Auditing, Financial Statement Fraud, Fraud Detection, Professional Skepticism, Internal Control, Audit Procedures

Introduction:

Financial statements are one of the main ways investors, lenders, managers, regulators, and other stakeholders understand the financial condition of a business. When those statements are intentionally manipulated, users may make decisions using information that does not represent the company fairly. The PCAOB defines fraud relevant to an audit as an intentional act that results in a material misstatement and distinguishes fraudulent financial reporting from misappropriation of assets (PCAOB, 2026).

Auditors therefore have an important responsibility in relation to fraud. Their role, however, is sometimes misunderstood. Management and those charged with governance have primary responsibility for establishing controls and a culture that prevent and detect fraud, while the auditor plans and performs the audit to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud or error (PCAOB, 2026). This distinction is important because even a properly performed audit cannot guarantee that every fraud will be discovered.

Fraud remains difficult to identify because it may involve collusion, forged documentation, deliberate concealment, biased estimates, or management override of controls. The Association of Certified Fraud Examiners reported that tips were the most common initial detection method in its 2024 occupational-fraud cases, while internal audit and management review were also important detection mechanisms (ACFE, 2024). These findings show why fraud detection depends on both formal audit work and a wider system of controls and reporting channels. The main research question is: How do auditors detect financial statement fraud, and how can their work help organizations prevent fraudulent financial reporting?

To answer this question, my study aims to:

- 1) Explain the auditor's responsibility regarding material misstatement caused by fraud.
- 2) Identify the main warning signs and fraud-risk factors considered during an audit.
- 3) Examine the audit procedures used to detect suspicious journal entries, estimates, revenue transactions, and unusual transactions.
- 4) Evaluate the role of professional skepticism and internal controls in fraud detection.
- 5) Explain how audit findings and recommendations can contribute to fraud prevention.

Literature Review:

Auditing literature separates fraud from ordinary error mainly through intent. Fraudulent financial reporting can include falsifying records, intentionally omitting transactions or disclosures, or deliberately misapplying accounting principles. Auditors focus on fraud that could cause a material misstatement rather than making a legal determination that a person has committed fraud (PCAOB, 2026).

One of the best-known ways to understand fraud risk is the fraud-triangle concept: pressure or incentive, opportunity, and rationalization. PCAOB standards describe these three conditions as commonly present when fraud occurs. Auditors use these risk factors to think about where manipulation may be more likely, but the presence of a risk factor does not prove that fraud exists. This is why professional judgment remains central to the audit.

Professional skepticism is especially important because fraud is designed to deceive. Auditors are expected to maintain a questioning mind and critically assess audit evidence instead of assuming that management is either honest or dishonest. ISA 240 (Revised), issued by the IAASB in 2025 and effective for periods beginning on or after December 15, 2026, strengthens the emphasis on professional skepticism, fraud-focused risk assessment, responses to identified fraud risks, and communication (IAASB, 2025).

Audit procedures become more targeted after fraud risks are identified. The PCAOB gives examples such as surprise inventory observations, confirmations with customers or suppliers, analytical procedures using detailed data, and interviews with personnel in higher-risk areas. Management override receives special attention because senior management may have the ability to bypass controls that otherwise appear effective. Journal-entry testing, reviewing accounting estimates for bias, and evaluating significant unusual transactions are therefore core fraud-related procedures (PCAOB, 2026).

Technology can support these procedures by allowing auditors to examine larger populations of transactions, identify unusual entries, and perform more detailed analytical comparisons. However, technology does not remove the need for judgment. An unusual transaction may have a legitimate explanation, while a fraudulent transaction may be designed to appear normal. The auditor must connect data patterns with documentary evidence, explanations, business purpose, authorization, and the broader risk assessment.

