

Internal Accounting controls and financial statements accuracy of Public Sector firms in Kenya

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Abstract:

This study examines the influence of internal accounting controls on the accuracy of financial statements within public sector institutions in Kenya. Accurate financial reporting is critical for ensuring transparency, accountability, and sound decision-making in public finance management. The study explores key components of internal controls, including the control environment, risk assessment, control activities, information and communication systems, and monitoring processes. Drawing from theoretical frameworks such as agency theory, stewardship theory, and contingency theory, the research highlights how robust internal controls contribute to the integrity and reliability of financial information. A review of relevant literature and case studies underscores that deficiencies in internal controls often lead to misstatements, financial irregularities, and diminished public trust. The findings affirm that strengthening internal control systems enhances the quality and accuracy of financial reporting. The study recommends that institutions adopt more comprehensive and technology-driven internal control mechanisms, empower internal audit functions, and cultivate a culture of accountability to ensure compliance with regulatory standards and improve financial reporting outcomes.

Keywords: Internal Accounting Controls, Financial Statement Accuracy, Public Sector firms, Financial Reporting

1. Introduction

Internal accounting control is used by the board of directors, management, and other staff members of an organization to give a reasonable level of assurance about the effectiveness and efficiency of operations, the accuracy of financial reporting, and compliance with pertinent laws and regulations. An organization's financial statements must include internal accounting control. According to Smith (2018), internal accounting controls are essential for guaranteeing the dependability and correctness of financial accounts. Internal accounting controls involve policies, procedures, and mechanisms designed to safeguard assets, maintain financial information integrity, and prevent fraud (Jones 2019).

Effective internal accounting control is essential for this organization to fulfill its objectives efficiently, effectively, and transparently. An organization with robust internal accounting control is better equipped to mitigate risks, ensure compliance with regulations, and enhance the accuracy of financial statements (Morris, 2011).

Internal accounting controls are limited to the control environment, which is the culture and environment that creates structures, procedures, and standards that serve as the basis for putting internal control in place across the entire company. Controls were noted and emphasized. An impartial, objective assurance and consulting function, internal audit seeks to enhance the organization's processes and add value. Control activities include accounting, information, and communication systems, as well as the realization that all operations require some degree of control.

Liquidity, or the speed at which an asset or security may be converted into cash without depreciating, is the main focus of a financial statement. The correctness of the financial statement is the responsibility of the finance team. Reporting efficiency measures the number of tasks that have been finished on time, the number that are past due, and the amount of time needed to accomplish each task. Verifying that bookkeeping and transactions are appropriately approved, precisely documented, comprehensive, and timely is crucial.

Internal accounting controls have the following effects on Kenyan firms' financial statement accuracy: Budget management: Internal accounting controls help to ensure that project expenditures are within the budgeted limits. Firms can accurately track project spending and prevent cost overruns that could impact financial statement accuracy. Asset management: the project involves the acquisition and sale of assets like construction equipment, material, and land. Internal accounting controls for asset tracking, inventory management, and asset valuation ensure that these resources are accurately recorded in financial statements, thereby reflecting the true value of a project's assets and liabilities. Internal Audit and Monitoring: Regular internal audits and monitoring of financial processes are vital in identifying control weaknesses, detecting errors and irregularities, and ensuring compliance with accounting policies and procedures.

The study was focused on the finance and accounting department since they are the ones conversant with internal accounting controls and their effects on financial performance. A questionnaire was used as a data-collecting instrument, which was delivered to the respondents in their workplace. In addition, interviews were done with the financial department staff.

Through continuous monitoring and enhancement of organizational and financial reporting standards, Kirsty (2018) argues that strong internal accounting controls boost

an organization's trust in its capacity to complete tasks while minimizing errors and preventing losses. These controls also guarantee adherence to pertinent laws and rules. Mutua (2023) examined the relationship between internal accounting controls and the accuracy of the firm's financial performance and discovered a significant association. When evaluating the efficacy of internal accounting controls in Kenya Yego and Oluoch (2018) found that these systems have flaws, with the severity of these flaws varying by sector. According to Ogneva et al (2007), who looked at how audit and internal accounting control can improve good governance in Kenya's public sector, internal accounting control has the biggest impact on corporate governance in government ministries, followed by risk management, while compliance and consulting have the least influence. The private sector in Kenya has a more robust internal control system than the public sector, according to a survey on internal accounting control systems carried out by Sarens and Abdolmohammadi (2011) in both publicly traded commercial enterprises and public sector organizations.

