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From Compliance to Responsiveness: Rethinking Internal Control Mechanisms in Nepal's Public Administration

Manju Kumari Jaisi[1*]

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[1]Office of the Prime Minister and Council of Ministers, Nepal
[*]Correspondent Author, Email: manju.jaisi@nepal.gov.np
ORCID: https://orcid.org/0009-0005-0300-9734

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ABSTRACT

Internal control systems are the key to responsive governance. In Nepal's public sector, these controls are merely compliance-based and focus on output, emphasizing procedural adherence and ex-post audit over substantive accountability and governance outcomes. Up to FY 2023/24, the annual financial irregularities exceed NPR 90 billion, and cumulative unsettled audit observations are over NPR 700 billion, where over 40% of capital expenditure is concentrated in the final month of the fiscal year. The study aims to explore the relationship between a compliance-oriented internal control system and administrative responsiveness. To institutionalize accountability within the public organization, the COSO framework is being used. Quantitative research design is used in this study, and data were obtained from published reports of different public institutions. The analysis is carried out by integrating quantitative analysis of an Internal Control Weakness Index (ICWI) with qualitative policy analysis. The ICWI is constructed from longitudinal data on financial arrears, Commission for the Investigation of Abuse of Authority (CIAA) cases, and capital expenditure absorption rates spanning fiscal years 2018/19 to 2023/24. The result shows that there is a significant positive correlation between ICWI and both arrears ($r = 0.666$) and CIAA cases ($r = 0.629$), and a significant negative correlation with capital expenditure ($r = -0.641$). Furthermore, Regression analysis indicates that the ICWI explains approximately 44.4% of the variance in total arrears ($R^2 = 0.444$). empirical analysis suggests that responsive control mechanism in public administration of Nepal is essential to promote fiscal sustainability and accountability throughout the government institution.

Keywords: Internal Control System; Responsive Public Administration; Financial Irregularities; COSO Framework; INTOSAI; Public Financial Management; Agency Theory

INTRODUCTION

Internal controls system is a major tool for quality public service. The aim of internal control system is to improve public value through quality government expenditure and institutionalizing the transparency and accountability in public administration (Hepworth, N. 2024). Mostly, the framework of internal control system is based on Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework. There are five components namely, control environment, risk identification, control measure, communication of information and monitoring and evaluation of the control measures. These five steps are in a continuous cycle, and these are implemented in each level of an organization from the central entity to the small operational unit.

According to Internal Control Guideline of Nepal, formulated by Financial Comptroller General Office in 2081, the central entity is responsible for making internal control of entities under their control. Even though there is clear guideline, many public institutions do not have proper internal control system within their organizations. These systems are treated as ritual and merely compliance oriented and non-performing bundles of papers. But public organizations are the protectors of the public funds and having liability of quality services to the people, that's why sound control mechanism are most important for responsive public administration (Liu, 2011). These controls work as a whole unit within the organizational structure, not in an isolated manner. Chodorowski (2013) explore that a shift has been seen in control mechanism of public institution from compliance oriented towards the risk focused, analytical and functional. In contrast, these measures are primarily, compliance-driven, intended to find out procedural compliance and ex-post audit rather than service delivery outcomes and risk management (Andrews, 2013; World Bank, 2018).

However, NPR 90 billion annual irregularities, the cumulative arrears reached nearly NPR 700 billion and more than 40% capital expenditure are in end month of the fiscal year (OAG,2024). notably, regulating arrear occupies approximately 65 percentage of the total arrears. Nepal has formulated internal control guideline, adopted the International Organization of Supreme Audit Institutions (INTOSAI) standards, Nepal Public Sector Accounting Standards and different laws and rule, procedures to enhance financial accountability and value for money. But increasing regulating arrears clearly shows there is gap in our control measures and its implementation mechanism.