The Pressure to Commit Fraud, Governance, and Reporting Quality

Financial statement fraud is fundamentally driven by underlying economic pressures, poor corporate governance, and a lack of financial transparency. The incentive for management to manipulate earnings is particularly high during periods of severe financial distress, where predictive models like the Altman Z-score reveal deep vulnerabilities within an organization's capital structure (Elia et al., 2021). To mitigate these pressures, maintaining stringent internal controls and elevating the role of internal audit are critical for ensuring financial transparency and accountability to external stakeholders (Saber & Sassine, 2022). Furthermore, the overarching quality of financial reporting and the ability to prevent fraud are heavily dependent on auditor independence, deep industry expertise, and robust corporate governance frameworks (El-Chaarani et al., 2023; Sawaya et al., 2025). As regulatory environments evolve, this governance must also extend beyond traditional financial metrics to encompass non-financial

performance and sustainability reporting, ensuring that companies do not engage in misleading disclosures or "greenwashing" that can create expectation disconfirmation and damage investor trust (Daou et al., 2025; Kaspard et al., 2025). Ultimately, the stability of these financial reporting mechanisms relies on broader country-level governance structures, especially when auditing institutions operate in vulnerable emerging economies (Athari et al., 2023).

The Role of Artificial Intelligence, Big Data, and Auditor Expertise

To combat increasingly complex fraud schemes and management overrides, modern auditing practice is being revolutionized by the integration of artificial intelligence and big data analytics. Implementing a data-driven culture and leveraging advanced business analytics allow external auditors to process massive transaction volumes and detect subtle anomalies in consolidated financial statements with unprecedented speed (Azoury et al., 2024; Sawaya et al., 2026; Subrahmanyam et al., 2024). However, the successful adoption of these AI-driven audit tools depends significantly on the perceived trust, technology analytic adeptness, and behavioral profiles of the auditors utilizing them (Bejjani et al., 2024; Jabbour Al Maalouf et al., 2026). While automated tools can flag unusual journal entries, they cannot replace the professional skepticism and deep business experience required to investigate qualitative issues like biased estimates or related-party transactions (Chaanine et al., 2023). Furthermore, deploying algorithmic assessments introduces complex ethical challenges regarding transparency and bias within corporate business culture (Diab & El Hajj, 2024). Therefore, while technology enhances detection capabilities, effective fraud prevention remains a collaborative effort requiring technological sophistication paired with expert human judgment.

Prevention also requires strong organizational controls. Auditors do not operate the company's controls, but their work can reveal weaknesses and communicate them to management and the audit committee. The ACFE (2024) evidence on detection methods also emphasizes the value of reporting mechanisms, internal audit, and management review. In this sense, external auditing contributes to prevention indirectly by increasing accountability, identifying control deficiencies, and making manipulation more difficult to conceal.

Methodology:

In this research, I used a structured illustrative audit case to demonstrate how an auditor would respond to possible financial statement fraud. The case is designed around a hypothetical medium-sized trading company at year-end. It is not a real company and the numerical figures are simulated for academic demonstration. This approach allows the audit procedures to be presented clearly without claiming that invented data are real empirical evidence.

The audit case focuses on five areas that commonly require attention when fraud risk is present: year-end revenue entries, manual journal entries, accounting estimates, significant unusual transactions, and internal-control exceptions. For each area, the auditor first identifies the

warning sign, then performs an appropriate procedure, and finally evaluates whether the evidence provides a reasonable explanation or requires additional investigation.

The procedures used in the case reflect recognized auditing guidance. They include selecting unusual journal entries for testing, confirming transactions with external parties, comparing financial relationships through analytical procedures, examining supporting documents, reviewing estimates for possible management bias, and checking the authorization and business purpose of unusual transactions. These procedures are consistent with the fraud-response approach described in PCAOB AS 2401 and with the stronger fraud lens emphasized by ISA 240 (Revised) (IAASB, 2025; PCAOB, 2026).

The objective is not to calculate a universal fraud-detection rate. Instead, the case shows the practical connection between a red flag and the evidence an auditor would obtain. The final evaluation considers whether the issue appears reasonably explained, represents a control weakness, or remains suspicious enough to require expanded testing and communication with management or those charged with governance.

