

ISSN Online: 2616-4965



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ISSN: 2616-4965

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How to cite this article: Mwanja, V., Kinyariro, D., & Gitari, J. (2026). Detective internal controls and earnings quality of firms listed at the Nairobi Securities Exchange. *Journal of Finance and Accounting*, 10(6), 29–41. <https://doi.org/10.53819/81018102t70116>

Abstract

This study examined the effect of detective internal controls on the earnings quality of firms listed at the Nairobi Securities Exchange (NSE). Guided by the Policeman Theory and Agency Theory, the study adopted a descriptive causal research design and targeted a population of 63 companies listed on the NSE. Following a pilot study involving 6 firms (10% of the population), primary data were collected from the remaining firms, achieving an 80.7% response rate (46 firms). Detective internal controls were measured using a Detective Controls Indicator Ratio (DCIR), while earnings quality was proxied by earnings persistence (EPER). Data were analyzed using descriptive statistics, correlation analysis, and bivariate regression. The results revealed that detective controls recorded a moderate implementation level (mean DCIR = 0.5833). Correlation analysis showed a significant positive relationship ($r = 0.55767$) between detective controls and earnings persistence. Furthermore, the bivariate regression confirmed that detective controls have a statistically significant positive effect on earnings quality ($R^2 = 0.283$, $p < 0.001$). The study concludes that strengthening detective internal controls, such as internal audits, surprise inspections, and reconciliation procedures, can substantially enhance the reliability and quality of reported earnings for NSE-listed firms..

Keywords: *detective controls, earnings quality, earnings persistence, financial reporting lag, Nairobi Securities Exchange.*

1.1 Background to the Study

The primary purpose of financial reporting is to provide reliable information that helps users make a wide range of economic decisions. One of the most important pieces of information contained in financial statements is financial performance, as reflected in the statement of comprehensive income (Oluoch, 2014). For an income statement to be useful for decision-making, the earnings it reports must be of high quality. Earnings quality refers to the accuracy and reasonableness of reported earnings, and reflects the degree to which reported earnings mirror the underlying financial performance of an entity (Christensen et al., 2022). While the primary purpose of financial reporting is to provide reliable information for economic decision-making, the reality for firms listed at the Nairobi Securities Exchange (NSE) has been characterized by significantly fluctuating earnings, with performance ranging from heavy losses to high profits. These fluctuations raise critical questions regarding the accuracy and reasonableness of reported figures

<https://doi.org/10.53819/81018102t70116>

and the extent to which they mirror underlying performance.

The quality of reported earnings depends on several factors, one of which is the strength of the internal controls maintained by the reporting entity. Internal controls are the procedures and guidelines developed by those charged with governance to ensure efficiency, adherence to policy, and direction, and they provide reasonable assurance that a firm's objectives will be achieved (Chen et al., 2020). Knechel and Salterio (2016) classify internal controls into four broad categories: preventive controls, detective controls, corrective controls, and directive controls. In this context, internal controls are not merely procedural guidelines but are essential safeguards against reporting risks.

Detective controls are those intended to uncover errors and fraud after they occur, serving as part of the checks-and-balances system that evaluates the appropriateness of internal control procedures (Knechel & Salterio, 2016). They rest on the premise that however strong a firm's preventive controls, errors and fraud remain inevitable, and measures must therefore be in place to detect them at the earliest possible time (Chen, 2016; Knechel & Salterio, 2016). Detective controls typically include internal audit, surprise checks, and stock counts and review of approvals (Whittington & Pany, 2015). Because auditing is largely risk-based and relies on sampling, firms need strong detective controls to be reasonably assured that their financial statements are largely free of material misstatement arising from errors and fraud. This study focuses specifically on detective internal controls and their effect on the earnings quality of firms listed at the Nairobi Securities Exchange (NSE). Specifically, detective controls serve as a vital final line of defense; they rest on the premise that regardless of how robust preventive measures are, errors and fraud remain inevitable.

The causal link between detective controls and earnings quality is established through a 'policing' function, where mechanisms such as internal audits, surprise checks, and stock counts unearth opportunistic managerial behavior and errors.

