

## **Internal Audit Function Quality and Financial Reporting Scandals: Evidence from Nairobi Securities Exchange Listed Companies**

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### **Abstract**

Internal audit functions are critical oversight mechanisms in corporate governance, yet their effectiveness in preventing financial reporting scandals remains underexplored, particularly in emerging markets. This study examines the relationship between the quality of the internal audit function (IAF) and financial reporting scandals among companies listed on the Nairobi Securities Exchange (NSE) in Kenya. Using a census approach encompassing all 62 NSE-listed companies, data were collected from 155 respondents through structured questionnaires administered to accountants, internal auditors, finance officers, and company secretaries. The study employed descriptive statistics, correlation analysis, and regression analysis to investigate the relationship between IAF quality and financial reporting practices. Results revealed a moderate positive correlation ( $r = 0.556$ ,  $p < 0.001$ ) between internal audit function quality and financial reporting quality. Regression analysis showed that IAF quality explains 30.9% of the variance in financial reporting practices ( $R^2 = 0.309$ ,  $F = 68.291$ ,  $p < 0.001$ ), with a standardized coefficient ( $\beta = 0.556$ ,  $p < 0.001$ ). The findings indicate that higher-quality internal audit functions are significantly associated with better financial reporting practices and a reduced likelihood of financial reporting scandals. However, implementation gaps were identified, particularly in management responsiveness to audit recommendations and professional certification requirements. The study concludes that while internal audit functions play a crucial role in financial reporting governance, their effectiveness depends on management support, adequate resources, and professional competence.

**Keywords:** *Internal audit Function, Financial reporting scandals, corporate governance, Audit quality, Nairobi Securities Exchange*

## **1.0 Introduction**

The role of internal audit functions in corporate governance has drawn heightened scrutiny following major financial scandals that exposed fundamental weaknesses in organizational oversight. High-profile cases, including Enron, WorldCom, Wirecard, and Luckin Coffee, highlighted significant failures in internal oversight and raised serious questions about the effectiveness of internal audit functions in detecting and preventing financial irregularities before they escalate into corporate disasters. Internal audit functions are strategically designed to provide comprehensive oversight of accounting and internal control systems while maintaining independence from operational management. These departments evaluate the adequacy and effectiveness of internal controls, assess regulatory compliance, and provide assurance to management and boards regarding the reliability of financial reporting, forming the foundation of stakeholder trust and market confidence.

Despite its theoretical importance and regulatory mandates, empirical evidence on internal audit effectiveness in preventing financial reporting scandals yields mixed results across organizational contexts and geographic regions. While some studies show positive relationships between internal audit quality and financial reporting integrity, others suggest that internal audit functions face significant implementation challenges and limited management responsiveness, substantially limiting their real-world effectiveness. This relationship is particularly critical in emerging markets like Kenya, where corporate governance frameworks are evolving, and institutional support mechanisms may be less developed than in mature markets. Kenya has experienced several high-

profile financial scandals involving prominent listed companies, including CMC Holdings, Imperial Bank, and Uchumi Supermarkets, raising questions about the effectiveness of internal audits and the broader corporate governance environment.

Although Kenya's Capital Markets Authority emphasizes that robust internal audit functions are essential for listed companies to ensure effective risk management and internal control systems, the extent to which internal audit function quality prevents financial reporting scandals among NSE-listed companies remains empirically underexplored. This study addresses this knowledge gap by systematically examining the relationship between internal audit function quality and financial reporting scandals among NSE-listed companies, providing empirical evidence from emerging market contexts and offering practical insights to strengthen internal audit functions, enhance financial reporting integrity, and prevent corporate scandals.

## **2.0 Materials and Methods**

This comprehensive study is grounded in three key theoretical frameworks that explain the role of internal audit functions in corporate governance. Agency Theory provides the foundation by explaining the relationship between shareholders (principals) and management (agents), and internal audit functions serve as critical monitoring mechanisms that reduce information asymmetry and address fundamental agency problems that lead to corporate misconduct. The study draws extensively on the Fraud Triangle Theory, which identifies opportunity as one of three essential elements of fraud, alongside pressure and rationalization. Effective internal audit functions systematically reduce opportunities for fraud by detecting internal

control weaknesses and continuously monitoring compliance with established procedures, serving as powerful deterrents to fraudulent financial reporting.

