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## Internal Control Systems and their role in Financial Fraud Prevention in Kenya

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### Abstract

Financial fraud, encompassing activities like embezzlement and misappropriation of assets, poses a substantial threat to businesses, potentially leading to financial losses, legal consequences, and the erosion of stakeholder trust. The study explores the critical realm of internal control mechanisms within organizations, particularly focusing on their role in ensuring the accuracy of financial statements and preventing financial fraud. The literature review aims to comprehensively analyze existing research on internal controls and their impact on preventing financial fraud. It evaluates dimensions such as the control environment, risk assessment, control activities, and monitoring, emphasizing their interplay in achieving financial reporting objectives and operational efficiency. Theoretical frameworks, such as the Fraud Triangle Theory and Agency Theory, form the basis for understanding the motivations behind fraudulent activities and the conflicts of interest that may arise within organizations. The study observed that internal control mechanisms, examined through the lens of the control environment, transaction monitoring, risk assessment, and internal audit, are crucial components in the fight against financial fraud. The integration of advanced technologies, continuous learning, and a commitment to ethical standards further enhance the effectiveness of internal controls in safeguarding organizations against the ever-evolving landscape of financial fraud.

**Keywords:** Financial fraud prevention, control environment, transaction monitoring, risk assessment, internal audit

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### 1. Introduction

Internal control refers to the various ways, mechanisms and procedures that firms use to ensure the validity and accuracy of their financial statements. [Puttick \(2001\)](#) says internal control mechanisms are implemented, maintained, and monitored by the top management of the firm to ensure firm operations are done as per schedule and all information is recorded accurately. These accounting internal controls may differ depending on a firm's operation

and are grouped into three, i.e., preventive, detective, and corrective controls ([Kashona, 2019](#)).

These detective controls highlight problems or possible errors within the accounting or organization process. Preventive control measures seek to prevent errors and irregularities from occurring, and corrective measures are implemented to cancel out any possible errors in these transactions.

[Talab et al. \(2017\)](#) postulates that internal control

represents an organization's plan, methods, and procedures used to meet its objectives and safeguard its assets, preventing and detecting errors, fraud, and mismanagement. A firm without effective internal control may lose its finances or revalue its assets at a low cost, as they may have lost most of the assets, they put in place to venture into the business.

These frauds may be committed in different ways, which may include manipulated financial documents, inflated earnings, hidden bad debts or expenses, manipulated payrolls, misreported tax liabilities, and false insurance claims or banking applications.

The company code 1963, Act 197, Section 123, states that "management will need to establish an effective accounting system comprising a number of controls". In an attempt to do this, there must be a well-defined organizational structure showing how responsibility and authority are delegated and clearly defined communication channels or lines of reporting (i.e., upward, downward, and horizontal lines of reporting) for the attainment of corporate objectives. These controls are such that different people are assigned to do different tasks. Management should ensure work delegation to ensure not one person is in control of processing and reporting the transactions.

Biased accounting officials indebted with the duty of checking, maintaining or reporting organization financial reports may be filled with greed, thereby recording false transactions benefiting themselves. The top management or the board of directors should take a keen step in ensuring officials in these internal control departments meet all needed requirements before undertaking to entrust them with the organization's core department. These financial statements and reports are the drivers or centre of an organization's existence as they provide information on expansion issues, sources of finance, and creditors may require this information to determine a firm's credit worthiness and ability to pay when debts fall due, a firm's financial position, whether a loss- or profit-making company, and also help in decision-making (Lev & Zarowin, 1999).

These internal accounting checks simply provide an overview of already-prepared statements or reports, giving more assurance of the accuracy and reliability of the information provided. In case of any errors or discrepancies, they may be corrected in the time and budget proposed with the available cash in place. Solid internal control mechanisms drive consistency, which ensures operation efficiency as they minimize the chances of overvaluing or undervaluing organizational potential, allowing the management to control the firm's performance and ensure they achieve the firm's goals and objectives.

