

**EFFECTIVENESS OF INTERNAL AUDIT IN PREVENTING FRAUD IN  
MICROFINANCE COMPANIES**

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## CERTIFICATION OF AUTHORSHIP

I hereby corroborate that I have researched and submitted the final draft of dissertation entitled “**Effectiveness of Internal Audit in Preventing Fraud in Microfinance Companies.**” The work of this dissertation has not been submitted previously for the purpose of conferral of any degrees nor it has been proposed and presented as part of requirements for any other academic purposes.

The assistance and cooperation that I have received during this research work has been acknowledged. In addition, I declare that all information sources and literature used are cited in the reference section of the dissertation.

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## REPORT OF RESEARCH COMMITTEE

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## APPROVAL SHEET

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## ABBREVIATIONS

AP	:	Audit Planning and Execution
CEO	:	Chief Executive Officer
CFEs	:	Certified Fraud Examiners
CIA	:	Competence of Internal Auditor
ERP	:	Enterprise Resource Planning
FP	:	Fraud Prevention
IA	:	Internal Auditors
IFC	:	International Finance Corporation
MFI	:	Microfinance Institutions
NPR	:	Nepali Rupees
NRB	:	Nepal Rastra Bank
PLS	:	Partial Least Square
SC	:	Scope of Internal Audit
SEM	:	Structural Equation Modeling
SPSS	:	Statistical Package for the Social Sciences
TU	:	Tribhuvan University
UT	:	Use of Technology in Auditing

## ABSTRACT

This study examines how the internal audit function helps to prevent the fraud in Nepalese microfinance companies. As the microfinance expands, they face greater risk of fraud, making effective internal audit essential for protecting their operational task and the stakeholders. This study has used the descriptive and casual research design as the research methodology to explore and assess the effectiveness of internal audit in preventing fraud in MFIs. A total of 484 responses were collected from the respondents using questionnaire and analyzed through reliability, correlation, regression and ANOVA test. Fraud prevention have been considered as dependent variable and scope of internal audit, competence of internal auditor, independence of internal auditor, audit planning and execution and use of technology in auditing were used as independent variables.

The result shows that the audit planning and execution ( $p=0.022$ ) and use of technology in auditing ( $p=0.014$ ) significantly improve the fraud prevention whereas the competence of internal auditor ( $p=0.058$ ) has the positive but less significant effect. Scope of internal audit and independence of internal auditor were not significant due to organizational limitation or limitation in internal audit or internal control. The data were also tested for reliability using Cronbach's alpha which has confirmed the internal consistency of the survey data. Correlation analysis was employed to investigate relationships between internal audit components and fraud prevention. Further, regression and ANOVA ( $p$  value = 0.012) (less than 0.05) were conducted to evaluate the significance and impact of these factors on fraud prevention effectiveness.

This finding offers a practical recommendation to strengthen audit practices, emphasizing the continuous improvement and adaption of new and advanced technology. It also suggests the future research to explore the audit effectiveness of MFIs in different contexts. It also advances both academic knowledge and practical strategy to enhance financial governance and safeguard the credibility of MFIs.

**Keywords:** *Internal Audit, Fraud Prevention, Microfinance Companies, Audit Planning, Audit Technology, Auditor Competencies and Independence, Scope of Audit*

# CHAPTER - I

## INTRODUCTION

### 1.1. Background to the study

Internal audit plays a crucial role in ensuring transparency, accountability, and effective governance within organizations. An audit is a systematic and independent examination of financial statements with the objective of expressing an opinion on their accuracy and fairness. The term "audit" originates from the Latin word "Audire," meaning "to hear." Internal auditing, in particular, focuses on value creation by assessing and improving an organization's governance, risk management, and control processes. According to Mutti and Macagnan (2022), the quality of effectiveness of internal audit is linked with management legitimacy and institutional credibility which are also the factors essential for long term sustainability and fraud resilience.

Internal auditing is "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations by systematically evaluating risk management, control, and governance processes." Internal auditors are professionals employed within organizations to ensure that company functions and procedures operate effectively and efficiently (Institute of Internal Auditors, 2017). Zikmund (2020) emphasized that weak internal control systems may result in regulatory punishments, poor financial management and the failure of the organization in extreme condition, causing significant risks to the individuals that the microfinance provide the services. In order to ensure the long term organizational sustainability, the control mechanism should be more strong which will also protect the interest of all the stakeholder of Microfinance Companies.

The importance of internal audit has grown over time due to the increasing complexity of business operations, transactions, risks, and the extensive use of information technology (Ljubisavljević and Jovanović, 2011). Furthermore, internal audit enhances an organization's long-term success by monitoring key business indicators such as efficiency, risk exposure, waste reduction, profitability, and regulatory compliance. According to Yazid and Suryanto (2024), if the quality of audit is better, it will lead to less financial fraud and will increase the effectiveness of internal auditing in the organization.

A well-functioning internal audit system is vital for identifying business risks and implementing timely corrective actions. Many corporations have struggled to achieve financial stability due to weak governance structures, fraudulent activities, and financial scandals, as demonstrated in the infamous cases of Enron and Parmalat (Mikes and Kaplan, 2013). Bubilek, O. (2017) emphasized that internal audit serves as a critical support function for management, audit committees, and corporate stakeholders, ensuring financial and operational integrity. According to the data presented by NRB (2023), Microfinance sector faces the risk similar to past MFIs crises, 41% of the outstanding loan belonging to individual with multiple accounts and 20% of the borrowers holds loan from multiple institutions.

### **1.2.The Role of Internal Controls in Fraud Prevention**

Internal controls are fundamental to an organization's financial stability and integrity. These controls include systems and policies designed to ensure accurate financial reporting, employee accountability, and fraud prevention. Properly implemented internal controls help organizations comply with legal and regulatory requirements while safeguarding assets and minimizing risks. By ensuring accurate financial reporting and asset protection, internal controls enhance trust and stability within the business environment. Alzeban and Gwilliam (2021) emphasized that strong management team support helps to enhance the audit effectiveness.

