

The Relationship between Internal Control Systems and Financial Reporting Scandals: Evidence from Nairobi Securities Exchange Listed Companies

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Abstract

Despite extensive regulatory frameworks designed to prevent financial misconduct, accounting scandals continue to emerge globally, undermining investor confidence and market integrity. This study examines the relationship between Internal Control Systems (ICS) and financial reporting scandals among Nairobi Securities Exchange (NSE)-listed companies in Kenya. Using a census of all 62 NSE-listed companies, data were collected from 155 respondents, including accountants, internal auditors, finance officers, and company secretaries, through structured questionnaires. The study was anchored in the Fraud Triangle theory, which recognizes pressure, opportunity, and rationalization as essential elements of fraud. This research used descriptive statistics, correlation analysis, and regression analysis to examine the relationship between ICS and financial reporting. Results showed a robust positive correlation ($r = 0.639$, $p < 0.001$) between internal control systems and financial reporting quality. Regression analysis showed that ICS explains 40.8% of the variance in financial reporting practices ($R^2 = 0.408$, $F = 104.441$, $p < 0.001$), with a standardized coefficient ($\beta = 0.639$, $p < 0.001$). Findings demonstrate that stronger internal control systems are significantly associated with better financial reporting practices and a reduced likelihood of financial reporting scandals. The study concludes that robust internal control systems are critical to preventing financial reporting irregularities and recommends that NSE-listed companies' boards of directors, audit committees, and regulatory authorities, such as the Capital Markets Authority, prioritize strengthening internal control frameworks to enhance financial reporting integrity.

Keywords: *Internal control systems, Financial reporting scandals, and Nairobi securities exchange, Kenya*

1.0 Introduction

Financial reporting refers to the process of producing statements that disclose an organization's financial status to management, investors, and regulatory authorities, including income statements, balance sheets, cash flow statements, and notes to accounts (Hassan & Hijazi, 2023). Internal Control Systems (ICS) are integrated processes designed by management to provide reasonable assurance regarding the achievement of objectives in operational effectiveness, reliable financial reporting, and compliance with applicable laws and regulations (COSO, 2013). In the context of the Nairobi Securities Exchange, the relationship between these variables has become increasingly critical following several high-profile corporate failures. This study aims to examine how internal control systems influence the occurrence of financial reporting scandals among NSE-listed companies, addressing the persistent gap between regulatory frameworks and their practical implementation in Kenya's capital market.

Global Perspective

Financial ecosystems worldwide have been severely disrupted by high-profile corporate accounting scandals, which have significantly influenced financial regulations and corporate governance frameworks (Nuridin, 2025). These scandals have caused immense financial losses for stakeholders and eroded public confidence in financial markets and institutions, creating waves of uncertainty that disrupt capital inflows, hinder investment, and compromise economic stability. This has occurred despite the establishment of regulatory frameworks such as the Sarbanes-Oxley Act (2002) and the adoption of International Financial Reporting Standards (IFRS). Accounting scandals, typically

perpetrated by company executives, involve misappropriation of funds, revenue inflation, cost concealment, asset value exaggeration, and underreporting of liabilities (Albrecht et al., 2023). According to Srinivas and Liang (2022), governments and regulatory bodies worldwide have consistently implemented comprehensive reforms to reduce fraudulent practices and promote ethical corporate behavior. The historical timeline of accounting scandals demonstrates their global reach and persistence. Major scandals, including Enron (2001), WorldCom (2002), and more recently Wirecard (2020) and Luckin Coffee (2020), have highlighted the critical importance of effective internal control systems in preventing financial reporting irregularities (Petra & Spieler, 2020; Zhang, 2025).

Regional Perspective

Building on these global lessons, regional studies further underscore the importance of internal control mechanisms in deterring financial misreporting. International research across regions consistently shows that strong internal control systems are critical to preventing financial reporting fraud. For instance, Abbasi et al. (2021) found that the probability of fraud commission decreases with measures that enhance fraud detectability, including robust internal controls. Similarly, Song et al. (2022) noted that after the passage of the Sarbanes-Oxley Act in 2002, companies—particularly in the U.S. and Europe—intensified their focus on internal audit budgets, staffing levels, and audit board meetings. These reforms underscore the significance of internal controls within regional corporate governance landscapes, reflecting how global benchmarks are adapted to regional contexts and socioeconomic realities.