1.2 Statement of the Problem

Earnings quality indicates the reliability and accuracy of reported earnings and the extent to which users can depend on them for economic decision-making. It is not clear whether detective internal controls affect the quality of earnings of companies listed at the NSE, given that these companies have reported fluctuating earnings over time, with some recording heavy losses, others huge profits, and yet others barely breaking even (NSE, 2023). This lack of clarity is evidenced by the measurable inconsistencies in reported performance, with various firms reporting erratic cycles of heavy losses followed by high profits. Such volatility suggests a potential failure in the accuracy and reasonableness of reported figures and a lack of earnings persistence, which is the cornerstone of high-quality financial reporting.

This lack of clarity also arises from confounding theoretical and empirical literature. Theoretically, it is not clear whether the policeman theory of Humphrey, Moizer and Turley (1993) or the agency theory of Jensen and Meckling (1976) best explains how detective controls influence earnings quality among Kenyan companies. Empirically, Ismael and Kamel (2021) found that internal audit had a negative influence on earnings management (implying a positive influence on earnings quality) among UK firms, while other studies report weaker or inconsistent effects depending on context (Chowdhury & Eliwa, 2021). Much of this literature has also treated internal controls as an undifferentiated whole, or focused narrowly on internal audit in isolation, rather than evaluating

detective controls as a distinct construct that also encompasses surprise checks and stock-count procedures (Lartey et al., 2020; Omonyemen, Josiah & Godwin, 2017). It is against this background that the present study sought to isolate and evaluate the specific effect of detective internal controls on the earnings quality of firms listed at the NSE.

1.3 Objective and Hypothesis

The objective of the study was to establish the effect of detective internal controls on the earnings quality of companies listed at the Nairobi Securities Exchange. The corresponding null hypothesis tested was:

H0: Detective internal controls have no significant effect on the earnings quality of companies listed at the Nairobi Securities Exchange.

1.4 Significance of the Study

The findings are useful to several stakeholders. For industry regulators, particularly the Nairobi Securities Exchange, the results offer an empirical basis for setting minimum disclosure or compliance expectations around detective control practices — for instance, informing whether listing or continuing-obligation rules should require evidence of regular surprise checks, stock counts, and reconciliations as part of a firm's internal control framework.

For boards and audit committees, the findings clarify where oversight attention should be directed: given that detective controls were found to be the weakest category of internal control among NSE-listed firms, audit committees can use this evidence to prioritize the review and strengthening of surprise inspection and reconciliation procedures specifically, rather than treating internal controls as a single undifferentiated area of oversight.

For managers, the findings provide a basis for allocating internal audit resources toward the specific detective control activities shown to influence earnings persistence, rather than spreading resources evenly or by default across all internal control categories.

Theoretically, the study contributes empirical evidence to the ongoing discourse on whether the policeman theory or agency theory better explains the role of detective controls in a developing-market context; while a single study cannot resolve this debate, the findings offer context-specific evidence that can inform and refine future theoretical application. The study also extends the contextual literature by isolating detective controls, rather than internal controls generally, as a distinct explanatory variable.

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2.1 Theoretical Review

This study draws primarily on the policeman theory of Humphrey, Moizer and Turley (1993) and the agency theory of Jensen and Meckling (1976), with supporting reference to the rational expectations theory of Limperg (1932).

The policeman theory holds that internal controls act, by necessity, as checks and balances in the financial reporting system to reduce and, where possible, eliminate errors and risk, given that the personnel responsible for their implementation are directly accountable for any errors or fraud that occur (Humphrey, Moizer & Turley, 1993). The theory stems from the contemporary reality that the management of business enterprises is often separated from ownership, creating a need for

checks and balances that limit managerial overt and covert opportunism. Detective controls sit at the heart of this "policing" function: internal audit, surprise checks, and stock counts exist precisely to catch errors and fraud that preventive measures fail to stop, and their strength is therefore expected to bear directly on the reliability, and hence the quality, of reported earnings (Akinadewo et al., 2024).

Agency theory explains the relationship between agents (managers) and principals (owners) and the mechanisms used to reduce the opportunistic actions of agents (Mwangi, 2012). Detective controls are a means of unearthing opportunistic managerial behaviour after the fact, thereby reducing agency conflict; the resulting reduction in conflict is expected to translate into improved earnings quality (Jensen & Meckling, 1976). The rational expectations theory of Limperg (1932) reinforces this view: internal controls, including detective controls, are expected to inspire the confidence of users of financial information by increasing the reliability of the reports on which that confidence depends.