Responsive internal control measures are anticipatory based on risk focused control activities and those control activities which is purely based on formal adherence of rule and regulation not on performance of organizations are unable to increase the quality of public services and creating value for money of public purse (Andrews, 2013). This gap between de jure adoption of frameworks and de facto governance performance is common in South Asian contexts and the pushing factors are institutional capacity constraints, political economy pressures, and informal behavioral norms interact to undermine formal control mechanisms (ADB, 2020).

The primary objective of this research is to explore the answers to the research questions; How do compliance-oriented internal control mechanisms affect administrative responsiveness in Nepal? And what reforms are required to improve their effectiveness? The study is based on secondary data from administrative annual reports, which may limit behavioral factors that influence administrative practices in practice. After analyzing the compliance responsive gap, the study provides the empirical evidence on failure of compliance-oriented control system in public administration and suggest the reform measures for responsive public administration.

LITERATURE REVIEW AND THEORETICAL FRAMEWORK

The evolution of internal control in public administration

From traditional public administration to today's network governance, creating value of public service is core ideas and there is always presence of some form of control mechanism in public sectors. Today many organizations either corporate or public, COSO Framework has been applied as the basis of their internal transparency and accountability tool. The five integrated components are introduced as an internal control system by COSO Framework in 1992, which is further revised in 2013 (Provasi & Riva, 2015). With its holistic approach, internal control system is aimed to risk management, governance, and fraud detection within the public organization. Public entities have their own role and responsibilities and to perform their roles there are some established rule and regulation, procedures, and chain of command. These institutional arrangements are known as control environment and these established norms don't always work properly. There are always risk of imperfections and fraud in process of service delivery.

Risk assessment is second step in this process, where risks are identified basically in operational level, reporting areas and compliance of rules and regulations. This is crucial and challenging part of internal control mechanism in the sense that proper diagnosis of underlying causes of the problem can be easily treated than ad hoc decisions. Sometimes shadow causes can mislead the original one for the problem. A sincerely identification of the deep-rooted cause of the problem and correct anticipation of the future risk can minimize the hassles of the organization in future and lead to proper planning.

According to COSO (2013), activities outlined by policies and procedures for the management to ensure right decision making to mitigate underlying risk in achievement of objectives are control activities. A paper written by Ahmad Zazili, et.al (2024) mentioned there are three key elements of control activities identified by Yahya et al. (2022): the development of technological controls to support internal control objectives, the execution of control activities, and the assurance of proper segregation of job responsibility, custody, and recordkeeping personnel. Additionally, Akinleye and Kolawole (2020) proposed four elements of control activities: the existence of an internal audit unit, the independence of this Unit, the generation of internal audit reports, and the subsequent review of these reports.

The information and communication are critical element of control measures. Improper information may hinder the progress or create the performance gap. Timely communication of control activities to the right authority is essential in sustainable control system. Finally, Monitoring assures the direction of the whole process and timely identify the challenges and weak sectors of the activities to meet the objectives of the organizations (Rae et al., 2017). These five components are assessed in operational level, reporting level and compliance level. Furthermore, Internationally, PEFA Framework and INTOSAI'S standards and guidelines are developed to enhance the performance of the internal control mechanism and these frameworks are also being adopted by the governments of Nepal.

However, there are different risk and challenges for the successfully implementation of control measures in regional public institutions of. The Asian Development Bank's (2020) comprehensive assessment of public financial management systems in the region explore persistent compliance gaps, weak enforcement, and limited institutional capacity to implement risk-based control approaches. Along with technological improvement, reform in organizational culture is essential for viable control system (Diamond, 2002).

Agency theory and internal control

The fundamental idea of this study is rooted in agency theory and clearly shows the behavioral dynamics between the agent and principal. Here, agents are the bureaucrats and public officials and principals are citizen and political authorities. Conflict of interest and information asymmetries are major issue behind the disrupted relationship between these two (Bianchi, 2010). Public organizations formulate their internal control system to align agent behavior with principal interest. Robust communication of information and modification of administrative culture with risk focused proactive analysis of situation and service-oriented attitude are primary step towards this interest alignment. According to Sunday (2026) the focus of traditional control mechanism is on procedural adherence, which is merely obeying the rules and regulations not the outcome and results of that activities. Which is characterized by status quo and rigid process ex-post audit and risk aversion culture. Just following the established norms without risk based proactive approach, sometimes leads nothing in outcome. In this situation officials may comply the rule but failing to achieve the organizational goal.