Despite their importance, internal auditors often face challenges when investigating financial irregularities, particularly if management is involved in fraudulent activities. To maintain independence and objectivity, internal auditors should report directly to the audit committee rather than management (Baharud-din et al., 2014). Additionally, they should have unrestricted access to records and employees, as well as the freedom to apply appropriate audit procedures without interference. The effectiveness of an internal audit function is ultimately determined by the competence and autonomy of its auditors. Ziorklui et al. (2024) highlight that internal control mechanisms play a key role for detecting and preventing fraud by encouraging ethical conduct and ensuring transparency within organizations. Moreover, they argue that effective internal controls improve the accountability and build trust among stakeholders by enhancing overall organizational operations.

### **1.2.1 Relevance of Internal Audit in the Financial Sector**

Financial stability is critical for both shareholders and stakeholders, as it directly affects a company's ability to operate as a going concern and generate returns on investment. Commercial banks, for example, play a pivotal role in economic stability by facilitating the movement of capital from savers to borrowers. Internal audit provides independent assurance that an organization's risk management, governance, and internal control systems are functioning effectively. When properly executed, internal audits contribute to a company's financial performance and sustainability (Beyanga, 2011).

According to Agapova and McNulty (2016), a bank's financial performance is influenced by three main factors: (1) bank-specific factors, (2) industry-specific factors, and (3) macroeconomic factors. These factors differ from traditional financial performance indicators such as financial ratio analysis, return on assets, return on equity, and net interest margin. Gul et al. (2011) further identified key determinants of banking performance, including bank size, capital, loan portfolios, inflation, and interest rates. While banks can control internal factors through corporate governance measures, external economic conditions also play a significant role in shaping their financial outcomes (Alam et al., 2011).

Kenton (2021) defined financial performance as a broad measure of an organization's ability to generate revenue and sustain operations. Investors and stakeholders assess financial performance to gauge a company's overall health and management efficiency. By ensuring accurate financial reporting and adherence to governance standards, internal audit helps reinforce stakeholder confidence and corporate credibility.

### **1.2.2 The Case of Microfinance Institutions in Nepal**

In recent years, Nepalese microfinance institutions (MFIs) have experienced rapid expansion, accompanied by various operational and financial challenges. Although microfinance programs have been active for decades through projects such as the Agricultural Development Bank, the formal establishment of microfinance financial institutions began in 2049 B.S. with the inception of the Grameen Development Bank.

The number of microfinance institutions in Nepal grew from just two in 2049 B.S. to a peak of 91 in Mangsir 2076, before declining to 63 by Chaitra 2079. While the total number of institutions has decreased, branch networks and employment have expanded significantly. Between 2074 and 2078, the number of branches and employees increased by 28.3% and

24.8%, respectively. During the same period, microfinance lending surged by 37.4%, rising from NPR 107 billion to NPR 366 billion. By Chaitra 2079, Nepal's 63 microfinance institutions collectively operated 5,164 branches with 22,846 employees and had a total loan portfolio of NPR 441 billion.

Despite this growth, Nepalese MFIs face mounting pressures, including financial mismanagement, governance issues, and fraud risks. Given their crucial role in economic development—particularly in serving underprivileged communities—ensuring strong internal audit functions within MFIs is essential to safeguarding financial stability and preventing fraudulent activities.

Since 2078, global economic slowdowns, the gradual withdrawal of Nepal Rastra Bank's loose regulatory policies implemented to mitigate the effects of COVID-19, and the adoption of tighter monetary policies to address external sector pressures have exposed several weaknesses in microfinance institutions. For instance, the non-performing loan (NPL) ratio, which remained below 3% for a long time, surged to 7.43% by Chaitra 2079. Additionally, the return on capital declined to 5.2%, and the operational self-sufficiency ratio dropped to around 103. These deteriorating indicators suggest that microfinance institutions are under significant financial strain.

The pressure on microfinance institutions has been further exacerbated by both local and national developments. Nationally, issues such as high-interest informal lending (meter-banking), financial problems in cooperative institutions, comparisons between microfinance institutions and meter-banking, loan repayment resistance movements, and the politicization of these issues have placed significant stress on the sector. Despite their role in financial inclusion and poverty alleviation, microfinance institutions have faced increasing scrutiny and opposition.

Recognizing the critical role of microfinance institutions in providing financial access and improving the living standards of underserved populations, Nepal Rastra Bank (NRB) initially pursued a promotional policy approach. The central bank facilitated the expansion of microfinance institutions by easing regulatory barriers for branch openings, providing capital flexibility, and ensuring access to financial resources for disadvantaged groups.

However, in response to rapid expansion and emerging challenges, NRB has shifted its focus from promotion to enhanced supervision. To address the pressures facing the

microfinance sector, various regulatory measures have been introduced to stabilize and strengthen financial governance within these institutions.

The banking industry in Nepal is governed by Companies Act, Bank and Financial Institution Act, Banking Offence and Punishment Act and the various directive and guidelines issued by Nepal Rastra Bank (NRB). Commercial bank and financial institutions are the institutions which accept deposit, make business loans and offer related services. Bank and financial institutions are licensed and regulated by the central bank of their jurisdiction in which they operate. In Nepal, Nepal Rastra Bank (NRB) licenses, supervises and regulates bank and financial institutions. Currently as per the data issued by Bank Supervision Report, 2022/2023, Nepal Rastra Bank there are 20 Commercial Bank, 17 Development Bank, 17 Finance Companies, 57 Microfinance Financial Institutions and 1 Infrastructure Development Bank.