Additionally, the research incorporates Fraud Diamond Theory, extending the fraud triangle by adding capability as a fourth critical element and emphasizing how individuals' skills and organizational positions enable fraud perpetration. Internal audit functions help identify and mitigate fraud risks by systematically assessing individual capabilities and strategically placing appropriate controls to prevent the exploitation of positions of trust and authority, thereby creating comprehensive fraud prevention mechanisms.

Internal audit function quality encompasses several critical dimensions, including independence from management interference, the professional competence of audit staff, a comprehensive scope of work, proficiency in methodologies, and sustained management support. According to the Institute of Internal Auditors, effective internal audit functions should maintain strict independence, possess adequate professional qualifications and certifications, have unrestricted access to the organization, and receive appropriate support from senior management and boards. Recent research identifies key factors that significantly influence internal audit quality: professional competence, measured by certifications and experience; operational independence from management interference; a comprehensive audit scope across organizational functions; and adequate resources, including staffing, technology, and budget allocations. Critically, internal audit effectiveness depends on management's responsiveness to audit findings and recommendations, as even the highest-quality audit work becomes ineffective

without management action on identified weaknesses.

*“This study provides compelling empirical evidence that the quality of the internal audit function significantly influences financial reporting practices among NSE-listed companies in Kenya”*

Recent empirical studies provide compelling evidence of significant relationships between the quality of the internal audit function and financial reporting outcomes across organizational contexts. Research shows that organizations with independent internal auditors and effective audit committees are associated with lower abnormal accruals, indicating that high-quality internal audit functions contribute to better financial reporting quality and reduced earnings management. Advanced studies reveal that internal audit quality directly correlates with reduced earnings management, lowering the likelihood of manipulation and strengthening stakeholder trust. Firms with high-quality internal audit functions are significantly less likely to engage in earnings forecast manipulation, resulting in more reliable financial communications with investors. Comprehensive studies show that high-quality internal audit functions contribute positively to overall audit and reporting quality. External certification enhances reporting quality while reducing external audit fees, suggesting that professional competence improves effectiveness and creates organizational value through enhanced governance.

Despite strong theoretical expectations and regulatory requirements, comprehensive studies

have identified significant challenges that systematically limit the effectiveness of internal audits in real-world organizational environments. Research shows that while internal audit functions have expanded substantially due to increased regulation, performance evaluation mechanisms have not kept pace, creating a critical misalignment between role expansion and evaluation that makes it difficult to assess whether internal audit functions meet stakeholder expectations. Management responsiveness to internal audit recommendations consistently emerges as a critical factor determining internal audit effectiveness across organizational contexts. Studies repeatedly show that even exceptionally high-quality internal audit functions may have a severely limited impact if management fails to implement recommendations or systematically address identified control weaknesses, highlighting the importance of organizational culture and management commitment in determining audit effectiveness.

In the Kenyan context, the Capital Markets Authority has consistently emphasized the critical importance of robust internal audit functions for listed companies, particularly through the comprehensive 2015 CMA Code of Corporate Governance Practices for Issuers of Securities to the Public. However, empirical evidence on the actual effectiveness of internal audit functions in Kenyan listed companies remains limited, leaving significant gaps in understanding governance effectiveness in this important emerging market. Existing studies in Kenya have focused primarily on implementation challenges rather than systematically examining the relationship between internal audit functions and financial reporting outcomes or scandal prevention. Research gaps remain regarding how the quality of the internal audit function specifically relates to financial reporting scandals among NSE-listed companies, particularly given the continued occurrence of high-profile financial irregularities in the Kenyan market, which suggest potential weaknesses in current governance mechanisms. The study adopted a comprehensive explanatory

research design to systematically examine the causal relationship between the quality of the internal audit function and financial reporting scandals among listed companies. This design is particularly appropriate for testing hypothesized relationships between variables and for developing a deeper understanding of the mechanisms through which internal audit functions influence financial reporting outcomes in organizational settings. The research employed a pragmatic philosophical approach, recognizing that internal audit effectiveness can be objectively measured through quantitative indicators while acknowledging that organizational contexts and cultural factors may significantly influence how internal audit functions operate in practice across different corporate environments.