Financial fraud has become a concern for organizations in recent years. The effects of fraudulent activities on businesses are well documented, necessitating the implementation of proper internal control measures. The

purpose of this literature review is to critically analyse existing research on internal controls and their impact on the prevention of financial fraud. By evaluating relevant studies, this review aims to provide a comprehensive overview of this field. It will focus on the various dimensions of internal controls, examining their significance, effectiveness, and implementation strategies in preventing fraudulent activities within organizations. Financial fraud includes embezzlement, misappropriation of assets, fraudulent financial reporting, and corruption. These fraudulent practices can result in financial losses, compromised stakeholder trust, legal repercussions, and even the collapse of organizations. Millichamp and Taylor (2008) argue that companies tend to implement preventive measures that minimize the risk of financial fraud and safeguard their assets.

Internal controls are designed to ensure the achievement of financial reporting objectives, operational efficiency, and compliance with relevant laws and regulations. Some interrelated components in internal control systems, as stipulated by Onger (2011) include the control environment, risk assessment, control activities, and monitoring. Additionally, it will investigate the factors that influence the effectiveness of internal controls, including organizational culture, management support, and technological advancements. This review will assess the effects of internal controls on different types of financial fraud, considering both their preventive and detective capabilities. By critically analyzing the findings from previous research, this review aims to identify gaps in the existing literature and provide recommendations for future research in the fields of internal control and financial fraud prevention.

## 2. Theoretical Review

The prevention of financial fraud through effective internal control mechanisms is based on several theoretical frameworks and concepts. This theoretical review aims to explore and discuss these frameworks, providing a foundation for understanding the underlying principles that guide the development and implementation of internal controls in fraud prevention.

### 2.1. The Fraud Triangle Theory

The Fraud Triangle Theory, developed by Donald Cressey (1953), proposes that three factors, i.e., opportunity, pressure, and rationalization, motivate individuals to engage in fraudulent activities. According to Kenyon and Tilton (2006), management and other employees may find themselves offered incentives or put under pressure to commit fraud. Internal controls play a vital role in addressing the opportunity factor by implementing measures that restrict access to assets, enforce segregation of duties, and promote accountability.

In reality, it is of utmost importance for auditors to take

into account all models of fraud in order to enhance their comprehension of the underlying reasons behind the commission of fraudulent acts (Kassem & Higson, 2012). Recently, there has been a proposition by Kassem and Higson (2012) for an updated version, which is referred to as the "New Fraud Triangle." Within this particular model, there are several key components: Pressure/Motivation acknowledges the significance of motivation as a crucial factor, encompassing a wide array of pressures that individuals encounter. It delves into a more comprehensive range of psychological and situational factors that influence motivations for engaging in fraudulent behavior. Rationalization delves deeper into the psychological and ethical aspects of justifying fraudulent actions, taking into consideration cultural influences, moral disengagement, and social context. Opportunity, which is emphasized by the new fraud triangle, highlights the importance of opportunity by examining systemic factors that contribute to the creation or elimination of opportunities, such as organizational culture, leadership, and technological advancements. Capability, as a new dimension, examines the individual's capability to carry out fraudulent actions, considering skills, knowledge of internal processes, and access to resources, while also emphasizing the impact of technology and sophisticated schemes. In recognizing the fear of being apprehended as a deterrent, the new fraud triangle incorporates this element, placing emphasis on the significance of robust monitoring and enforcement mechanisms within organizations.