### **1.3. Problem Statement**

Microfinance institutions (MFIs) play a crucial role in economic development by providing financial services, including loans and credit facilities, to underserved populations. These institutions contribute to financial inclusion and poverty alleviation, supporting small businesses and individuals who lack access to traditional banking services. However, as MFIs expand their operations, they face increasing risks related to fraud, poor financial mismanagement, and weak governance structures.

Fraud remains a significant threat to the sustainability of microfinance institutions, as financial irregularities can lead to operational losses, reputational damage, and regulatory penalties. Weak internal controls and inadequate oversight mechanisms often create opportunities for fraudulent activities, such as misappropriation of funds, falsification of records, and unauthorized transactions. Given these challenges, a strong and effective internal audit function is crucial to detect, prevent, and mitigate fraud risks within MFIs.

According to Mullinger (2020), internal audit serves as a key component of an organization's internal control system, ensuring compliance with financial regulations, identifying weaknesses in risk management, and safeguarding assets. However, despite the implementation of internal audit functions, fraud cases continue to emerge in microfinance institutions, raising concerns about their effectiveness in detecting and preventing fraudulent activities. This brings into question the actual impact of internal audits on fraud prevention and overall financial performance in MFIs.

Microfinance institutions (MFIs) are vital in extending financial services to underserved populations in developing countries like Nepal. But they often struggle with internal fraud and weak financial oversight. The internal audit function, though essential for promoting accountability and minimizing fraud, often encounters limitations in practice. These include narrow audit coverage, insufficiently trained audit staff, and challenges to maintaining auditor independence. According to Asaolu et al. (2021), inadequate internal controls are a major contributor to fraud in MFIs, which can lead to serious financial and reputational setbacks. Likewise, Kabuye et al. (2021) emphasize that internal audits are less effective when auditors lack autonomy and necessary expertise to identify and confront fraudulent activities.

Although the importance of internal audits in larger financial institutions is well documented, there remains a significant gap in empirical research focused specifically on microfinance institutions in developing economies like Nepal (Nguyen & Tran, 2021). Therefore, it becomes essential to assess how different dimensions of internal audit—such as scope, competence, independence, audit planning, and use of technology—affect fraud prevention in Nepalese microfinance companies.

This study seeks to bridge this gap by evaluating the effectiveness of internal audit in preventing fraud in microfinance institutions. Unlike previous studies that focused on general risk management and corporate governance, this research will specifically analyze the internal audit function, its role in fraud detection and prevention, and its influence on the financial stability of microfinance companies.

#### **1.4. Research Questions**

To assess the effectiveness of internal audit in preventing fraud in microfinance companies, this study seeks to answer the following questions:

- What are the factors that affect internal audit in preventing fraud in Microfinance Companies?
- Is there any relationship of internal audit effectiveness with fraud prevention in Nepalese microfinance institutions?
- Do the internal audit effectiveness effect on fraud prevention in Microfinance Companies?

### **1.5. Objectives of the Study**

The aim of this study is to assess the effectiveness of internal audit in preventing fraud in microfinance companies in Nepal. Specifically, the study seeks to:

- To assess the factors that affect internal audit in preventing fraud in Microfinance Companies.
- To examine the relationship between internal audit effectiveness and fraud prevention in Nepalese microfinance institutions.
- To analyze the effect of internal audit effectiveness in fraud prevention in Microfinance Companies.

### **1.6. Rationale of the Study**

Microfinance institutions (MFIs) are growing quickly, and as their financial activities become more complex, the chances of fraud and financial mismanagement also increase. Effective internal audit systems are critical in detecting and preventing such issues, thereby safeguarding stakeholders' interests and enhancing institutional integrity (Mutti & Macagnan, 2022). However, in countries like Nepal, many MFIs face challenges such as limited resources and weak internal controls, making it harder for audits to be effective. This study aims to bridge the gap in existing literature by evaluating key factors influencing internal audit effectiveness within MFIs in Nepal. It also supports policymakers and practitioners in strengthening internal control systems (Saeed & Sameer, 2024). 2024). By doing this, the study hopes to support both researchers and those involved in managing MFIs, offering useful ideas to strengthen oversight and improve trust in these institutions. Furthermore, this study also highlights the future need for better risk management system in the microfinance sectors. With the increase in compliance by regulators and increasing financial pressure, MFIs must adopt more reliable internal control mechanism by creating more strong internal audit department. Overall the study contributes a valuable knowledge that can help to ensure the long term success and credibility of MFIs.

### **1.7. Limitations of the study**

This study has several limitations. First, among the 59 microfinance institutions engaged in retail transactions, borrower data from Grameen Microfinance Financial Institution was not available. Similarly, depositor data was obtained from only 53 institutions. Second, due to the limited timeframe of the study, an extensive field survey could not be conducted. Third, given the diverse challenges currently faced by the microfinance sector, the proposed

solutions may not be sufficient to fully address the issues. Additionally, there is a significant need for principles, ethics, and integrity among the directors and employees of microfinance institutions. The study was carried out only in microfinance companies in Nepal. Because of this, the results may not apply to other countries or financial institutions that have different systems, rules, or practices. The findings mostly reflect the situation in Nepal, so care should be taken when applying them to a wider context.

Also, the information was collected through questionnaires filled out by employees of microfinance institutions. This method depends on the honesty and understanding of the respondents. Some participants may have answered based on what they think is the “right” answer, rather than their actual experience. Also, some people may have been hesitant to give full details about fraud or audit weaknesses due to fear of consequences.

This research was conducted at a single point in time. Because of this, it was not possible to see how things change over time or how internal audit practices improve or worsen. A long-term study would give a better picture of changes and trends. Lastly, not all institutions were fully open in sharing sensitive or confidential information. Some important details about internal processes or fraud cases may have been left out, which could affect the completeness of the findings. Even with these limitations, the study still offers important information and suggestions for improving internal audit systems in microfinance companies

## **CHAPTER - II**

### **LITERATURE REVIEW**

Internal audit plays a crucial role in ensuring transparency, accountability, and fraud prevention within organizations, particularly in financial institutions such as microfinance companies. An effective internal audit function helps in identifying and mitigating risks, ensuring compliance with regulatory frameworks, and promoting good governance (Dellai and Omri, 2016). Enofe et al. (2013) emphasized that internal audit enhances operational efficiency, assisting institutions in achieving their objectives.