The impact of internal accounting controls on the profitability of different businesses has been the subject of several studies conducted locally, regionally, and worldwide. For instance, regional analysis by Yego and Oluoch (2018) and Ngari (2017) and worldwide research by Wittayapoom (2021) have found a link between a firm's financial success and robust internal accounting controls. While some of these studies have examined various listed corporations in their respective locations, most of this research has focused on distinct company types.

According to a Simiyu (2019) study on the efficacy of internal control systems in Kenyan universities, these establishments have a number of difficulties with regard to internal accounting controls. Liquidity problems, financial reporting delays, inadequate responsibility for financial resources, fraud, and inappropriate use of institutional assets are some of these difficulties. Thus, the purpose of this

Mohammed investigated the impact of internal accounting controls at the Ethiopian. DeAngelo (1981) looked at the internal accounting control systems used by financial institutions and found that while there are a number of systems in the banking industry, operational controls are given more attention than other kinds.

2. Literature Review

The study has provided theoretical literature as well as empirical literature. The chapter has provided a summary and critique of literature received with the aim of bringing out the research gaps to be addressed by the proposed study. A conceptual framework captures the variables and clearly shows the relationships among the research variables.

2.1 Theoretical Framework

A theory is a set of statements or principles devised to explain a group of facts or phenomena, especially one that has been repeatedly tested or is widely accepted and can be used to make predictions about natural phenomena (Creswell, 2006). This study will use three theories to explain the influence of the independent variables on the dependent variable. The theories are the agency theory, positive accounting theory, and agency theory.

2.1.1 Agency Theory

Agency theory was conceived in 1976 by Jensen and Meckling. This theory describes an agency relationship as a contract whereby one or more individuals (the principal(s)) appoint another individual (the agent) to perform a service on their behalf, which entails delegating some decision-making powers to the agent. Agency theory examines the connection between two parties: investors and managers. The agent (manager) commits to executing specific duties for the principal (investors), while the principal commits to compensating the agent. According to the agency theory, a firm is portrayed as a web of contracts linking the holders of economic resources (the principals) and managers (the agents) responsible for utilizing and overseeing those resources. According to the hypothesis, agents are more informed than principals, and this information asymmetry makes it more difficult for the primary to keep an eye on whether the agents are appropriately serving their interests. Accordingly, the idea portrays businesses as crucial to contract maintenance, enabling control mechanisms to lessen agents' opportunistic actions (Mwangi, 2019). According to the notion, a thorough contract that takes into account the requirements of both the principal and the agent should be created to align the interests of both parties. When the principal hires an expert and puts in place measures (such as auditors and control mechanisms) to monitor the agent, the agent-principal connection is further strengthened (Jussi & Petri, 2018). Furthermore, the theory recognizes that moral hazard and unfavorable outcomes could result from incomplete knowledge about the agent's connection, interests, or performance. Two significant ways that moral hazard and adverse selection affect an agent's performance are through a lack of task comprehension and a failure to complete the duties for which the agent was hired. Accordingly, agency theory is predicated on the idea that both principals and agents use contracts to maximize their wealth and behave rationally (Jensen & Meckling, 2019). Internal control lessens information asymmetry, lowers investor risk, and boosts revenue

by making more information about the agent's (management's) actions available to the principal (shareholder).

This theory is relevant to our study primarily because internal control is one tactic employed by companies to resolve the agency conundrum by lowering agency expenses that impact the overall quality of the relationship and the advantages to the principal (Payne, 2020). Internal control enhances the provision of extra information for the principal (shareholder) about the actions of the agent (management), while also lowering investor risks and low revenue and eliminating information asymmetry.

2.1.2 Positive Accounting Theory

It is referred to as either normative research or positive research in accounting. Positive research is defined as research that aims to forecast and explain specific phenomena. Positive hypotheses are those that are associated with this type of research (Deegan & Unerman, 2006). Usually based on observations, these theories can be empirically evaluated and refined with additional data. Other theories are not grounded in observations, in contrast to positive theories. These ideas are normative and based on the researcher's personal convictions. The goal of normative research theories is to prescribe how a specific practice should be carried out (Deegan & Unerman, 2006). This study deviates from a positive theory since it explains business sustainability strategies using actual data.