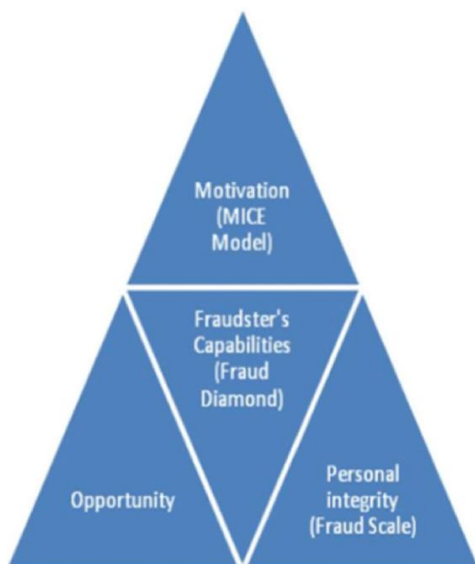


Figure 1: The new fraud triangle

The new fraud triangle offers a more intricate and nuanced framework for comprehending and preventing fraudulent behavior in a constantly evolving socio-economic landscape, with the aim of assisting organizations and investigators in developing effective strategies to identify and mitigate fraud risks. The model new fraud triangle is shown above.

## 2.2. Agency Theory

The agency theory was first put forth by Stephen Ross and Barry Mitnick in 1973. It is defined by a conflict of interest that arises between principals, or owners, and agents, or managers. The fundamental principle underlying both perspectives is similar, even though Mitnick perceived the agency problem as a problem of institutional structure and Ross as a matter of incentives (Mitnick, 2019).

Agency theory is a conceptual framework within the realms of economics and management that delves into the intricate relationship between principals (owners or stakeholders) and agents (individuals or entities employed to carry out tasks on behalf of the principals). This theory scrutinizes the difficulties and potential conflicts of interest that may arise when the goals of the principal and agent are not in perfect alignment. It holds particular relevance in situations where there exists a division between ownership and control, such as in corporations where shareholders delegate decision-making authority to executives.

Agency theory acknowledges the presence of information asymmetry between principals and agents. Agents may possess a greater amount of information regarding their actions and decisions compared to the principals. This disparity in information provides opportunities for deceitful activities. In essence, agency theory furnishes a framework for comprehending the dynamics between principals and agents, offering insights into the motivations and hazards that can give rise to fraudulent behavior. Through the implementation of strategies informed by agency theory, organizations can enhance their efforts in detecting fraud and cultivate an environment that is more trustworthy and accountable.

## 3. Internal Control and fraud Detection

This section describes the various principles that guide the development and implementation of internal controls in fraud prevention. Some of the aspects discussed are internal control environment, internal audit, transaction monitoring and risks assessment.

### 3.1. Control environment

The control environment influences the control consciousness of its people (Suhler & Churchland, 2009). It comprises the overall tone and culture of the organization regarding ethical behavior and integrity. It includes the commitment of management, the independence of oversight functions, and the establishment of policies and procedures that promote ethical conduct.

The internal control environment assumes a paramount significance within an organization's framework as it assumes the responsibility of preventing, detecting, and responding to any fraudulent activities that may arise. This encompassing environment is characterized by the tone set by management, the overall culture that permeates throughout the organization, and the efficacy of the policies

and procedures in place. It is important to acknowledge that the ethical tone established by the upper management has a far-reaching impact on the entirety of the organization. A steadfast commitment to upholding integrity and ethical behavior acts as a formidable deterrent against any potential fraudulent acts (Murphy & Dacin, 2011). Conversely, a lackadaisical attitude towards ethical standards might inadvertently create an environment that is susceptible to the occurrence of fraudulent activities. It is unequivocally clear that a positive and ethical corporate culture, one in which employees are imbued with a profound sense of responsibility and integrity, is indispensable when it comes to the prevention of fraud. Furthermore, it is vital for this culture to foster an environment that encourages open communication and the reporting of any suspicious activities, as this will undoubtedly bolster the organization's efforts in detecting and combatting fraud.

### 3.2. Transaction monitoring

Theofanis et al. (2011) describe monitoring as establishing an ongoing process to assess the effectiveness of internal controls in preventing financial fraud. This can involve periodic internal audits, management previews, data analysis, and the establishment of key performance indicators to track the organization's fraud prevention efforts.