#### **2.1. Theoretical Review**

##### **2.1.1. Concept and role of Internal Audit**

Tuovila (2021) defined internal audit as a process involving the evaluation and analysis of an organization's internal controls to ensure compliance with laws and regulations. Internal audit is responsible for assessing and improving corporate governance and accounting processes, facilitating accurate financial reporting and timely decision-making. Similarly, Beyanga (2011) highlighted that internal audit helps organizations reduce operational costs, improve efficiency, and mitigate financial risks. By enhancing internal control mechanisms, internal audit plays a key role in preventing fraud and financial mismanagement.

According to Alzeban and Gwilliam (2014), several factors influence the effectiveness of internal audit in organizations, including independence, efficiency, and management support. The contingency theory in auditing suggests that various factors influence the effectiveness of an audit process, including the business environment, regulatory requirements, employee competence, and available audit technology (Barra & Grippa, 2016). During the audit process, auditors perform substantive procedures and test controls to ensure financial integrity. They then draft reports highlighting key deficiencies and recommend corrective measures to management and regulatory authorities.

Independence and objectivity are fundamental principles that enhance the effectiveness of internal auditors in preventing fraud. According to Lonto et al. (2023), when internal auditors operate independently, their ability to detect fraud significantly improves. Independence ensures that auditors can objectively evaluate financial statements and internal controls without interference from management, allowing them to identify and report irregularities without fear of retaliation. Without independence, auditors may feel

pressured to overlook fraudulent activities or manipulate findings to align with the interests of senior executives.

One critical aspect of auditor independence is the reporting structure within an organization. Internal auditors should report directly to the audit committee or board of directors rather than executive management. This structure minimizes conflicts of interest and ensures that auditors can carry out their duties without undue influence. Organizations that implement a clear reporting hierarchy empower auditors to scrutinize financial transactions thoroughly and hold management accountable for any discrepancies they uncover.

Furthermore, freedom from management interference is essential in maintaining auditor objectivity. Lonto et al. (2023) highlighted that internal auditors in organizations with strong governance policies are more effective at fraud detection because they have the authority to challenge financial decisions without fearing job insecurity or retaliation. In contrast, when auditors are dependent on management for promotions, salary increases, or job security, their ability to conduct unbiased audits is significantly compromised.

Another critical factor in ensuring auditor objectivity is adherence to professional auditing standards. Global frameworks such as the Institute of Internal Auditors (IIA) Code of Ethics emphasize that internal auditors must remain independent in both fact and appearance. Organizations that align with international best practices experience lower levels of fraud because their auditors operate in an environment that promotes transparency, accountability, and professional skepticism. When auditors strictly follow these ethical guidelines, they are better positioned to detect, report, and prevent fraudulent activities within microfinance institutions.

Despite these advantages, several challenges threaten auditor independence. Budget constraints can limit the ability of the internal audit function to operate effectively, especially when financial resources are controlled by management. In some microfinance institutions, internal auditors may also face job security concerns, making them reluctant to report fraudulent activities. Additionally, management override remains a significant challenge, as executives with unchecked power can dismiss audit findings or manipulate financial reports to conceal fraudulent behavior.

In conclusion, the independence and objectivity of internal auditors are critical in preventing fraud in microfinance institutions. Organizations that establish strong

governance structures, ensure direct reporting to the board, and foster a culture of transparency and accountability are more likely to detect and prevent financial misconduct. As Lonto et al. (2023) emphasize, without independence, the internal audit function loses its effectiveness, allowing fraudulent activities to persist undetected.

### **2.1.2. Factors Affecting Internal Audit Effectiveness**

Studies have identified various factors affecting the effectiveness of internal audit at both the country and organizational levels. Internal audit effectiveness is measured by proficiency, independence and objectivity, scope of audit work, quality of planning and execution, and quality of reporting and follow-up (Sayag, 2014). Internal audit quality is assessed based on how well the internal audit function (IAF) follows up on identified issues and its ability to plan and execute audits in a timely manner.

A study on the Ethiopian Road Authority found that audit quality, competence of the internal audit team, management support, independence of internal audit, and an approved internal audit charter significantly impact internal audit effectiveness (Berehe, 2016). Similarly, Mustika (2015) examined factors influencing internal audit effectiveness, including auditor competencies, auditor independence, auditee support, and the internal-external auditor relationship. The study found that internal audit effectiveness is strengthened by increased auditor competence, independence, and strong relationships between internal and external auditors, while auditee support had no significant effect.

Another study in Vietnam identified that the effectiveness of internal audit is influenced by audit independence, audit competence, management support, and audit quality, with positive and significant relationships between these factors (Mustika, 2015).

Cohen and Sayag (2010) emphasized that the effectiveness of internal audits is directly linked to the level of independence auditors have from management influence. When internal auditors are free from managerial pressure, they can conduct thorough assessments of financial records, internal controls, and operational processes without fear of retaliation or interference. This autonomy allows them to objectively analyze financial transactions and identify any irregularities that may indicate fraudulent activities. If auditors are subjected to management influence, their ability to report unethical or fraudulent behavior can be compromised, making the audit process ineffective in detecting financial misconduct.

A key factor in maintaining auditor independence is the reporting structure within an organization. Cohen and Sayag (2010) highlighted that internal audit departments that report directly to audit committees or boards of directors, rather than senior management, are significantly more effective in detecting and preventing fraud. The reason for this is that when internal auditors report to senior management, there is a higher likelihood of conflicts of interest. Management may exert pressure on auditors to overlook financial misstatements or downplay audit findings that could negatively impact executive decision-making or company reputation. On the other hand, an independent reporting structure ensures that auditors can disclose their findings without external influence, allowing for unbiased risk assessment and fraud prevention.