Following procedure in documentation but indirectly accomplishing personal motives is major problems in internal control system of Nepal. Heightening arrears and corruption cases can be taken as consequences of malicious behavior of agents. This study's primary focus is to explore the similar type of compliance-performance gap in the public organization of Nepal. In today's diversified administrative culture and environment, instead of this compliance-oriented control mechanism, the organizations must adopt the anticipatory and responsive internal control system. This means it should be proactive, risk-based audit, behavior modification, reporting clarity and must be based on international and national standards.

Practice of internal control system in Nepal's public administration

In Nepal, Financial accountability, and fiscal procedural act, 2019 and Regulations, 2020 is major laws about the internal control system in public organization. Each organization must have their control mechanism and internal control committee to monitor its functions. Internal control system formulation guidelines are prepared by Financial Comptroller General Office in 2081, this is foundation guidelines to formulate these measures in public organization of three level of government. Additionally, District Treasury Offices are liable to conduct trimester wise internal audit and external audit is conducted by Office of the Auditor General.

From Governments finance system coding to different forms of accounting and reporting, are implemented and reporting is done according to Nepal public sector accounting standards based on IPSAS.

Even though there is a dedicated team to carry out internal and external audits, regular ex-post audit, guidelines about the austerity measures, directives, and many other approaches are being implemented by public institutions. In contrast, there are annually increasing figures of arrears, fraud, cases of corruption, and the number of defaulters. Is the situation noticeable, whether we are going on the right path or not? Do we implement correct control measures in public entities or not? How can a compliance-oriented mechanism impact the performance of these institutions. And what are the ways forward? The answer would be a responsive internal control system instead of a traditional one.

Conceptual Framework of the Study

The core idea of this study is that a responsive internal control system leads to responsive public administration in comparison to traditional compliance-focused system. Responsive control measure is not only following rule and regulation, but it also includes anticipating the risk and timely introducing the preventive mechanism. The figure 1 clearly describes the conceptual framework of the study. It shows that, proposed control mechanism leads the responsive public administration. Which is results in stewardship and integrity culture, risk-based audit, and investigations, result based approached and real time monitoring of the services for quality public service delivery.

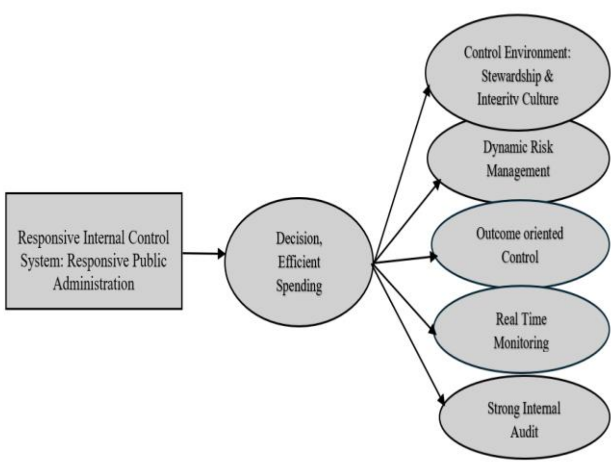

Figure 1: *Conceptual Framework*

METHODOLOGY

Research design

This study is descriptive and analytical in nature, and it adopts the descriptive quantitative research design with panel data analysis of six consecutive fiscal year of all seven provinces of Nepal to explore the performance of compliance-oriented control mechanism.