According to Watts and Zimmerman (1986), who established the positive accounting theory itself, the theory aims to explain accounting practice. It does not specify which accounting system a firm should employ; rather, it explains and forecasts which firms will and will not utilize a given method. According to Deegan and Unerman (2006), the theory is predicated on "the assumption that all individual actions are driven by self-interest and that individuals will always act in an opportunistic manner to the extent that the actions will increase their wealth." According to this viewpoint, the positive accounting theory forecasts that businesses will try to implement controls to curtail self-serving behavior. This is necessary to match the interests of the company's owners (the principals) and management (the agents). "Monitoring costs" are the expenses associated with addressing issues pertaining to the agency relationship and putting in place suitable safeguards.

2.1.3 Stewardship Theory

Stewardship theory has its roots in psychology and sociology and is defined by Davis, Schoorman, and Donaldson (1997) as "a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions are

maximized.” Unlike agency theory, stewardship theory stresses not the perspective of individualism (Donaldson & Davis, 1991), but rather the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. Argyris (1973) argues that while agency theory looks at an employee or people as an economic being, which suppresses an individual’s own aspirations, on the other hand, Donaldson and Davis (1991) argue that stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust. It stresses the position of employees or executives to act more autonomously so that the shareholders returns are maximized. Indeed, Likalama and Nyangau (2017) contends that executives and directors are also managing their careers to be considered effective stewards of their organization, while Shleifer, Andlei, and Vishny (1997) claim that managers return finance to investors to establish a good reputation so that they can re-enter the market for future finance.

Meckling and Jensen (2019) further state the cost incurred to curb agency problems (reducing information asymmetries and accompanying moral hazards) is less when owners directly participate in the management of the firm, as there is a natural alignment of owner-managers’ interests with growth opportunities and risk. It follows from the above that stewardship theory, unlike agency theory, is a complete contrast and doesn’t emphasize the need to incur monitoring or agency costs, which include establishing an internal audit function. Nevertheless, Donaldson and Davis (1991) further note that returns are improved by having both of these theories combined rather than separated, which implies that management must strike a balance. In this study, the steward theory supports the study by the fact that managers of institutions of higher learning act as stewards of shareholders, suppliers, creditors, consumers, and employees of these institutions.

2.2 Empirical Review

2.2.1 Risk Assessment

According to Likalama and Nyangau (2017), risk management is crucial for financial organizations to create value for their clients and shareholders. The objective of increasing shareholder value has been linked to the advantages of risk management in the realm of corporate finance. A company may adopt risk management techniques in response to a rise in shareholder value, claim Bartram (2000). As a result, effective risk management, which may be used in both the banking and non-banking industries, can raise expectations for

growing the firm's worth and shareholder wealth. Likalama and Nyangau 's research focused mostly on the internal control framework's risk management component, emphasizing how important it is for increasing shareholder wealth. This viewpoint differed from that of other scholars studying related topics since it was heavily impacted by agency theory.

According to a study by Kimotho (2015), bank profitability was positively impacted by credit risk management practices. The study aimed to find out if Kenyan commercial banks' financial performance was impacted by credit risk management procedures. Kimotho collected primary data using a semi-structured questionnaire and a descriptive study design. Version 20 of the Statistical Package for Social Sciences (SPSS) was used to analyze the data. As both studies used a descriptive research approach, Kimotho's research design was similar to Mwangi's (2014). Additionally, Kimotho, like Olumbe and Mwangi, concentrated solely on risk management, a component of the internal control system, which was deemed insufficient to demonstrate that internal control systems affect commercial banks' financial performance.

Descriptive and correlational research methods were used as the methodology in a study by Oyoo (2014) to assess the impact of internal accounting controls on the financial results of microfinance institutions in Kisumu Central Constituency, Kenya. The investigator gathered information from primary and secondary sources. A semi-structured questionnaire was used to collect primary data, and the audited financial statements of the microfinance organizations under investigation provided secondary data. To examine the data, Pearson product moment correlation was employed. The results demonstrated a positive correlation between the financial success of microfinance firms and their internal controls. Although Oyoo's research methodology was similar to that of Olumbe (2012), Mwangi (2014), and Kimotho (2015), the main distinction between these studies is the kinds of institutions in which the internal control analysis was conducted.