Results:

The illustrative case produced five audit findings. Because the case is simulated, the table below demonstrates the type of results that an audit investigation could produce; it must not be described as evidence collected from a real company.

Table 1: Illustrative fraud-risk findings

Area Tested	Red Flag	Illustrative Audit Result	Auditor Response
Year-end revenue	Large sales recorded in final 5 days	3 of 20 selected sales lacked valid delivery evidence	Expand cut-off testing and confirm customers
Manual journal entries	Entries posted late at night by senior user	4 of 35 selected entries had unusual support	Inspect authorization and underlying documents
Accounting estimates	Allowance fell while overdue receivables rose	Estimate appeared overly optimistic	Recalculate estimate and challenge assumptions
Unusual transactions	Large non-routine related-party sale	Business purpose and terms required clarification	Inspect agreement, approval and disclosure
Internal controls	Same user could prepare and approve entries	Segregation-of-duties weakness identified	Report deficiency and recommend access changes

The first issue concerned revenue cut-off. In the simulated test, three of twenty selected year-end sales did not contain sufficient delivery evidence supporting recognition before year-end. This result would not automatically prove fraud. It would, however, increase the auditor's concern and justify expanding cut-off testing, obtaining customer confirmations, and examining subsequent delivery or payment evidence.

The second issue involved manual journal entries. Four of thirty-five selected entries contained unusual supporting documentation or required additional explanation. Journal-entry testing is particularly important because management override can be used to manipulate reported results, especially near the end of a reporting period. The auditor would investigate who prepared and approved the entries, their business purpose, and whether the accounting treatment was appropriate.

The third and fourth findings concerned estimates and unusual transactions. An allowance that decreases while overdue receivables increase may indicate optimistic assumptions, while a large non-routine related-party transaction can create additional fraud risk because its economic purpose or terms may be unclear. Both findings require evidence and professional judgment rather than an immediate conclusion that fraud occurred.

Finally, the simulated control review identified a segregation-of-duties weakness because one user could both prepare and approve journal entries. This weakness increases opportunity for manipulation. The appropriate response would include communicating the deficiency, recommending access changes and independent review, and considering whether the weakness changes the nature or extent of substantive audit procedures.

Discussion and Conclusion:

This study shows that auditors detect possible financial statement fraud by combining risk assessment, professional skepticism, analytical review, detailed transaction testing, external evidence, and evaluation of internal controls. No single procedure can identify every fraud. The strength of the audit comes from connecting unusual patterns with persuasive evidence and remaining alert when explanations conflict with documents or other information.

The role of professional skepticism is especially important. Fraud can be concealed through apparently valid documents or explanations, and management override can defeat controls that normally work well. For this reason, auditors test journal entries, challenge estimates, investigate significant unusual transactions, and change the nature, timing, or extent of procedures when fraud risk is higher. Current PCAOB guidance explicitly requires reasonable assurance rather than absolute assurance, while the IAASB's revised ISA 240 strengthens the fraud lens and auditor response to identified risks (IAASB, 2025; PCAOB, 2026).

Auditing also contributes to prevention, although management retains primary responsibility for preventing and detecting fraud. When auditors communicate control deficiencies, question unsupported transactions, recommend stronger segregation of duties, and report significant fraud concerns to those charged with governance, they increase accountability and reduce opportunities for manipulation. Strong whistleblower channels and internal audit functions can

complement this work; ACFE data show that tips, internal audit, and management review are major ways occupational fraud comes to light (ACFE, 2024).

The main limitation of this project is that its numerical case is illustrative rather than a real audit engagement. The results therefore demonstrate the audit process and should not be generalized as measured fraud-detection performance. Future research could analyze anonymized audit cases, survey external auditors about the procedures they use most often, or compare traditional sampling with data-analytics techniques. The main conclusion remains that effective fraud detection depends on a disciplined combination of professional skepticism, targeted audit procedures, reliable evidence, strong controls, and timely communication.

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