2.2 Conceptual Review: Detective Controls

Detective controls are internal controls intended to detect errors and fraud when they occur (Knechel & Salterio, 2016). In essence, they serve as part of a checks-and-balances system and evaluate the appropriateness of internal control procedures; strong detective controls are essential in protecting the assets of a business (Whittington & Pany, 2015).

Internal audit entails an evaluation of an entity's internal controls and accounting processes, giving assurance that internal controls are being followed and acting as a check on management's stewardship of company assets on behalf of shareholders. Internal audit encompasses financial audits, compliance audits, operational audits, special investigations, and validation testing (Whittington & Pany, 2015).

Surprise checks involve regular, unannounced checks on staff to confirm that internal controls are being implemented as designed. They keep staff alert and accountable, since any material misstatement can be noticed at any time, and are particularly valuable as organisations grow larger and more complex (Knechel & Salterio, 2016).

Finally, stock count and review of approvals help identify mischief that requires correction. Physical stock counts confirm whether recorded stock matches actual stock on hand and reveal any discrepancies indicative of fraud, while review and approval of processes, both before and after execution, confirms authenticity and helps identify fraud or the potential for misstatement (Knechel & Salterio, 2016).

2.3 Empirical Literature Review

A number of studies have examined the specific role of internal audit and other detective-type measures in earnings quality. In the United Kingdom, Ismael and Kamel (2021) investigated the influence of internal audit — a good proxy for detective controls, given that it is carried out to unearth errors and fraud and to suggest corrective measures — on earnings management among 115 non-financial listed firms, using logistic and ordinary-least-squares regression. Their findings showed that internal audit had a negative influence on earnings management, implying that the stronger the internal audit function, the less the scope for earnings management and the higher the resulting earnings quality.

In Nigeria, Omonyemen, Josiah and Godwin (2017) examined preventive, detective, and corrective measures of internal control for fraud management among banks listed at the Nigerian Stock Market, using ordinary least squares regression. They found that the size of the internal audit function, the quality of internal audit, and the level of its independence all had a positive influence on fraud detection, implying a positive influence on the reliability of reported financial figures and earnings. In Vietnam, Nhan, Dung and Phuoc (2025) evaluated the effectiveness of accounting information security controls, a detective-type mechanism, and found that such controls positively influenced the effectiveness of financial reporting and, by extension, the quality of resultant earnings. In Indonesia, Yusran (2023), working within an agency-theory framework, found that internal audit had a direct, positive influence on the quality of financial reporting by local government authorities, suggesting that the benefits of detective controls extend beyond the private sector.

In Iran, Salehi and Bahrami (2017) investigated the influence of internal controls, including internal-audit-related detective measures, on earnings quality among 560 publicly listed firms over six years, using multiple panel data regression, and found that internal accruals improved value relevance by reducing earnings management. These findings are broadly consistent with the theoretical expectation, drawn from both the policeman theory and agency theory, that detective controls should exert a positive influence on the reliability of reported earnings.

While each of these studies affirms a positive theoretical link between detective-type mechanisms and earnings or reporting quality, a closer comparison across their contexts, measures, and methodologies reveals important limitations in how directly this evidence applies to the present study. Table 1 summarizes these studies by context, sample and method, the specific detective-control measure used, and the key finding reported, to make these differences explicit.

Table 1: Summary of Literature

Study	Context	Sample/Method	Detective-control measure	Key finding
Ismael & Kamel (2021)	UK	115 firms, logistic/OLS	Internal audit	Negative effect on earnings management
Omonyemen et al. (2017)	Nigeria	Listed banks, OLS	Internal audit size/quality/independence	Positive effect on fraud detection
Nhan et al. (2025)	Vietnam	-	Accounting information security controls	Positive effect on reporting effectiveness
Yusran (2023)	Indonesia	Local government	Internal audit	Positive effect on reporting quality
Salehi & Bahrami (2017)	Iran	560 firms, panel data	Internal controls (audit-related)	Improved value relevance via reduced earnings