2.2.2 Control Environment

According to Scott (1995), in order for an organization to survive, it must adhere to set regulations and rely on the systems that are accessible in its environment. In a similar vein, Arwinge (2013) highlights that those restrictions are developed and implemented in order to achieve legitimacy and satisfy survival needs. This perspective aligns with the Sarbanes-Oxley Act's standards and corporate governance concepts. As part of larger efforts to stop fraud and rebuild confidence in financial reporting, this law, which was put into force in 2002 in response to the Enron affair, requires businesses to reveal the efficacy of their internal controls when presenting their financial performance and condition.

Mawanda (2008) looked into how financial performance in Ugandan higher education institutions is affected by internal accounting control systems. The study evaluated financial performance using accountability, liquidity, and reporting while examining internal controls via the prisms of internal audit, the control environment, and control activities. Internal control systems and financial performance were shown to be significantly correlated by the researcher, who employed an exploratory research methodology. Mawanda's research focused on higher education institutions, whereas Nyaga's study examined the Nairobi Securities Exchange (NSE). Neither study looked into financial institutions. Mawanda focused on control environment and control activities, whereas Nyaga's study examined two facets of internal control systems: monitoring and control environment. Both studies could have improved their analyses if they had looked at all five internal control system components. Additionally, Mawanda's research took place in Uganda, while Nyaga's was conducted in Kenya.

The findings of the study conducted by Magara (2013) indicated a strong positive connection between the independent and dependent variables. The researcher identified the control environment, risk assessment, and monitoring as independent factors in order to determine whether internal controls had an impact on the financial performance of Kenyan SACCOs. Both primary and secondary sources of data were gathered for the analysis, with the SACCOs' annual reports providing the secondary data. Magara found that the independent variables enhanced the financial performance of SACCOs in Kenya after examining the data using a variety of regression models. Both Magara and Olumbe employed multiple linear regression models in their studies.

Magara included four components of internal control systems, but he left out one: communication and information. While Olumbe investigated internal controls in relation to corporate governance inside Kenyan commercial banks, Magara focused on the relationship between internal controls and the financial performance of SACCOs. The financial performance of commercial bank branches was not examined in either study.

2.2.3 Monitoring and Evaluation

According to Khawaja (2011), monitoring is a feedback mechanism developed in accordance with management's directives. Improving management procedures and ensuring the best possible use of finances and other resources are the primary goals. According to Kamau and Mohamed (2015), effective monitoring increases output, reduces operating costs, and offers recipients efficient services.

Mutua (2023) looked at the connection between internal control systems and Kenya's financial performance. Using a descriptive approach, the researcher found that monitoring,

risk assessment, and the control environment were independent contributors. Questionnaires were used to collect study data, and a linear regression model was used for analysis. According to the findings, the internal accounting control system cannot be considered successful unless all independent variables are present. According to the study, the private sector's financial performance in Kenya was most significantly impacted by monitoring, which was followed by risk assessment, the control environment, and control activities. Mutua's independent variables were quite similar to those used by Muthusi (2017) and Magara (2013).

Mosago (2013) investigated the connection between program efficacy and financial monitoring in Kenyan international non-governmental organizations (INGOs). Using both quantitative and qualitative methods, the researcher used questionnaires to gather primary data. Multiple regression techniques and the Statistical Package for Social Sciences (SPSS) were used in the analysis. The findings demonstrated that financial monitoring improved the efficacy of INGOs' programs. Organizations that regularly used financial monitoring, in particular, saw improved program outcomes. Mosago came to the conclusion that boosting program effectiveness requires the regular application of financial monitoring approaches. As with the study by Naibei and Kipyego (2017), Mosago focused on a single facet of the internal accounting control system, which might restrict the capacity to draw firm conclusions regarding the overall impact of internal control systems on the financial performance of an organization.

According to a study by Nyakundi (2014), internal accounting controls have a significant impact on the financial results of SMEs in Kisumu. According to the report, operators of small and medium-sized businesses (SMEs) ought to receive training on the importance of these controls. Nyakundi collected data using structured questionnaires and using a cross-sectional research design. Multiple linear regression models were used in the data analysis, which was carried out using SPSS. With the exception of Ejoh and Ejom's (2014) research, which yielded different results, Nyakundi's findings were consistent with those of other academic papers that were analyzed.