Additionally, internal audit effectiveness is strengthened when the audit committee provides direct oversight and support to the internal audit function. Audit committees that have a strong commitment to corporate governance often encourage auditors to conduct comprehensive and independent reviews. This structure not only enhances fraud detection but also ensures that audit recommendations are implemented effectively. Without direct access to the audit committee, internal auditors may struggle to enforce corrective actions, as management could disregard or delay necessary improvements.

Moreover, a reporting line that bypasses management reinforces accountability and transparency within an organization. When internal auditors have direct communication with the audit committee, they can report fraudulent activities or control weaknesses without fear of suppression. This reporting structure creates a checks-and-balances system that holds management accountable for implementing ethical financial practices. Organizations that adopt this model experience lower instances of fraud because auditors have the authority and confidence to act upon their findings.

Despite these advantages, some organizations still face challenges in maintaining audit independence. In some microfinance institutions, management may resist direct reporting to the audit committee, citing administrative inefficiencies or hierarchical complexities. Additionally, in environments where corporate governance is weak, the audit committee itself may lack the expertise or authority to fully support internal auditors. In such cases, external regulatory bodies or professional associations may need to step in to enforce audit independence and best practices.

In conclusion, Cohen and Sayag (2010) affirmed that internal audit effectiveness is significantly enhanced when auditors are free from management influence and report directly to audit committees. A governance structure that promotes auditor independence fosters transparency, strengthens fraud prevention mechanisms, and ensures that internal auditors can operate without fear of interference. Organizations that prioritize this reporting framework are better equipped to detect, prevent, and mitigate fraudulent activities, ultimately contributing to stronger financial integrity and corporate governance.

### **2.1.3. Fraud in Microfinance Institutions**

Microfinance institutions, given their nature of serving low-income and marginalized communities, are highly susceptible to financial irregularities, including fraud and misappropriation of funds. Fraud within microfinance institutions can take various forms, including loan fraud, embezzlement, and financial statement manipulation. Barua, Rama, and Sharma (2010) highlighted that internal audit strengthens risk management and governance processes, ensuring financial stability. Norman and Rose (2010) further emphasized that systematic and consistent internal audits help detect and prevent fraudulent activities within financial institutions.

According to Nwanyanwu (2017), weak internal audit functions contribute significantly to fraudulent practices in financial institutions, leading to financial instability and loss of stakeholder confidence. Effective internal audit mechanisms, including risk-based audit approaches, forensic auditing, and real-time monitoring, are crucial for safeguarding the integrity of financial transactions within microfinance institutions.

Adetoso et al. (2013) demonstrated that fraud detection rates significantly improve when internal auditors possess specialized training and extensive industry experience. Auditors with advanced certifications, such as Certified Internal Auditors or Certified Fraud Examiners (CFEs), are particularly adept at identifying fraudulent activities due to their in-depth knowledge of financial reporting standards, forensic accounting, and fraud detection methodologies. Their expertise allows them to recognize complex financial irregularities that may go unnoticed by less experienced auditors. In microfinance institutions, where fraudulent activities such as loan diversion, unauthorized fund withdrawals, and document falsification are common, auditors with specialized training are better equipped to analyze transaction patterns, detect anomalies, and implement effective fraud prevention measures.

In addition to professional certifications, industry-specific experience plays a crucial role in enhancing fraud detection capabilities. Internal auditors who have spent years working in the financial sector develop a keen understanding of industry trends, common fraud schemes, and regulatory requirements. Their familiarity with internal control systems, operational risks, and governance frameworks allows them to conduct more targeted and effective audits. Adetoso et al. (2013) emphasized that auditors with forensic accounting backgrounds bring an added advantage, as they are trained to investigate financial crimes, analyze suspicious transactions, and trace fraudulent activities to their root causes. For microfinance institutions, where financial transactions often involve multiple stakeholders and decentralized operations, the expertise of such auditors becomes even more critical in maintaining financial integrity and preventing fraud.

Similarly, Baharud-din et al. (2014) found that the effectiveness of an internal audit function is heavily dependent on the auditors' level of expertise. Auditors with up-to-date knowledge of fraud detection techniques, risk assessment, and financial analysis are far more capable of identifying and addressing fraud risks. Given the evolving nature of financial fraud, continuous professional development is essential for internal auditors to stay ahead of emerging threats. Training programs, workshops, and certifications provide auditors with the latest fraud detection tools, data analytics techniques, and regulatory updates. For instance, modern fraud schemes increasingly involve cyber-related crimes, such as identity theft and digital payment fraud. Auditors trained in forensic data analysis and cybersecurity risk management are better equipped to prevent and detect such frauds in microfinance institutions.

Moreover, auditors who regularly engage in knowledge-sharing initiatives and professional networking are more effective in fraud prevention. By participating in fraud prevention forums, industry conferences, and audit associations, they gain insights into emerging fraud trends and best practices. Baharud-din et al. (2014) argued that well-trained auditors are also more proficient in conducting risk-based audits, which focus on high-risk areas prone to fraud. This proactive approach ensures that resources are allocated efficiently to detect fraudulent activities before they escalate into major financial losses.

In microfinance institutions, where internal audit teams may sometimes be small and resource-constrained, having skilled and knowledgeable auditors is essential to compensate for limited manpower. A highly trained auditor can maximize the effectiveness of audit

procedures by utilizing advanced fraud detection methodologies such as data analytics, artificial intelligence, and predictive modeling. Institutions that invest in continuous auditor training and certification programs benefit from improved fraud detection capabilities, stronger internal controls, and enhanced financial transparency.