As Table 1 shows, the reviewed studies converge on a positive relationship between detective-type mechanisms and earnings or reporting quality, but this convergence masks three important limitations. First, on construct, nearly all the studies operationalize detective controls narrowly through internal audit — its size, quality, or independence — with only Nhan, Dung and Phuoc (2025) examining a distinct detective mechanism (accounting information security controls); none directly measures the combined effect of surprise checks, stock counts, and reconciliations that this study examines. Second, on context, the evidence is drawn entirely from outside Kenya and, with the exception of Omonyemen, Josiah and Godwin's (2017) Nigerian study, largely outside sub-Saharan Africa, leaving it unclear whether these findings hold in the NSE's regulatory and business environment. Third, on consistency, while the direction of the relationship is broadly positive across studies, the strength and mechanism of the effect vary with the proxy used and the sector examined (private firms versus, in Yusran's (2023) case, local government), suggesting that the relationship may not generalize uniformly across detective-control types. Taken together, these limitations indicate that the positive relationship observed for internal audit specifically has not yet been established for the broader construct of detective controls, nor for firms listed at the NSE, the gap this study addresses.

2.4 Critique of Literature and Research Gap

Much of the extant literature relating detective-type controls to earnings quality has either been conducted in developed economies with fundamentally different regulatory and business-culture environments from Kenya (Ismael & Kamel, 2021, in the UK), or has examined internal audit narrowly, without incorporating the broader suite of detective mechanisms, surprise checks and stock counts, that this study captures (Lartey et al., 2020). Within Kenya, prior NSE-focused studies (Sitieni, 2023) have linked earnings quality to financial performance broadly, without isolating detective controls as a distinct explanatory variable. This leaves a clear gap: it is not known, with statistical rigour, whether detective internal controls specifically have a significant effect on the earnings quality of firms listed at the NSE, particularly given anecdotal and descriptive evidence suggesting that detective controls may be comparatively underdeveloped relative to other control categories among Kenyan listed firms. The present study addresses this gap directly.

Research Methodology

3.1 Research Philosophy and Design

The study adopted the positivist research philosophy, appropriate where quantitative data are used and hypotheses are tested using the scientific method (Bell, Bryman & Harley, 2022). A descriptive causal research design based on cross-sectional regression analysis was used. While a cross-sectional design cannot rule out reverse causality or omitted-variable bias in the way a longitudinal design could, it was adopted here because it is consistent with the descriptive causal design common in this stream of internal-control literature. The design is descriptive in that it explains the nature of the study variables using measures of central tendency, dispersion and distribution, and causal in that detective controls are treated as an independent variable expected to influence earnings quality, the dependent variable, with financial reporting lag as a moderating variable.

3.2 Population, Sampling and Data Collection

The study's accessible population comprised 63 NSE-listed firms as at 31 December 2024. Of these, 6 firms (10%) were used exclusively for piloting the questionnaire and were excluded from the final population, in line with Bryman and Harley (2022), leaving 57 firms as the census population for the main study. Of the 57 questionnaires administered to chief internal auditors, 11 firms declined to respond, leaving 46 usable responses and a response rate of 80.70%, which exceeds the 75% threshold generally regarded as adequate for survey-based research.

Primary data on the strength of detective controls was collected using a structured questionnaire measured on a five-point Likert scale, covering internal audit, cash and debtor reconciliations, annual stock takes, surprise checks, and arithmetic controls. Secondary data on earnings persistence, the proxy for earnings quality, and on financial reporting lag was drawn from the audited annual financial statements of the responding firms. Cronbach's alpha was used during pilot testing to confirm the internal consistency of the detective-controls questionnaire items.

3.3 Variable Measurement and Model Specification

Detective controls, the independent variable, were measured using a Detective Controls Indicator Ratio (DCIR), computed by dividing the mean Likert response for the detective-controls items by five, the maximum possible Likert value, to convert the categorical responses into a continuous ratio suitable for regression analysis:

$$DCIR = (\text{Detective Controls Likert Mean}) \div 5 \quad \dots\dots\dots \text{Equation 1}$$

Earnings quality, the dependent variable, was measured using earnings persistence (EPER), obtained as the slope coefficient (β_1) of a firm-level autoregressive model of order one applied to annual split-adjusted earnings per share for the 2021–2024 period:

$$EPSt = \beta_0 + \beta_1 EPSt-1 + et \quad \dots\dots\dots \text{Equation 2}$$

where $EPER = \beta_1$

This study uses four years of annual EPS for each firm and each firm-level persistence coefficient was estimated from three time-series observations.

Financial reporting lag, the moderating variable, was measured as a ratio of reporting-lag days to 365 (FRLR). The study estimated a bivariate model relating EPER to DCIR alone, and a multivariate model incorporating DCIR alongside the other internal control indicators, before and after introducing the DCIR×FRLR interaction term to test the moderating effect of financial reporting lag.