The target population comprised all 62 companies listed on the Nairobi Securities Exchange as of August 2024, distributed across 13 sectors, including manufacturing, financial services, telecommunications, and agriculture. The study employed a comprehensive census approach to eliminate sampling bias and ensure complete representation across all sectors and company sizes. Within each company, purposive sampling selected respondents based on specific expertise and direct involvement in internal audit functions and financial reporting processes. Target respondents included internal auditors as primary respondents, accountants and finance officers involved in financial reporting processes, and company secretaries with crucial oversight and governance roles. Data was systematically collected through carefully structured questionnaires administered between October 2024 and February 2025, ensuring sufficient time for comprehensive responses from busy professionals. The questionnaire was meticulously developed based on established literature and international best practices, including specific sections measuring Internal Audit Function Quality through 14 comprehensive indicators covering independence, competence, scope of work, management support, and professional qualifications, all measured on a

validated 5-point Likert scale. Additionally, Financial Reporting Practices were assessed using 15 detailed indicators that evaluated various aspects of financial reporting quality and potential irregularities, also measured on a comprehensive 5-point Likert scale. The study used SPSS version 27.0 for comprehensive statistical analysis, including descriptive statistics to summarize respondent characteristics and variable distributions, reliability analysis using Cronbach's alpha to assess measurement consistency, correlation analysis using Pearson's correlation coefficient to examine relationships between variables, and bivariate regression analysis to systematically examine the relationship between internal audit function quality and financial reporting practices.

### **3.0 Results and Discussion**

The study achieved an excellent 83.3% response rate, with 155 completed questionnaires out of 186 distributed, demonstrating strong engagement from the target population. Respondent distribution provided comprehensive representation across key organizational roles: accountants (56.8%), internal auditors (15.5%), finance officers (12.9%), company secretaries (8.4%), and other professionals (6.5%), ensuring diverse perspectives from individuals directly involved in internal audit functions and financial reporting processes. The demographic profile revealed exceptionally high professional competence and extensive relevant experience. Notably, 69.7% held a prestigious Certified Public Accountant (CPA) designation, while 89% held at least a bachelor's degree, indicating strong educational foundations in accounting and finance. Furthermore, 62.6% had held their current positions for over four years, demonstrating substantial practical experience in internal audit functions and financial reporting processes that significantly enhanced the reliability and validity of their expert responses.

The study's measurement instruments demonstrated excellent reliability and validity for both primary constructs. Reliability analysis

revealed strong internal consistency for Internal Audit Function Quality, with an impressive Cronbach's alpha of 0.868, substantially exceeding the conventional 0.7 threshold for acceptable reliability in social science research. Financial Reporting Practices also demonstrated acceptable reliability, with a solid Cronbach's alpha of 0.733, confirming consistent measurement across respondents and organizational contexts. Validity assessments provided strong support for the data's appropriateness for statistical analysis. The Kaiser-Meyer-Olkin measures were 0.851 for Internal Audit Function Quality and 0.545 for Financial Reporting Practices, with the former substantially exceeding the preferred 0.8 threshold and the latter meeting the minimum 0.5 threshold for factor analysis. Additionally, Bartlett's Test of Sphericity was highly significant for both variables, confirming that the correlation matrices were suitable for factor analysis and that the data met the statistical assumptions for the planned analytical procedures.

The comprehensive assessment of internal audit function quality revealed varying effectiveness across critical dimensions, with mean scores ranging from 2.80 to 4.54 on the 5-point Likert scale, indicating significant variation in implementation quality. The strongest performance was consistently observed in mandated responsibilities, suggesting organizations have successfully established formal frameworks that meet basic regulatory requirements. Compliance with laws and regulations scored highest at 4.54, followed by assessments of management policies and procedures at 4.50, internal control systems at 4.32, and operational review authority at 4.30. However, critical concerns emerged that could limit the effectiveness of the internal audit in achieving governance objectives. Management's responsiveness to audit reports scored only 3.79, indicating moderate but inconsistent support for audit findings. Implementation of control improvement recommendations scored 3.83, while professional certification requirements

scored 3.67, suggesting significant gaps in professional development and qualification standards. Most concerning was separation from bookkeeping duties at 2.80, though this low score actually indicates positive practice, as separation of operational duties is essential for maintaining audit independence.