Transaction monitoring and fraud detection are essential components of financial systems and security measures implemented by organizations to protect against fraudulent activities. These processes encompass the continuous and real-time analysis of financial transactions with the aim of identifying abnormal patterns, potential risks, and deceptive behavior. The objective is to safeguard businesses, financial institutions, and their clients from financial losses and reputational harm. The integration of cutting-edge technologies, such as artificial intelligence and machine learning, greatly enhances the capacity to identify and prevent fraudulent activities. This, in turn, contributes to the overall security and trustworthiness of financial transactions.

### 3.3. Risk assessment

According to Karagiogos et al. (2007), risk assessment refers to factors that affect the possibility of an organization's objectives not being achieved. Organizations need to identify and assess the risks of financial fraud. This involves understanding the potential vulnerabilities, assessing the likelihood and impact of fraud, and prioritizing the areas of highest risk.

Risk assessment serves as a crucial and multifaceted tool in the realm of fraud detection, functioning as a vigilant guardian against potential financial malfeasance (Nyakarimi et al., 2020). Its efficacy lies in its ability to meticulously scrutinize diverse elements associated with transactions and user behavior, thereby fortifying the defenses of organizations against fraudulent activities. At its core, risk

assessment involves the comprehensive evaluation of potential risks and vulnerabilities within a financial system. By delving into transactional data, it discerns patterns, irregularities, and anomalies that may signify fraudulent behavior. This process operates as a preemptive measure, allowing organizations to identify and address potential threats before they materialize into substantial losses.

In the intricate dance of financial transactions, risk assessment acts as a discerning partner, constantly monitoring for deviations from established norms (Serem, 2016). Through the lens of statistical models, machine learning algorithms, and historical data analysis, it establishes a baseline of expected behavior. Any departure from this norm, whether in transaction amounts, frequency, or geographical origin, is promptly flagged for further investigation. Moreover, risk assessment extends its watchful gaze beyond mere transactional patterns. It incorporates behavioral analysis, recognizing the distinct digital fingerprints of users and their devices. This nuanced approach considers factors such as login times, the number of failed attempts, and device characteristics to identify potentially fraudulent activities. By doing so, it not only scrutinizes the 'what' but also the 'how' and 'who' behind transactions, adding layers of complexity to its fraud-detection capabilities.

### 3.4. Internal Audit

Internal auditing involves evaluating a company's internal control, including its corporate governance and accounting processes (Tumwebaze et al., 2018). These audits ensure compliance with laws and regulations and help maintain accurate and timely financial reporting and data collection. The Sardines-Oxley Act of 2002 holds managers legally responsible for the accuracy of their company's financial statement. Internal audits provide risk management and safeguarding against potential waste, fraud, or abuse. The reports from the findings help the management improve the current internal controls or institute new ideas to make them more effective. According to Kamau (2013), there exists an expectation among the general public that auditors possess the ability to identify instances of fraud throughout the course of their audit engagement. Respondents who participated in the research study reached a consensus that auditing has the potential to uncover instances of fraud, albeit to a restricted extent. This limitation is contingent upon various factors, such as the level of authority granted to the audit assignment, the significance of the fraudulent activity, and the adequacy of the internal control system.

Within the intricate framework of organizational governance and risk management, the internal audit emerges as a stalwart guardian, playing a pivotal role in the detection and prevention of fraud. Far beyond a routine examination of financial records, the internal audit serves as a diligent investigator, scrutinizing the inner workings of an organization to identify irregularities and safeguard against

the insidious threat of fraudulent activities. At its essence, the internal audit is a comprehensive and systematic examination of an organization's processes, controls, and financial transactions. Its primary objective is to provide an unbiased assessment of the organization's internal controls and risk management practices. In the realm of fraud detection, this process involves a meticulous analysis of financial records, operational procedures, and adherence to established policies.