Abdulahi asserted that the internal audit department was efficient, well-staffed, conducted audit activities on a regular basis, and produced audit reports on a regular basis. The findings demonstrated that roles were clearly defined, system flaws were appropriately fixed, and monitoring was essential for analyzing and gauging the level of performance inside the organization over time. Studies by Likalama and Nyangau (2017), Adagye (2015), Ejoh and Ejom (2014), and Mawanda (2008) were comparable to Abdulahi's research. Despite being carried out in different nations and at different times, all of this research focused on educational institutions.

Numerous studies have investigated the effect of internal accounting control on the financial performance of parastatals. Ndiwa (2014) studied the assessment of the internal control system on financial performance in institutions in Kenya. The study, therefore, endeavored to investigate the persistent poor financial performance from the perspective of internal controls, which had been ignored. The general objective of the study is to examine the effect of internal accounting control on the financial statement accuracy of Kenya Urban Roads. The findings indicated that most respondents were of the view that indeed there was a relationship between internal control and financial statement accuracy. Mwakimasinde, Odhiambo, and Byaruhanga (2014) analyzed the effect of internal control systems on the financial performance of companies in Kenya.

In contrast, Mawanda (2008) states that institutions that have enforcement of proper internal control systems will always lead to improved financial performance. The study, therefore, recommends that the internal control environment should be enhanced to further improve the financial statements accuracy on public firms.

2.3 Conceptual Framework

Figure 1 below presents the conceptual framework

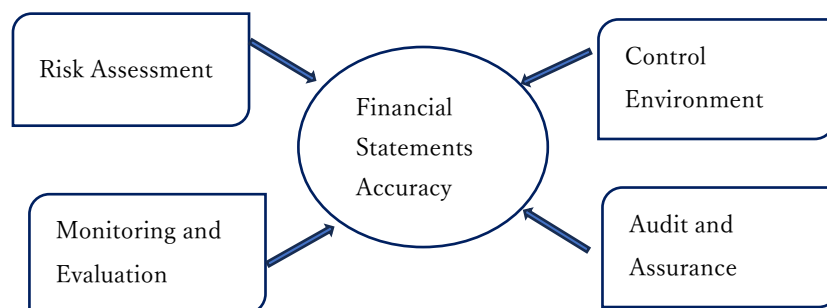


Figure 1: Conceptual Framework

The accuracy of financial statements is influenced by several key factors that work together to ensure reliability and integrity in financial reporting. One of these factors is risk assessment, which involves the identification and evaluation of potential financial and operational risks that could affect the accuracy of financial data. By proactively assessing risks, organizations are better positioned to implement controls that minimize errors and prevent misstatements. Another critical element is the control environment, which encompasses the organizational structure, ethical values, and management's commitment to integrity and accountability. A strong control environment lays the foundation for sound financial practices and helps reinforce adherence to policies and procedures.

Audit and assurance also play a significant role in maintaining financial statement accuracy. Through independent examination and verification, audits provide assurance that financial reports are complete, accurate, and comply with relevant accounting standards and regulations. This external oversight enhances stakeholder confidence in the reported information. Lastly, monitoring and evaluation contribute to the ongoing accuracy of financial statements by ensuring that internal controls are functioning as intended. Regular reviews and assessments help detect any deviations or weaknesses in the financial reporting process and provide opportunities for continuous improvement. Together, these components—risk assessment, control environment, audit and assurance, and monitoring and evaluation—form an integrated framework that supports the production of accurate and trustworthy financial statements.

3. Research Methodology

This study adopts a literature review methodology to explore the relationship between internal accounting controls and the accuracy of financial statements. The literature review involves the examination of existing scholarly articles, books, reports, and government publications to draw insights from prior research. By synthesizing findings from a wide range of sources, the study aims to provide a comprehensive understanding of how internal control factors influence the accuracy of financial statements among firms in Kenya.

4. Results and Discussion

As indicated in Figure 1 which is a conceptual framework that highlights four critical components that influence the accuracy of financial statements: risk assessment, control environment, audit and assurance, and monitoring and evaluation. These components work together to ensure that financial reports reflect a true and fair view of an organization's financial position and performance. Each element plays a distinct but interrelated role in supporting transparency, compliance, and sound financial management.