The detailed assessment of financial reporting practices revealed both significant organizational strengths and notable vulnerabilities, with mean scores ranging from 3.07 to 4.63 across critical dimensions. The strongest areas showed excellent adherence to fundamental accounting principles and documentation standards. Documentation support for payments achieved the highest score of 4.63, indicating robust transaction support across organizations. Consistent depreciation methodologies scored 4.20, while proper inventory valuation achieved 4.04, suggesting strong technical compliance with accounting standards. However, serious concerns emerged, suggesting potential earnings management practices among some organizations, indicating vulnerability to financial reporting scandals. Profit adjustments to meet targets scored only 3.07, suggesting that some companies may systematically manipulate earnings to achieve predetermined financial targets. Financial statement restatements scored 3.15, suggesting relatively frequent revisions to previously reported financial information that could indicate poor initial reporting quality or potential manipulation.

The correlation analysis provided crucial empirical evidence of the relationship between internal audit function quality and financial reporting practices across the sample organizations. The analysis revealed a moderate positive relationship between Internal Audit Function Quality and Financial Reporting Practices, with a correlation coefficient of  $r = 0.556$ , statistically significant at  $p < 0.001$ , providing strong evidence that the relationship is not due to chance. According to established guidelines for interpreting correlation strength,

this represents a moderate positive relationship, indicating that systematic improvements in internal audit function quality are consistently associated with better financial reporting practices across the sample organizations.

The comprehensive bivariate regression analysis between Internal Audit Function Quality and Financial Reporting Practices yielded statistically significant and practically meaningful results, supporting the study's hypotheses. The model summary revealed a correlation coefficient of 0.556, a coefficient of determination of 0.309, and an adjusted  $R^2$  of 0.304, indicating that internal audit function quality explains approximately 30.9% of the variance in financial reporting practices, representing a substantial relationship in organizational governance research contexts. The resulting regression model was expressed as:  $FRP = 2.088 + 0.420(IAF) + \varepsilon$ . This equation indicates that a one-unit increase in internal audit function quality is associated with a 0.420-unit increase in financial reporting practices quality, holding all other factors constant, demonstrating the practical significance of investing in internal audit function quality for organizations seeking to enhance their financial reporting integrity and reduce the risk of financial reporting scandals. The findings demonstrate a significant positive relationship between internal audit function quality and financial reporting practices among NSE-listed companies in Kenya, providing strong empirical support for theoretical expectations derived from agency theory and fraud prevention theories. This result confirms that effective internal audit functions serve as important monitoring mechanisms in corporate governance and can meaningfully help prevent financial reporting scandals. The study revealed that NSE-listed companies generally perform well in establishing formal mandates for internal audit functions, particularly in compliance assessment and policy evaluation, suggesting strong regulatory compliance. However, significant implementation gaps were identified, particularly in management's responsiveness to audit reports and the implementation of recommendations, suggesting

that even when internal auditors identify issues, management may not consistently respond effectively, limiting the practical impact of audit work.

#### **4.0 Conclusions**

This comprehensive study provides compelling empirical evidence that the quality of the internal audit function significantly influences financial reporting practices among NSE-listed companies in Kenya. The moderate positive relationship shows that effective internal audit functions are important mechanisms for enhancing financial reporting integrity and reducing the likelihood of financial reporting scandals when properly implemented and supported. However, internal audit effectiveness depends critically on factors beyond formal establishment, including sustained management responsiveness, the professional competence of audit staff, and comprehensive organizational support for audit activities. The findings contribute significantly to agency theory by demonstrating that internal audit functions serve as effective monitoring mechanisms that reduce information asymmetry between management and shareholders. The study supports the theoretical proposition that independent oversight functions enhance the reliability of financial reporting by providing objective assessments of internal controls and compliance with established procedures.

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#### **5.0 Recommendations**

For organizations, the study recommends strengthening management support through formal mechanisms for responding to internal audit findings, enhancing professional development through investment in certification and continuous development, strengthening independence structures through direct reporting lines to audit committees, and ensuring adequate resource allocation for internal audit functions. For regulators, the study suggests strengthening requirements for internal audit function qualifications and independence structures while shifting the focus from compliance with formal requirements to assessing substantive effectiveness. For professional bodies, the research recommends developing industry-specific standards for the quality of the internal audit function and enhancing training programs that address both technical competence and soft skills. The study acknowledges limitations, including its cross-sectional design, focus on listed companies, potential response bias in self-reported data, and the lack of an examination of specific mechanisms through which internal audit functions influence financial reporting. Future research should employ longitudinal designs, explore mediating mechanisms, examine contextual factors, conduct comparative studies, and focus on implementation research to identify best practices for emerging market contexts.

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