Local (Kenyan) Perspective

Within the local context, Kenya has faced similar challenges, with weak internal controls and inadequate accounting systems identified as key enablers of financial misreporting and fraud. According to Kariuki and Jagongo (2022), banks with efficient internal controls had fewer instances of fraud or financial misstatement. However, high-profile scandals at institutions such as CMC Holdings, Imperial Bank, and Uchumi Supermarkets illustrate persistent gaps between the adoption of governance frameworks and their effective implementation (Mwangi & Kariuki, 2023; Odhiambo, 2024). These cases underscore the urgent need for Kenya to strengthen its internal control mechanisms, align them more closely with global best practices, and ensure enforcement that bridges the gap between theory and practice.

“The research provides compelling evidence that internal control systems significantly influence financial reporting practices among NSE-listed companies in Kenya”

Despite extensive regulatory frameworks and control mechanisms, accounting scandals continue to occur in Kenya with devastating consequences. The impact has been severe, leading to the collapse of institutions such as Imperial Bank Ltd, Chase Bank Ltd, Nakumatt Supermarkets Ltd, and Uchumi Supermarkets Ltd (Gitau & Mutiso, 2022; Wanjiku et al., 2023). This persistent gap between theoretical frameworks and practical implementation raises fundamental questions about the effectiveness of

internal control systems in Kenya. Therefore, this study examines the relationship between internal control systems and financial reporting scandals among NSE-listed companies, contributing to the understanding of how effective internal controls can prevent financial reporting irregularities in emerging markets.

Literature review

This research was grounded in the Fraud Triangle Theory, which identifies three essential elements for fraud to occur: pressure, opportunity, and rationalization (Omar et al., 2021). The theory is particularly relevant to this study because it emphasizes the role of opportunity in the commission of fraud. Robust internal controls and well-designed accounting systems reduce opportunities to manipulate or misstate financial data, whereas weak internal controls create opportunities for fraud (Lokanan & Sharma, 2022). The study also draws on Agency Theory, which elucidates the relationship between agents and principals in corporate governance (Jensen, 2022). Internal control systems serve as tools to align the goals of managers (agents) with those of shareholders (principals), helping to minimize agency issues that could lead to financial misreporting.

Internal control systems are the measures and procedures put in place to ensure that proper books of account are maintained and that the organization's operations are carried out smoothly and efficiently (Hassan & Hijazi, 2023). These systems help an organization achieve operating success and efficiency, accurate financial reporting, and compliance with applicable laws, rules, and policies. According to Hassan and Hijazi (2023), a robust internal control system includes preventive and detective levels of control to ensure that the organization is run in an orderly

manner, protect its assets, discourage wrongdoing, assure the accuracy and completeness of information, and generate accurate and timely information.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework outlines five key elements of internal control: the control environment, risk assessment, control activities, information and communication, and monitoring (COSO, 2013). These components work together to provide reasonable assurance that objectives related to operations, reporting, and compliance are achieved.

Recent studies have consistently demonstrated the importance of internal control systems in preventing financial reporting fraud. Boulhaga et al. (2022) found that firms reporting internal control problems also reported material errors, qualified or adverse audit opinions, and earnings misstatements, suggesting a direct link between financial reporting quality and weak internal controls. In the Kenyan context, several studies have examined the relationship between internal controls and financial reporting quality. Mwangi and Waweru (2023) found that staff competency, management commitment, and resource availability were critical to the effectiveness of internal control systems, affecting the quality of financial reporting. Ndung'u and Murigi (2022) found that many banks had weak internal controls, which led to poor financial performance and increased fraud. However, despite these studies, there remains a need for a comprehensive examination of how internal control systems specifically relate to financial reporting scandals among NSE-listed companies, particularly given the continued occurrence of financial irregularities in the Kenyan market.

2.0 Materials and Methods

An explanatory research design was used to examine the cause-and-effect relationship between internal control systems and financial reporting scandals. Explanatory research seeks to answer 'why' questions and is suitable for studying causal relationships between variables (Saunders et al., 2023). The target population comprised all 62 companies listed on the Nairobi Securities Exchange as of August 2024, with 3 key informants (accountants, internal auditors, and finance officers) purposively selected from each company, yielding a population of 186. The study employed a census approach to include all NSE-listed companies, eliminating sampling bias and ensuring comprehensive representation across all sectors. Within each company, purposive sampling was used to select respondents based on their roles and expertise in financial reporting and internal controls. The study conformed to ethical requirements by seeking approval from Kenya Methodist University and obtaining a research permit from the National Commission of Science, Technology, and Innovation (NACOSTI).