Risk Assessment is a fundamental step in ensuring financial statement accuracy. It involves the identification and evaluation of internal and external risks that may compromise the integrity of financial data. Organizations face a variety of risks, including operational inefficiencies, fraud, regulatory non-compliance, and market fluctuations. A thorough risk

assessment process enables management to pinpoint vulnerabilities within financial systems and processes, thereby allowing for the implementation of targeted controls and mitigation strategies.

Furthermore, risk assessment is not a one-time activity but a continuous process that must adapt to the evolving operational and regulatory landscape. As business environments become increasingly complex, organizations must regularly revisit their risk profiles and reassess the likelihood and potential impact of various threats. A proactive approach to risk management enhances the reliability of financial reporting by minimizing errors and providing stakeholders with greater confidence in the financial statements.

The Control Environment refers to the overall attitude, awareness, and actions of directors and management regarding the internal control system and its importance to the organization. A strong control environment is characterized by ethical leadership, a commitment to integrity and accountability, and clear policies and procedures that guide financial reporting. It sets the tone at the top and influences the behavior of employees across all levels, fostering a culture of responsibility and diligence.

In practice, the control environment includes factors such as the competence of personnel, the organizational structure, management philosophy, and the assignment of authority and responsibility. When these factors are well-established, they provide a foundation for effective internal controls, ensuring that transactions are properly authorized, recorded, and reported. This greatly reduces the risk of material misstatements and enhances the credibility of financial statements.

Audit and Assurance activities serve as independent checks on the financial reporting process. Through systematic examination of financial records, auditors assess whether the statements comply with accounting standards and reflect the true financial position of the entity. Internal audits focus on improving internal processes and controls, while external audits provide an objective opinion that enhances stakeholder trust, especially among investors, regulators, and lenders.

In addition to verifying the accuracy of figures, audit and assurance functions identify control weaknesses and provide recommendations for improvement. This not only strengthens internal processes but also helps in detecting and preventing fraud. A rigorous audit process contributes significantly to the transparency and reliability of financial statements, ultimately supporting informed decision-making by stakeholders.

Monitoring and Evaluation ensures that internal control systems and financial reporting practices are functioning as intended. This involves continuous or periodic assessments of accounting processes, compliance with policies, and performance indicators. Effective

monitoring enables early detection of errors or irregularities, allowing for timely corrective actions before they affect the overall integrity of financial statements.

Moreover, evaluation goes beyond detection; it involves learning and adapting. By analyzing trends, feedback, and audit findings, organizations can refine their financial processes and improve internal controls over time. This dynamic feedback loop is essential for sustaining high standards of financial reporting, ensuring that financial statements remain accurate, comprehensive, and reflective of actual organizational performance.

In conclusion, the accuracy of financial statements is a result of a well-integrated system of risk assessment, a robust control environment, independent audit and assurance, and continuous monitoring and evaluation. Together, these elements create a strong foundation for financial integrity, supporting sound governance and stakeholder confidence.

5. Conclusions and Recommendations

This study set out to examine the relationship between internal accounting controls and the accuracy of financial statements, with particular focus on public institutions in Kenya. The findings reveal a strong and positive correlation between well-established internal controls and the reliability of financial reporting. Internal controls—particularly those involving the control environment, risk assessment, control activities, communication systems, and monitoring—are shown to be foundational in ensuring that financial statements present a true and fair view of an organization's financial position.

The literature and theoretical frameworks reviewed, including agency theory, stewardship theory, and contingency theory, underscore the importance of aligning organizational controls with the objectives of transparency, accountability, and performance efficiency. Empirical studies both within Kenya and internationally affirm that effective internal control systems help to minimize errors and fraudulent reporting, thereby enhancing stakeholder confidence and compliance with statutory obligations.

In light of these findings, the study recommends that public sector organizations should invest in strengthening their internal accounting control systems. This includes continuous staff training on internal control procedures, updating policies in line with evolving financial reporting standards, and leveraging modern technology to enhance monitoring and information-sharing processes. Furthermore, internal audit functions should be empowered and adequately resourced to ensure regular, objective evaluations of control systems.

Management should foster a culture of accountability and ethical financial stewardship by setting the tone at the top. By doing so, organizations can mitigate risks associated with

financial misstatements, improve their operational transparency, and enhance the credibility of their financial reports. These recommendations, if effectively implemented, will not only promote accurate financial reporting but also reinforce public trust in government institutions entrusted with public funds.

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