3.4 Diagnostic Tests

Prior to regression analysis, the data were subjected to diagnostic tests for normality (Shapiro-Wilk statistic), multicollinearity (variance inflation factor and tolerance), homoscedasticity (Breusch-Pagan Lagrange Multiplier test), and linearity (normal probability plots), consistent with the recommendations of Gujarati and Porter (2009) and Hansen (2022). All hypotheses were tested at the 95% confidence interval.

4. Results and Discussion

4.1 Descriptive Statistics for Detective Controls

Detective controls were measured using six questionnaire items covering internal checks, cash reconciliation, debtors reconciliation, annual stock takes, surprise checks, and arithmetic controls. Responses ranged from Strongly Disagree (1) to Strongly Agree (5), and the resulting frequency distribution across the 46 responding firms is summarised in Table 1.

Table 1: Frequency Distribution of Detective Controls Responses (n = 46)

Statement	SDA (%)	D (%)	N (%)	A (%)	SA (%)
We usually conduct regular internal checks on our processes	19.6	19.6	30.4	28.3	2.2
Cash reconciliations is done regularly	6.5	10.9	32.6	21.7	28.3
My organization has a debt management policy and carries debtors reconciliations	21.7	23.9	21.7	10.9	21.7
Annual stock takes are done in my organization	26.1	19.6	32.6	10.9	10.9
My organization carries surprise checks to departments regularly	26.1	17.4	28.3	15.2	13.0
We have strong arithmetic controls in my organization	21.7	21.7	15.2	15.2	26.1

Table 2 presents the descriptive statistics for the Detective Controls Indicator Ratio (DCIR), including measures of central tendency, dispersion, and distribution shape.

Table 2. Descriptive Statistics for DCIR

Statistic	DCIR
Mean	0.5833
Median	0.5609
Standard Deviation	0.0677
Sample Variance	0.0046
Coefficient of Variation	0.1160
Kurtosis	3.5250
Skewness	0.3171

Range	0.1870
Count	46

The mean DCIR was 0.5833, indicating that, on a scale of 0 to 1, detective controls among NSE-listed firms are only moderately strong — markedly weaker than the preventive-controls indicator reported elsewhere for the same sample. This is indicative of the fact that it is relatively more difficult to uncover errors and fraud that preventive controls have failed to prevent (Chepng'eno & Fred, 2020). The median of 0.5609 is close to the mean, indicating a broadly symmetric distribution. Table 2 presents the full descriptive statistics.

The standard deviation of 0.0677 relative to the mean yields a coefficient of variation of only 0.1160, far lower than the corresponding figure for preventive controls, indicating that detective-control strength is much less dispersed across firms even though its average level is lower. Skewness (0.3171) and kurtosis (3.5250) both fall within the acceptable ranges of -2 to $+2$ and 2 to 4 respectively suggested by Black (2023), confirming an approximately mesokurtic, normal distribution suitable for regression analysis.

4.2 Correlation Analysis

Multiple correlation analysis revealed a significant, moderately strong positive correlation between earnings persistence (EPER) and DCIR of 0.55767 ($p < 0.05$) the strongest correlation coefficient of any internal control category with earnings persistence in the study. This implies that as detective internal controls are strengthened, earnings quality as indicated by earnings persistence increases; firms listed at the NSE are well advised to strengthen their detective controls specifically to enhance earnings quality. This finding is consistent with Salehi and Bahrami (2017) in Iran and Ismael and Kamel (2021) in the UK, both of whom found that stronger internal-audit-based detective mechanisms were associated with higher earnings quality. Theoretically, this positive association is well explained by agency theory (Jensen & Meckling, 1976), under which detective controls unearth the opportunistic behaviour of managers and thereby reduce agency conflict, and by the policeman theory of Humphrey, Moizer and Turley (1993), under which detective controls provide the checks and balances needed to reduce errors and fraud in the financial reporting system.