Data were collected through structured questionnaires from key personnel, including accountants, internal auditors, finance officers, and company secretaries. The questionnaire measured internal control systems using 20 indicators based on the COSO framework and financial reporting practices, and financial reporting quality and potential irregularities using 15 indicators. All items were measured on a 5-point Likert scale. The study employed descriptive statistics, correlation analysis, and regression analysis. Content validity was established through expert review by three accounting academics. The instrument was pilot-tested with 20 respondents. Construct validity was

confirmed via factor analysis, with loadings exceeding 0.50 (Hair et al., 2019). Field practitioners verified face validity. Reliability of the instruments was tested using Cronbach's alpha, and the assumptions of normality, linearity, homoscedasticity, and multicollinearity were tested before conducting regression analysis.

3.0 Results and Discussion

Respondent Demographics

To better understand the composition of the study participants, demographic data were collected and analyzed. The distribution of respondents across professional categories is presented in Table 1, which shows their frequencies and corresponding percentages.

Table 1
Respondent Demographics

Category	Frequency (n=155)	Percentage (%)
Accountants	88	56.8
Internal Auditors	24	15.5
Finance Officers	20	12.9
Company Secretaries	13	8.4
Other Professionals	10	6.5
Total	155	100

Of the 186 questionnaires distributed, 155 were completed and returned, yielding an excellent response rate of 83.3%. A majority of respondents were Accountants (56.8%), indicating their

Table 2
Reliability Analysis (Cronbach's Alpha)

Variable	No. of Items	Cronbach's Alpha (α)	Interpretation
Internal Control Systems (ICS)	20	0.865	Good
Financial Reporting Practices (FRP)	15	0.733	Acceptable

The study's measurement instruments demonstrated strong reliability, as indicated by Cronbach's Alpha coefficients. Internal Control Systems (ICS) showed excellent internal

dominant role in the study sample. Internal Auditors (15.5%) and Finance Officers (12.9%) also made-up significant proportions of respondents. Company Secretaries (8.4%) and Other Professionals (6.5%) formed the minority groups in the sample.

The study primarily included accountants, aligning with their central role in financial reporting and compliance. Internal auditors and finance officers provided additional perspectives on assurance and oversight functions, while company secretaries contributed governance insights. This professional diversity enhances the study's validity by capturing views across various financial roles. However, the heavy concentration of accountants may introduce bias toward their specific experiences and challenges, potentially limiting the generalizability of findings to other financial professionals, despite otherwise balanced representation.

Reliability Analysis

To assess the research instrument's consistency, reliability testing was conducted using Cronbach's Alpha. The results are summarized in Table 2, which presents the number of items tested for each variable, their respective alpha coefficients, and the corresponding interpretations.

consistency ($\alpha = 0.865$), while Financial Reporting Practices (FRP) met acceptable thresholds ($\alpha = 0.733$). Both constructs are suitable for statistical analysis, and the results

support the research instrument's robustness and validity for subsequent findings.

Descriptive Statistics – Internal Control Systems

To evaluate perceptions of internal control systems (ICS), descriptive statistics were generated. These results, summarized in Table 3, present the mean (M) and standard deviation (SD) for the key ICS elements measured in the study.

Table 3
Descriptive Statistics – Internal Control Systems

ICS Element	Mean (M)	Std. Dev (SD)
Board Oversight	4.35	0.59
Organizational Structure	4.33	0.66
Ethical Foundations	4.32	0.99
Internal Communication	4.30	0.56
Consistent Information Capture	4.27	0.61
External Communication	3.70	0.91
Human Resource Management	3.69	1.02

The assessment of internal control systems (as shown in Table 3 above) revealed generally positive implementation across NSE-listed companies, with mean scores ranging from 3.69 to 4.35 on a 5-point scale. Board oversight emerged as the strongest element (M = 4.35, SD = 0.59), followed by organizational structure (M = 4.33, SD = 0.66) and ethical foundations (M = 4.32, SD = 0.99). Internal communication (M = 4.30, SD = 0.56) and consistent information capture for financial reporting (M = 4.27, SD = 0.61) also scored highly. Areas of weakness included human resource management (M = 3.69, SD = 1.02) and external communication regarding internal controls (M = 3.70, SD = 0.91), suggesting challenges in attracting and retaining competent personnel and in effectively communicating control matters to external stakeholders.