Internal auditors act as ethical detectives, employing a discerning eye to identify anomalies, inconsistencies, or deviations from standard operating procedures. Through a combination of forensic accounting techniques, data analytics, and a deep understanding of the organization's intricacies, they unravel the subtle threads of potentially fraudulent activities (Kalume & Kamau, 2021). Crucially, internal audits not only focus on financial transactions but also extend their purview to operational and compliance aspects. By examining the alignment of activities with established policies and ethical standards, internal auditors are well-positioned to uncover fraudulent schemes that may lurk beneath the surface of day-to-day operations.

One of the key strengths of internal audits in fraud detection lies in their independence and objectivity. Operating as an internal function, auditors are positioned to assess the organization without bias, ensuring a thorough and impartial evaluation. This independence allows them to delve into sensitive areas and challenge existing practices, providing an essential check and balance within the organization (Arya & Glover, 2014). Moreover, internal auditors play a crucial role in the development and enhancement of internal controls. By identifying weaknesses or gaps in control mechanisms, they contribute to the fortification of the organization's defenses against fraud. Their recommendations for improvements not only serve as a response to identified risks but also as a proactive measure to prevent potentially fraudulent activities.

In the ever-evolving landscape of fraud, internal audits adapt and evolve. The integration of advanced technologies, such as data analytics and artificial intelligence, enhances their ability to detect patterns indicative of fraud. Continuous learning and staying abreast of emerging threats ensure that internal auditors remain at the forefront of the organization's defense against fraudulent activities. In essence, the internal audit is the organization's watchful guardian, tirelessly working to ensure the integrity of financial transactions and the adherence to ethical standards. By providing an independent and thorough examination, internal audits contribute significantly to the detection, prevention, and mitigation of fraud, thereby safeguarding the organization's reputation and financial well-being.

### 3.5. Fraud Detection

Effective internal control has reduced fraudulent activities in companies prone to fraud. Researchers suggest that opportunity, pressure, and rationalization force fraudsters to focus on their weaknesses of internal control, which are to allow them to commit crime (Mars Group 2008). In Kenya, GFRP issued directions to all accounting officers in all government bodies to ensure an effective internal control unit to shield against fraudulent practices. It further directed the accounting staff to make sure that the system of internal inspection occurs under the direction as well as regulator of an Internal Accountant General to assess the efficiency of internal control. Worker's theft has been discovered to be affected by the company's work environment as well as staff attitudes towards morality (Greenberg, 2002). When management institutes or focuses on these internal control measures, incidences of fraud reduce significantly as the chances or opportunities to commit fraud have been prevented.

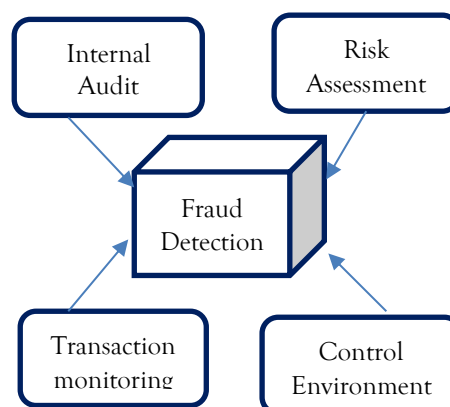


Figure 2: Fraud detection tools

Internal control is the organizational infrastructure that encompasses policies, procedures, and mechanisms put in place to safeguard assets, maintain accurate financial records, and ensure adherence to laws and regulations. In the context of fraud detection, this multifaceted system operates as a sentinel, tirelessly monitoring and evaluating transactions, processes, and activities for signs of irregularities. One of the fundamental aspects of internal control in fraud detection is the establishment of robust financial and operational processes (Opiyo, 2023). By clearly defining workflows, delineating authority levels, and implementing segregation of duties, internal control mechanisms create barriers that deter and detect fraudulent behavior. These measures ensure that no single individual has unchecked control over a critical aspect of a process, reducing the opportunity for fraud to occur unnoticed.