Kashona (2019) identified weak internal controls as a major factor contributing to fraud in microfinance institutions. In many cases, inadequate control mechanisms create opportunities for fraudulent activities such as misappropriation of funds, unauthorized loan approvals, and financial statement manipulation. The absence of proper oversight, coupled with a lack of accountability, allows employees to exploit loopholes in financial systems for personal gain. Microfinance institutions, which often operate in environments with high financial vulnerability, are particularly susceptible to such risks. Kashona (2019) found that organizations implementing stringent internal controls experience significantly lower incidents of fraud. These controls include segregation of duties, mandatory approvals for financial transactions, regular reconciliations, and strict authorization processes. When financial responsibilities are divided among multiple employees, it reduces the likelihood of fraud, as no single individual has unchecked authority over financial operations.

A key element of strong internal controls is the enforcement of approval hierarchies for financial transactions. By requiring multiple levels of authorization for expenditures, fund disbursements, and loan approvals, organizations can prevent unauthorized transactions and detect discrepancies before they escalate into major fraud cases. In microfinance institutions, where rapid loan processing is often a priority, ensuring that all approvals follow due diligence processes is critical in mitigating fraudulent activities. Additionally, the integration of automated control systems, such as enterprise resource planning (ERP) and real-time monitoring tools, helps detect anomalies in financial transactions. Kashona (2019) emphasized that institutions with well-structured internal control frameworks benefit from improved financial transparency, reduced risk exposure, and enhanced overall governance.

Building on this perspective, Sayag (2014) stressed that effective internal controls, when combined with regular internal audits, significantly strengthen fraud prevention efforts. Internal audits play a crucial role in ensuring that established control measures are being followed and that any deviations or weaknesses are promptly identified and corrected. By conducting routine audits, organizations can assess the adequacy of their internal controls,

detect potential fraud risks, and implement corrective actions in a timely manner. Sayag (2014) found that organizations with proactive internal audit functions are better positioned to identify fraud at an early stage, thereby minimizing financial losses and reputational damage.

Regular internal audits serve as a deterrent to fraudulent behavior, as employees are aware that financial transactions and compliance processes are being closely monitored. The presence of an independent and competent internal audit team ensures that control mechanisms remain effective and adaptable to emerging fraud risks. Sayag (2014) also highlighted the importance of continuous evaluation and improvement of internal controls, as static control systems may become obsolete in response to evolving fraud tactics. By integrating fraud risk assessment into internal audit procedures, microfinance institutions can proactively identify high-risk areas and implement targeted anti-fraud measures.

Moreover, Sayag (2014) emphasized that internal audits enhance fraud prevention when audit recommendations are promptly implemented. Simply identifying weaknesses in internal controls is not sufficient; organizations must take corrective actions to strengthen their control environment. This includes addressing audit findings, reinforcing compliance measures, and ensuring that employees receive training on fraud detection and ethical financial practices. The synergy between internal controls and internal audits creates a comprehensive fraud prevention framework that helps microfinance institutions safeguard their financial resources and maintain operational integrity.

In conclusion, Kashona (2019) and Sayag (2014) highlighted the critical role of internal controls and internal audits in preventing fraud within microfinance institutions. Strong internal control mechanisms, such as segregation of duties and approval hierarchies, significantly reduce fraud risks by limiting unauthorized access to financial transactions. Furthermore, regular internal audits reinforce these controls by continuously monitoring compliance and identifying areas for improvement. When effectively implemented together, internal controls and internal audits form a robust defense against fraudulent activities, ensuring financial stability and organizational credibility in the microfinance sector.

#### **2.1.4. Challenges in Internal Audit Implementation in Microfinance Institutions**

In the context of Nepal, Paudel (2019) examined the role of internal audit in microfinance institutions and found that a lack of skilled auditors and weak regulatory enforcement

contributed to increasing fraud cases. The study suggested that enhancing audit independence and using technology-driven audit techniques could significantly improve fraud detection and prevention. Similarly, Sharma and Adhikari (2021) highlighted that microfinance institutions in Nepal face challenges due to inadequate audit coverage, emphasizing the need for stricter internal audit controls.

From an Indian perspective, Gupta and Sharma (2020) explored the effectiveness of internal audit in preventing fraud within Indian microfinance institutions. Their study indicated that internal audits significantly reduce fraudulent activities when combined with proper governance policies and management support. Similarly, Patel et al. (2021) emphasized the role of digital audit techniques in improving the efficiency and accuracy of internal audits within India's financial sector.

#### **2.1.5. Impact of Internal Audit on Financial Stability in Microfinance Institutions**

Mia (2017) noted that multiple banking in microfinance institutions arises due to both supply-side and demand-side factors. On the supply side, the high presence of microfinance institutions, aggressive business expansion, and institutional inefficiencies contribute to multiple borrowing. On the demand side, factors such as high household consumption, poverty, and the emergence and expansion of small enterprises drive borrowers to take loans from multiple institutions.

Multiple banking has some positive aspects, such as regulating the demand and supply of credit and allowing clients to choose financial institutions. However, it also leads to challenges, including excessive debt, increased borrowing costs, and financial instability (Chichaibelu & Waibel, 2017). These challenges underline the importance of internal audits in microfinance institutions. Internal audits help assess risk management, enforce credit discipline, and improve governance structures to mitigate financial instability. Studies highlight that a strong internal audit function enhances an institution's ability to detect financial mismanagement, fraud, and inefficiencies in operations (Alzeban & Gwilliam, 2014).

#### **2.1.6. Lessons from Microfinance Crises and the Need for Strengthened Internal Audit**

The microfinance sector has faced crises in various countries over the years. For instance, crises occurred in India in 2010, Pakistan in 2008, Morocco in 2008, Bangladesh between 2008–2009, and Nicaragua in 2009 (Chen et al., 2010; Chen & Rutherford, 2013; IFC,

2017; Mader, 2015). Despite differences in microfinance structures across countries, the root causes of these crises were often similar. Key factors included excessive expansion of microfinance institutions (MFIs), ignorance of early warning signs, local resistance from political and religious groups, loan default movements, misinformation regarding loan waivers, multiple borrowing, debt overburden, weak internal controls, and poor credit discipline (Roodman, 2012).