These findings align with previous research in the Kenyan context. Mwangi and Waweru (2023) similarly identified management commitment and organizational structure as critical success factors for effective internal control in Kenyan public institutions, reporting mean scores above 4.0 for

governance elements. The strong performance in board oversight (M = 4.35) is consistent with Kariuki and Jagongo's (2022) observation that Kenyan banks with active board participation demonstrated superior implementation of internal controls. However, the weakness in human resource management (M = 3.69) corroborates Ndung'u and Murigi's (2022) findings that staff competency and retention challenges undermine the effectiveness of internal controls in Kenyan financial institutions. The higher standard deviation in ethical foundations (SD = 0.99) suggests variability across companies, mirroring the inconsistent governance practices documented by Odhiambo (2024) in Kenya's financial sector.

Organizations demonstrate strong internal control in governance areas such as board oversight, organizational structure, ethics, and internal communication. However, external-facing aspects, including stakeholder communication and HR management, show weaker performance and greater variation, suggesting inconsistent implementation. While internal governance frameworks are well-established, strengthening

external communication and HR practices would enhance transparency, compliance, and stakeholder trust, thereby creating more balanced and comprehensive control systems.

Descriptive Statistics – Financial Reporting Practices

Table 4

Descriptive Statistics – Financial Reporting Practices

FRP Element	Mean (M)	Std. Dev (SD)
Payments supported by approved documentation	4.63	0.49
Depreciation methodology consistently applied	4.20	0.79
Proper inventory valuation	4.04	0.90
Financial statements restated to reflect management views	3.15	1.11
Company profits adjusted to meet yearly targets	3.07	0.88

The assessment of financial reporting practices revealed both strengths and vulnerabilities, with mean scores ranging from 3.07 to 4.63, as shown in Table 4 above. Documentation integrity emerged as the strongest element, with "Payments are always supported by approved documentation" scoring highest (M = 4.63, SD = 0.49). Adherence to established accounting policies appeared robust, with consistent depreciation methodologies (M = 4.20, SD = 0.79) and proper inventory valuation (M = 4.04, SD = 0.90). However, concerning patterns emerged, suggesting potential earnings management practices. The moderate scores for "Company profits are adjusted to meet yearly targets" (M = 3.07, SD = 0.88) and "Financial statements are restated to reflect management and shareholder desires" (M = 3.15, SD = 1.11) indicated divided opinions among respondents.

The moderate scores for profit adjustments (M = 3.07) and management-driven restatements (M = 3.15) align with international research on earnings management practices. Boulhaga et al. (2022) reported similar patterns among French companies, in which discretionary adjustments to

To assess how organizations handle financial reporting, descriptive statistics were computed for key elements of financial reporting practices (FRP). These results are presented in Table 4, which reports the mean (M) and standard deviation (SD) for each FRP indicator.

meet earnings targets were prevalent despite strong control frameworks. The concerning levels of potential earnings manipulation identified in this study align with Albrecht et al. (2023), who noted that management pressure to meet financial targets creates incentives for reporting irregularities even in well-controlled environments. The strong documentation practices (M = 4.63) are consistent with Hassan and Hijazi's (2023) observation that preventive controls related to transaction authorization tend to be more robust than detective controls addressing managerial discretion. The variability in financial statement restatements (SD = 1.11) suggests sectoral differences, which aligns with Wanjiku et al.'s (2023) findings that accounting scandals in Kenyan companies often stem from inconsistent application of reporting standards across industries.

The findings indicate that organizations demonstrate strong compliance with documentation, depreciation, and inventory valuation, reinforcing transparent reporting. However, lower scores for profit adjustments and management-driven restatements signal risks of

earnings manipulation and reduced credibility. High variability in restatements suggests inconsistent practices across firms. While overall reporting is reliable, managerial discretion creates vulnerabilities, highlighting the need for stronger oversight, transparency, and compliance to safeguard stakeholder trust and ensure accurate financial reporting.

Table 5
Correlation Analysis

Variables	r	p-value	Interpretation
ICS and FRP	0.639	< 0.001	Strong Positive

The correlation analysis (as shown in Table 5 above) revealed a strong positive relationship between Internal Control Systems and Financial Reporting Practices ($r = 0.639$, $p < 0.001$). This correlation indicates that as internal control systems improve, the quality of financial reporting practices also improves. According to Evans' (1996) interpretation guidelines, this represents a strong positive relationship between the variables.