Crucially, internal control relies on a system of checks and balances. Regular reconciliations, independent reviews, and oversight mechanisms are integral components designed to verify the accuracy and reliability of financial information. In the context of fraud, these control activities act as red flags, signaling the need for further investigation

when inconsistencies or deviations from established norms are identified. In the digital age, technology plays a vital role in internal control and fraud detection (Kubasu, 2014). Automated monitoring systems, data analytics, and anomaly detection tools are leveraged to sift through vast amounts of data, identifying patterns indicative of potentially fraudulent activities. These technological advancements enhance the efficiency and effectiveness of internal controls, enabling real-time scrutiny of transactions and activities.

Furthermore, internal control contributes to a culture of compliance and ethical behavior within an organization (Mungai et al., 2021). Clear communication of policies, codes of conduct, and ethical standards fosters an environment where employees understand the consequences of fraudulent actions and are more likely to adhere to established norms. This preventative aspect of internal control is instrumental in creating a resilient defense against fraud. In essence, internal control is the organization's guardian, fortifying its defenses against the ever-present threat of fraud. Through meticulous oversight, systematic checks, and the integration of technological tools, it serves as a proactive force in detecting and preventing fraudulent activities. As organizations adapt to evolving risks and challenges, the role of internal control in fraud detection remains paramount, preserving the trust of stakeholders and ensuring the continued stability of the organization. Yavuzaslan et al. (2023) posited that the acquisition of proper conduct solely through literary works or testimonies from individuals affiliated with any particular collective is an unattainable feat. Consequently, the detection of deceit necessitates the employment of a conglomerate of methodologies and frameworks.

#### 4. Summary and Conclusion

In conclusion, the study delves into the critical role of internal control in fraud detection within organizational settings. Internal control encompasses a multifaceted system of checks and balances, including preventive, detective, and corrective controls, designed to ensure the validity and accuracy of financial statements. The study highlights the significance of a well-defined organizational structure, clear communication channels, and delegation of tasks to prevent fraudulent activities. Financial fraud, including embezzlement, misappropriation of assets, fraudulent financial reporting, and corruption, poses significant threats

to organizations. The Fraud Triangle Theory, introduced by Donald Cressey, identifies opportunity, pressure, and rationalization as motivating factors for individuals engaging in fraudulent activities. Internal controls play a crucial role in addressing the opportunity factor by implementing measures that restrict access, enforce segregation of duties, and promote accountability.

The study explores the agency theory, emphasizing the conflict of interest between principals (owners) and agents (managers), particularly in situations where there exists a division between ownership and control. It acknowledges information asymmetry as a potential source of fraudulent activities and underscores the importance of strategies informed by agency theory in detecting fraud. Internal controls, such as the control environment, transaction monitoring, and risk assessment, play integral roles in preventing and detecting financial fraud. The control environment, influenced by management commitment and ethical culture, acts as a deterrent against fraudulent acts. Transaction monitoring involves ongoing processes to assess the effectiveness of internal controls, while risk assessment identifies and assesses potential vulnerabilities to prevent fraud.

The study also underscores the vital role of internal audits in fraud detection. Internal auditors, acting as ethical detectives, conduct comprehensive examinations of processes, controls, and financial transactions. Their independence and objectivity contribute to a thorough and impartial evaluation, and their recommendations enhance internal controls to fortify defenses against fraud. The Fraud Triangle Theory is complemented by the "New Fraud Triangle," incorporating additional components such as Pressure/Motivation, Rationalization, Opportunity, and Capability. This updated model provides a more nuanced understanding of fraudulent behavior, emphasizing the importance of organizational culture, leadership, and technological advancements. The study concludes by emphasizing the ongoing evolution of fraud detection strategies, incorporating advanced technologies, continuous learning, and staying abreast of emerging threats. In essence, the collaboration of internal controls, audits, and theoretical frameworks creates a robust defense against financial fraud, preserving the trust of stakeholders and ensuring organizational stability.

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