Nepal's microfinance sector is currently experiencing similar pressures. Rapid expansion of MFIs has led to high multiple borrowing rates and over-indebtedness. Studies on global microfinance crises indicate that over-concentration of MFIs in specific areas leads to debt saturation and regulatory violations (Giné et al., 2012). Nepal has a significant issue with multiple borrowing, where approximately 20% of borrowers have loans from at least two or more institutions, and around 41% of outstanding loans belong to borrowers with multiple loan accounts (NRB, 2023).

Multiple borrowing was a primary cause of past microfinance crises in various countries. For instance, in Nicaragua in 2009, 40% of borrowers had more than one loan account, similar to Morocco in 2007 (40%), Bosnia in 2009 (40%), and Pakistan in 2009 (21%, rising to 30% in affected regions) (Bhatt & Tang, 2012). These figures highlight that multiple borrowing and over-indebtedness are common issues leading to financial instability in microfinance sectors globally.

A third significant cause of financial distress in Nepal's microfinance sector is the excessive expansion of the system and weak internal controls. Rapid institutional expansion has resulted in increased branch numbers and employee growth, putting pressure on internal systems. Studies suggest that over-expansion of microfinance without adequate internal control mechanisms is a major contributor to financial crises in this sector (Rosenberg et al., 2013).

## **2.2. Empirical Review**

Internal audit plays a crucial role in maintaining financial integrity, detecting fraud, and ensuring governance within microfinance institutions (MFIs). This literature review examines various studies that explore the effectiveness of internal audit in preventing fraud, focusing on key variables such as auditor independence, competence, management support, and audit quality.

Hazaea et al. (2024) emphasized that internal audit practices, particularly adherence to international standards, auditor independence, and management support, significantly impact organizational performance. While their study focuses on commercial banks, the findings suggest that similar principles apply to MFIs, where robust audit practices can mitigate fraud risks.

Omidiji (2024) examined internal audit functions in microfinance institutions across developing economies, revealing that regulatory environments and governance structures influence audit effectiveness. This study underscores the need for strong institutional frameworks to support internal audit functions in MFIs.

Yazid and Suryanto (2024) utilized panel data analysis to show that higher audit quality reduces financial statement fraud, reinforcing the necessity of strong internal audit functions in financial institutions, including MFIs. Panel data analysis of Indonesian company's fraud has been taken as research methodology. This study found that the higher audit quality was associated with a reduced likelihood of financial statement fraud, highlighting the critical role of effective internal audit in fraud prevention.

Lonto et al. (2023) provided empirical evidence that auditor independence significantly enhances fraud prevention. By reporting directly to the audit committee rather than executive management, auditors are better positioned to identify and address fraudulent activities.

NRB (2023) outlined the risks in Nepal's microfinance sector, where multiple borrowing has led to financial instability. Their study indicates that internal audits must be strengthened to address such risks and prevent potential fraud.

Adato (2022) presented findings from Ethiopian MFIs, showing that management support, auditor independence, and a well-defined internal audit charter contribute significantly to audit effectiveness. This study provides direct evidence of how internal audits can mitigate fraud in microfinance institutions.

Mutti and Macagnan (2022) highlighted the role of internal audit quality in establishing management legitimacy, which is essential for preventing financial mismanagement and fraud in public institutions. These insights reinforce the importance of maintaining high internal audit standards in microfinance companies. Strengthening audit functions not only boosts stakeholder trust but also ensures compliance with regulatory and ethical standards.

Pham and Nguyen (2022) elaborated on this by conducting a survey in Vietnam, revealing that independence, auditor competence, and management support are critical to internal audit effectiveness. This study is particularly relevant to microfinance institutions, which often struggle with limited oversight and governance.

Ta and Doan (2022) found that internal auditor competence and audit quality play a direct role in preventing fraudulent financial statements in state-owned enterprises. They used internal audit independence, internal audit quality and fraudulent financial statement as their variables and used the survey from state-owned enterprises in Indonesia and analyzed data using SEM-PLS method.

Patel et al. (2021) highlighted the impact of digital audit techniques on internal audit efficiency. With technological advancements, internal audits have become more accurate and less susceptible to human error, which is crucial for fraud detection in MFIs. This shift towards digital tools enables auditors to analyze larger datasets more efficiently, improving the timeliness and effectiveness of fraud prevention measures.

Alzeban and Gwilliam (2021) emphasized the role of management support in enhancing audit effectiveness. Their studies across Saudi Arabia and Poland, respectively, show that without strong management backing, internal audits may lack the necessary authority and resources to detect and prevent fraud.

Endaya and Hanefah (2021) identified organizational independence as a key driver of audit effectiveness, using conceptual method as research methodology to emphasize the positive auditor-management relationships improve audit functions. These studies collectively suggest that MFIs must ensure auditor independence while fostering constructive engagement with management.

Musah et al. (2021), highlighted auditor competence as a fundamental component of effective internal audits. They emphasized that well-trained and knowledgeable auditors are better equipped to detect fraudulent activities and also focused that the competence and management support are essential for audit effectiveness.

Shamki and Alhajri (2021) also highlighted the audit competence and independence as the variables and emphasized that the auditor competence has direct positive relationship with the audit effectiveness.

Chevers et al. (2021) also highlighted the audit competence and independence as the variables and studied in Caribbean public sector and emphasized that the audit independence and competence are the key audit success factors.

Joshi (2021) further supported this argument, demonstrating that auditor competency and active interaction with the audit committee significantly enhance internal audit effectiveness. Their studies also highlighted that ongoing skill development and transparent dialogue between auditors and oversight teams contribute to better audit outcomes. Building mutual trust within the audit environment encourages prompt and effective identification of fraudulent activities.