Data sources and the internal control weakness index

The longitudinal secondary data from fiscal year 2018/19 to 2023/24 are used in this study from different published governments reports. Three primary data series are utilized in this study:
(i) Amount of Total Arrears: It is derived from annual reports of OAG (54th to 62nd editions) across seven provinces.
(ii) Number of CIAA Cases: Annual data on corruption-related cases registered in CIAA, Nepal throughout the country.
(iii) Capital Expenditure Ratio: Annual capital expenditure ratio taken from ministry of finance.

Internal Control Weakness Index is developed as a composite measure from standardized values of three variables namely, total arrears, Number of CIAA cases and capital expenditure ratio to find out the relationship between these individual variables with Index. CIAA cases and Total Arrears were log-transformed prior to standardization then each of the three component variables (log-transformed arrears, log-transformed CIAA cases, and capital expenditure ratio) was converted to a z-score (mean = 0, standard deviation = 1), and the ICWI was computed as the equally weighted average of the three z-scores. The standardized capital expenditure variable was reverse signed before averaging, so that higher ICWI values reflects higher internal control weakness across all three components.

This index is developed to measure the traditional compliance-oriented internal control system. This index is developed to measure the traditional compliance oriented internal control system. Higher ICWI scores represents greater internal control weakness, as reflected in higher arrears, higher CIAA cases, and lower capital expenditure performance. Study use the panel data of seven provinces observed over six consecutive fiscal years (2018/19 to 2023/24), yielding 42 province-year observations. The ICWI is definitionally associated with the variables because it is constructed from the same three variables. The correlation and regression results reported in the results section should therefore be interpreted as descriptive associations rather than independent validation of internal control weakness.

Research hypothesis

Since the ICWI index is made of from three core PFM variables, this study only claims the associations of these variables with the ICWI through the following hypothesis:

H_0: There is no significant association between ICWI and selected variables.

H_1: There is significant association between ICWI and selected variables.

This paper examine association rather than causation, and the study does not control for potential confounding factors such as political cycles, the federal transition, the COVID-19 pandemic, or changes in overall budget size, which may also influence arrears, CIAA cases, and capital expenditure over the study period.

Methods of analysis

Q-Q plot analysis of ICWI is done to test the normality of data distribution. And bivariate relationships between ICWI and the three outcome variables is assessed through Pearson correlation analysis. Data are also analyzed by using simple linear regression and descriptive trend analysis. Qualitative policy analysis draws on the COSO framework to systematically assess gaps in Nepal's control environment, risk assessment, control activities, information systems, and monitoring practices.

Q-Q plot analysis of ICWI is done to test the normality of data distribution. The ICWI displayed a skewness value of 0.343 and a kurtosis value of 1.098, both within the acceptable range of ±1 to ±2, showing an approximately normal distribution appropriate for parametric analysis. Bivariate relationships between ICWI and the three outcome variables are assessed through Pearson correlation analysis. Qualitative policy analysis completed by using COSO framework to systematically assess gaps in Nepal's control environment, risk assessment, control activities, information systems, and monitoring practices.

RESULTS

Trend analysis of the internal control weakness index

The trend analysis of the ICWI shows the important structural dynamics in internal control performance of Nepal. It reveals a sharp decline from its peak in fiscal year 2018/19, to lowest at 2021/22, this could be due to the initial impact of federal restructuring and PFM reform strategy at subnational levels. But a notable resurgence of ICWI in 2022/23 and still high level in 2080/8, resonate the systemic weaknesses in internal control. Additionally, the wide dispersion of ICWI values (ranging from -1.45 to 1.72) also explain about the inconsistency of internal control performance within the observed fiscal years, which is clear indication about the absence of a stable and self-reinforcing control environment.

Correlation analysis

The correlation matrix explores a coherent and theoretically consistent pattern of relationships among the study variables. Table 1 presents that, the ICWI is strongly and positively associated with total arrears ($r = 0.666$, $p < 0.01$), confirming that higher levels of internal control weakness are systematically linked with higher financial irregularities. It is further verified by the positive association between ICWI and CIAA cases ($r = 0.629$, $p < 0.01$). Moreover, inverse relationship between ICWI and capital expenditure shows that greater index force to poor public expenditure. This proves the well-documented phenomenon of end-of-year spending rushes in Nepal. Which is manifested as poor planning, inadequate project supervision, and substandard infrastructure outcomes.