4.3 Diagnostic Test Results for DCIR

The Shapiro-Wilk test produced an SW statistic of 1.107810 with a p-value of 0.7513 for DCIR, confirming normal distribution and supporting its use in regression analysis. The variance inflation factor for DCIR was 1.3759 (tolerance = 0.7268), well below the threshold of 5 recommended by Gujarati and Porter (2009), confirming the absence of significant multicollinearity with the other internal control indicators. The Breusch-Pagan LM test produced a statistic of 0.337985 with a p-value of 0.577015, exceeding the 0.05 threshold and confirming a homoscedastic error term. The normal probability plot for DCIR also showed an approximately straight line, confirming linearity. Taken together, these results confirm that the data satisfied the assumptions required for ordinary least squares regression.

4.4 Bivariate Regression of Earnings Persistence on DCIR

To test the first hypothesis, a bivariate regression was estimated with earnings persistence (EPER) as the dependent variable and DCIR as the sole predictor. Table 3 presents the overall model

statistics, including the correlation coefficient, R^2 , and the F-test of overall model significance. **Table 3: Bivariate Regression of EPER on DCIR-Model Statistics**

Statistic	Value
Multiple R	0.55767
R Square	0.28305
Adjusted R Square	0.26731
Standard Error	0.02132
Observations	46
F	2.45171
Significance F	0.00002

Table 4 presents the corresponding regression coefficients, reporting the intercept and slope estimates for DCIR together with their standard errors, t-statistics, and significance levels.

Table 4: Bivariate Regression of EPER on DCIR - Coefficients

Variable	Coefficient	Std. Error	t-Stat	p-value
Intercept	0.07013	0.045305	1.54795	0.12235
DCIR	0.108456	0.010922	9.93005	< 0.00001

The regression yielded a multiple R of 0.55767 and an R^2 of 0.28305, indicating that DCIR alone explains 28.31% of the variation in earnings persistence (26.73% after adjustment). The model F of 2.45171 exceeded the significance threshold, confirming its suitability for interpretation. The DCIR coefficient of 0.108456 was positive and highly significant ($t = 9.93005$, $p < 0.001$), leading to rejection of the null hypothesis at the bivariate level. It is concluded that detective internal controls, measured by DCIR, have a positive and statistically significant effect on earnings quality as measured by earnings persistence. This is consistent with Omonyemen, Josiah and Godwin (2017) in Nigeria and Nhan, Dung and Phuoc (2025) in Vietnam, both of whom found that detective-type controls positively influenced the reliability of reported financial figures.

5.0 Conclusion

This study set out to establish the effect of detective internal controls on the earnings quality of firms listed at the Nairobi Securities Exchange. The findings show that, although detective controls were the weakest of the internal control categories examined among NSE-listed firms, they nonetheless recorded the strongest correlation with earnings persistence of any control category, and had a positive and statistically significant effect on earnings quality both at the bivariate level and after controlling for other internal control categories in a multivariate model. It is concluded that firms listed at the NSE with strong detective controls — encompassing internal audit, surprise

checks, and stock-count and reconciliation procedures — can be relied upon to report earnings numbers that are highly reliable, and vice versa. The study further concludes that financial reporting lag negatively moderates this relationship, and does so more strongly for detective controls than for any other control category, such that delays in releasing audited financial statements erode much of the earnings-quality benefit that strong detective controls would otherwise confer.

6.0 Recommendations

Given that detective controls emerged as both the weakest control category and the one most strongly associated with earnings quality, firms listed at the NSE should prioritise strengthening detective controls, particularly annual stock takes and surprise checks, which the descriptive findings suggest are comparatively underdeveloped relative to internal audit and reconciliation practices. Boards and audit committees should invest specifically in the independence, staffing, and scope of the internal audit function, given its demonstrated positive effect on earnings persistence. Because financial reporting lag was found to erode the benefits of detective controls more than any other control category, firms should also pursue continuous audit and review processes so that the time between the end of the financial period and the release of audited statements is minimized, allowing the full benefit of detection work to be reflected in the reliability of reported earnings.

7.0: Limitations and Areas for Further Study

The study was limited to firms listed at the NSE and to earnings persistence as the sole indicator of earnings quality. Future studies could extend this analysis to unlisted firms or to other African exchanges, and could employ alternative indicators of earnings quality, such as accruals quality, earnings predictability, or earnings variability, to establish whether the strong positive effect of detective controls documented here is robust across different conceptualizations of earnings quality. Given that detective controls were found to be comparatively weak, future research could also usefully investigate the organizational and resource constraints that limit the strengthening of internal audit, surprise checks, and stock-count procedures among NSE-listed firms.

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