Table 6
Regression Analysis Results

Statistic/Parameter	Value	Interpretation
R	0.639	Strong correlation
R ²	0.408	40.8% variance explained
Adjusted R ²	0.404	Reliable model
F-value	104.441	Highly significant
p-value	< 0.001	Significant model
Unstandardized Coefficient (B)	0.635	Positive effect
Standardized Coefficient (β)	0.639	Strong predictor
t-value	10.268	Significant

The bivariate regression analysis between Internal Control Systems (ICS) and Financial Reporting Practices (FRP) produced significant results, as shown in Table 6. The model summary reported a correlation coefficient (R) of 0.639 and a coefficient of determination (R²) of 0.408,

Correlation Analysis

To examine the relationship between internal control systems (ICS) and financial reporting practices (FRP), a correlation analysis was conducted. The results, presented in Table 5, include the correlation coefficient (r), the p-value, and an interpretation of the relationship between the two variables.

Regression Analysis Results

To further test the predictive relationship between internal control systems (ICS) and financial reporting practices (FRP), a regression analysis was conducted. The results are summarized in Table 6, which presents key model statistics and coefficients, along with their interpretations.

indicating that approximately 40.8% of the variance in financial reporting performance can be explained by variations in internal control systems. The adjusted R² of 0.404 confirmed the model's reliability after adjusting for sample size. The ANOVA results showed strong statistical

significance ($F = 104.441$, $p < 0.001$), confirming that internal control systems have a significant and measurable influence on financial reporting performance. A high F-value indicates that the regression model fits the data significantly better than a model without any predictor variables. The regression coefficients showed that the unstandardized coefficient (B) for ICS was 0.635, indicating that for every one-unit increase in the internal control system score, financial reporting performance increases by 0.635 units. The standardized coefficient (Beta = 0.639, $t = 10.268$, $p < 0.001$) confirmed the strength and significance of this relationship.

The results indicate a strong positive relationship between internal control systems and financial reporting reliability among NSE-listed companies in Kenya. This finding aligns with previous research by Amudo and Inanga (2020), who reported similar R^2 values in their study of NGOs in Uganda, and supports the theoretical foundation established by the COSO (2013) Internal Control Framework. The substantial explanatory power (40.8%) of internal control systems suggests that strengthening ICS can lead to significant improvements in financial reporting quality. This finding is particularly important in the Kenyan context, where high-profile accounting scandals have highlighted weaknesses in financial reporting practices.

The dominance of board oversight and ethical foundations in the ICS assessment indicates that these elements are fundamental to the effective implementation of internal controls. However, identified weaknesses in human resource management and external communication suggest areas where NSE-listed companies can focus improvement efforts. Moderate scores in financial reporting practices, particularly those related to

earnings management, indicate ongoing vulnerabilities that need attention. The finding that some companies acknowledge adjusting profits to meet targets and restating financial statements at management's discretion suggests that, despite generally strong internal controls, opportunities for financial reporting irregularities remain.

4.0 Conclusions

The research provides compelling evidence that internal control systems significantly influence financial reporting practices among NSE-listed companies in Kenya. The strong positive correlation ($r = 0.639$) and substantial explanatory power ($R^2 = 0.408$) indicate that robust internal control systems are critical mechanisms for preventing financial reporting scandals. The findings support the theoretical proposition that effective controls reduce the opportunity element of the fraud triangle, thereby decreasing the likelihood of financial reporting irregularities. The research confirms that internal control systems are not merely compliance requirements but essential foundations for financial reporting integrity.

5.0 Recommendations

Based on the study's findings, it is recommended that NSE-listed companies strengthen their internal control frameworks by fully implementing all five COSO components, with particular focus on the weaker areas of human resource management and external communication. While board oversight emerged as the strongest element, it should be sustained and enhanced through consistent monitoring and evaluation to ensure financial reporting integrity. Similarly, companies need to address vulnerabilities related to earnings management, such as profit adjustments to meet targets and

financial statement restatements, by instituting stricter review mechanisms that safeguard against manipulation and align reported results with actual economic performance.

In addition, firms should invest more in human capital by recruiting, training, and retaining qualified personnel to strengthen internal control functions, as weaknesses in this area were evident.

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