Table 1
Correlation Matrix of Key Study Variables

Variable	ICWI	Arrears	CIAA Cases	Capital Exp.
ICWI	1	0.666**	0.629**	-0.641**
Arrears	0.666**	1	0.600**	-0.620**
CIAA Cases	0.629**	0.600**	1	-0.580**
Capital Exp.	-0.641**	-0.620**	-0.580**	1

*** Significant at p < 0.01. Source: Annual Reports of OAG & CIAA, Nepal (FY 2018/19 to 2023/24)*

Hypothesis testing

Association hypothesis is tested to verify the assumptions of the study, where selected PFM indicators are significantly associated with the Internal Control Weakness Index (ICWI). Results of correlation show that ICWI has a strong and statistically significant positive association with total arrears ($r = 0.666$, $p < 0.01$) and CIAA cases ($r = 0.629$, $p < 0.01$), and a strong negative association with capital expenditure performance ($r = -0.641$, $p < 0.01$). These findings provide sufficient statistical evidence to reject the null hypothesis and accept the alternative hypothesis. But the study does not claim a direct causal relationship between the ICWI and variables.

COSO framework gap analysis

Based on the elements of COSO Framework, internal control system of Nepal shows the weak performance. This is closely associated with the study conducted by Bianchi (2010). From the control environment to monitoring, the institutional provisions are either lacking or inadequate. And this situation is further compounded by the behavioral and cultural phenomenon inside the organization. For example, the civil service act is major act in public administration and after adoption of federalism it should be reformulated but unfortunately, this act is heavily politicized and not formulated yet. Similarly, decisions are made in havoc and implementation is on limited capacity. The rules mania and risk aversion are deep rooted culture in overall public services of Nepal. The reporting part is critically undermined even there is guidelines of reporting. Not reporting, inadequate reporting which is compounded by poor coordination among the institutions. This qualitative analysis strongly verifies the quantitative results of the study.

DISCUSSION

The compliance-responsive gap

Empirical analysis of the study clearly outlines the gap between the existing control mechanism and responsive public administration. The strong positive association of ICWI with total arrear and CIAA cases shows that only obeying the rule and regulations without anticipating the risk areas and proactive approach to mitigate those risks are not the ideal control system in public services. Similar issues are raised by Andrew (2013) that just comply the procedure without having capacity, and positive attitude towards the service is ineffective. Even if officials follow the rules and process, quality of services and cases of frauds are not being controlled. However, it should be noted that the ICWI is constructed from the same variables it is correlated with, the association partly reflect the index's own definition; this circularity limits how strongly the findings can be read as independent evidence of a compliance-responsiveness gap, and the conclusions above should be understood with this qualification in mind.

In contrast, responsible public administration gives emphasis on proactive approach towards the problems, innovative ideas for public finance management and financial accountability and responsive administrative culture (Bianchi, 2010). For this reason, responsive control mechanism is essentials to reduce the heightening arrears, control the corruption and frauds and improve the public expenditure.

Structural drivers of internal control weakness

The statistical analysis points the number of structural drivers of failure of existing control system. The first one is increasing amount of arrears annually and among them regularizing arrear is almost 65 percentages of total. Thus, being a ritual framework doesn’t work properly unless until our behavior and capacity is increased. Secondly, high volume of public expenditure approximately at last month of the fiscal year, is another chronic systemic failure. This is primarily, side effects of faulty process and adherence to them. Similarly, increasing number of corruptions represents the conflict of interest and abuse of authority by public officials. These structural deviations are also explained by ADB and IMF in their annual and theme-based country reports.

After 2015, three tiers of governments are responsible to implement their annual budget and policy, but they still have inadequate capacity to formulate policy and lack of sufficient budget, human resources, and their pork barrel culture in policy decision. The partly variation of ICWI may reflect these scenarios.

Comparative perspective

Sigma (2018) highlight that the purpose of internal control is create the environment where organization goals are achieved without creating any abuse of authority. Similarly, in south Asian regions the similar approaches are being adopted. As outlined by ADB (2020), internal control system is mainly compliance focused and identical types of administrative and financial issues are pervasive in these countries. However, The World Bank's (2018) analysis of accountability reforms in public sectors globally explored the different criteria for the improvement. Among other, Political commitment to performance-based governance is critical importance with professional civil service systems. where merit is basis of employee posting to transfer, adequate capacity development, adequate legal framework.

Comparative analysis from other South Asian countries demonstrates that both the promise and hidden risk of such reforms. According to ADB (2025), in West Bengal of India, IT-based integrated public financial management information system linking budgeting, revenue administration, and debt management across departments and levels of government results in improved operational efficiency, transparency, and public service delivery, illustrating how a subnational government within a federal system can move toward more responsive financial management (Asian Development Bank, 2025).

In opposite to this, Indonesia's post-1998 shift from cash-based to accrual-based public sector accounting was hindered by inadequate staff accounting capacity and the continued parallel use of old-style reporting, producing a rise in qualified audit findings rather than improved accountability (McLeod & Harun, 2014). Based on these cases this study suggest that the success of internal control reform depends less on the formal adoption of new frameworks or systems and more on sustained investment in institutional capacity and coherent implementation, a lesson directly relevant to Nepal's own compliance-responsiveness gap.

Policy recommendations

Overall, the findings and analysis of the study suggest the following policy reform to institutionalize the responsive internal control system in public administration of Nepal:

- To promote the control environment, there must be adequate and necessary legal arrangement in different level of governments.
- For the risk assessment, the Financial General Comptroller General Office, should initiate the risk based internal audit system.
- The public organizations must initiate the capacity building training to the officials, so that they can proactively identifies the vulnerable areas within the organization.
- Each central entities must have well-functioning Internal Control Committee, regular meetings of the committee on reform agenda.
- Reorientation of existing mechanism towards responsive and accountable internal control system. This must be initiated by Financial Comptroller General Office.
- Risk based and theme based internal audits to mitigate the future problem of the organizations must be implemented.
- Real time monitoring through virtual, field visit to the project and programs.
- Performance based pay system in organizations.
- Strong commitment from political and bureaucratic leaders to motivate public officials to perform their best for assigned job.
- Clear and consistent information and communication mechanism with strong follow up system is essential to achieve the organizational goals.

CONCLUSION

This study analyzes the performance of internal control system in public administration of Nepal through both empirical analysis and qualitative policy assessment. The results show a wide gap between formal compliance and responsive governance.

Findings reveals that strong positive correlations of ICWI with arrears and corruption cases, combined with strongly adverse relationship with capital expenditure make clear that compliance-oriented internal control systems are insufficient to address challenges of public services of Nepal. And theoretical foundations based on the agency theory explain in details why existing systems are failed to institutionalize the responsive public administration.

The responsive internal control system is paradigm shift in control mechanism of public administration of Nepal. It ensures stewardship and integrity culture, dynamic risk management, outcome-oriented control, real time monitoring and risk-based audits. It also promotes allocation and implementation efficiency of annual budget and program of governments. To sustain these changes must be supported by sustained political commitment, professional capacity development, institutional strengthening, and active engagement of Nepal's audit institutions, parliamentary oversight bodies in holding government accountable for both procedural compliance and governance outcomes. The broader lesson of the study is that strengthening internal control must be understood as a transformation of administrative culture, and not solely adoption of framework. For Nepal, and for similar administrative contexts across South Asia, this reorientation of internal control from compliance instrument to governance enabler is essential for responsive public institutions.

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