The importance of auditor independence is further supported by Gupta and Sharma (2020), who argue that internal audits are most effective when combined with strong governance policies. Their case study of Indian MFIs indicates that internal audit functions play a pivotal role in reducing fraudulent activities.

Turetken et al. (2020) identified key indicators of internal audit effectiveness, including audit independence, management support, and operational efficiency. Their comprehensive literature review underscores the need for a structured approach to evaluating internal audit functions.

The literature highlights that internal audit effectiveness in preventing fraud within microfinance companies is influenced by several key factors: auditor independence, competence, management support, and audit quality. While technological advancements improve efficiency, governance structures and regulatory oversight remain critical for ensuring that internal audits effectively deter fraudulent activities. Future research should focus on developing standardized internal audit frameworks tailored to the microfinance sector to enhance fraud prevention efforts.

This table includes the key details such as variables, methodology and major findings for each paper.

**Table 1***Summary of Empirical Review*

SN	Authors	Variables	Methodology	Major Findings
1	Hazaea et al. (2024)	Internal audit practices and bank performance	Survey of 34 commercial banks in five Arab countries; Structural Equation Modeling (SEM) analysis	Internal audit practices, including adherence to international standards, independence, auditor quality, gender diversity, meeting frequency, and management support, significantly and directly influence the performance of commercial banks, except for auditor professional competence.
2	Yazid and Suryanto (2024)	Audit quality, financial statement fraud	Panel data analysis of Indonesian companies	Higher audit quality is associated with a reduced likelihood of financial statement fraud, highlighting the critical role of effective internal audits in fraud prevention.
3	Omidiji (2024)	Determinants of internal audit function in microfinance institutions	Examination of internal audit functions in microfinance institutions across transitional and developing economies	The presence of an internal audit function in microfinance institutions is influenced by factors such as institutional and regulatory environments, hybrid organizational focus, and governance structures.
4	NRB (2023)	Lessons from MFI Crises	Empirical Study	Nepal's microfinance sector faces risks similar to past crises, with 20% of borrowers holding loans from multiple institutions and 41% of outstanding loans belonging to individuals with multiple accounts.

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5	Lonto et al. (2023)	Auditor Independence and Fraud Prevention	Empirical Study	Independent auditors improve fraud detection and reduce conflicts of interest by reporting to the audit committee rather than executive management.
6	Mutti and Macagnan (2022)	Management legitimacy and internal audit quality in public universities	Conceptual model based on literature review	The quality of internal audits supports the management legitimacy of public universities, emphasizing the importance of effective internal audit functions in the public sector.
7	Adato (2022)	Management support, independence, internal audit charter, competence of internal audit staff, quality of internal audit	Mixed research design with quantitative approach; survey of microfinance institutions in Hawassa, Sidama Region, Ethiopia	Management support, internal audit independence, presence of an approved internal audit charter, adequate and competent internal audit staff, and quality of internal audit significantly contribute to internal audit effectiveness in microfinance institutions.
8	Ta and Doan (2022)	competence, audit quality, fraudulent financial statement	Survey of 475 respondents from 33 enterprises in Indonesia; data analyzed using SEM-PLS	Internal auditor competence positively impacts internal audit quality and helps prevent fraudulent financial statements.
9	Pham and Nguyen (2022)	Factors affecting internal audit effectiveness in Vietnam	Quantitative and qualitative evaluations; Logistic regression analysis	Independence of internal audit, competence of internal auditors, management support, and quality of internal audit work significantly affect internal audit effectiveness in Vietnam.

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10	Tuovila (2021)	Definition and Role of Internal Audit	Conceptual Study	Internal audit evaluates internal controls, strengthens corporate governance, enhances financial reporting accuracy, and improves decision-making.
11	Patel et al. (2021)	Challenges in Internal Audit	Empirical Study	Digital audit techniques improve efficiency and accuracy of internal audits.
12	Chevers et al. (2021)	Audit independence, competence	Study in Caribbean public sector	Independence and competence are key audit success factors.
13	Bednarek (2021)	Corporate governance, internal audit role	Study in Poland	Internal audit improves governance and performance.
14	Joshi (2021)	Competency of internal audit staff, interaction with audit committee	Survey of 64 internal audit heads, chief accountants, and CEOs from Nifty500 companies in India	Competency of internal audit staff and their interaction with the audit committee significantly enhance internal audit effectiveness.
15	Karyawati (2021)	Competency of internal audit staff, interaction with audit committee	Survey of 252 Nifty companies in India	Competency of internal audit staff and their interaction with the audit committee are critical determinants of internal audit effectiveness.
16	Alzeban and Gwilliam (2021)	Management support, audit quality, independence	Survey in Saudi Arabia	Strong management support enhances audit effectiveness.

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17	Shamki and Alhajri (2021)	Auditor competence, independence	Survey in Jordan	Auditor competence directly affects audit effectiveness.
18	Endaya and Hanefah (2021)	Audit effectiveness, organizational independence	Conceptual model	Identified key drivers of internal audit effectiveness.
19	Musah et al. (2021)	Audit competence, management support	Study in Ghana	Competence and management support are essential for audit effectiveness.
20	Lenz et al. (2020)	Auditor-management relationship	Qualitative study	Positive auditor-management relationships improve audit effectiveness.
21	Gupta and Sharma (2020)	Challenges in Internal Audit	Case Study	Internal audits significantly reduce fraudulent activities when combined with governance policies and management support in Indian MFIs.
22	Rudhani et al. (2020)	Auditor independence, effectiveness	Study in Kosovo's public sector	Management support is critical for effective audits.
23	Bednarek (2020)	Auditor attributes, effectiveness	Study in Poland	Continuous professional development is crucial for audit effectiveness.
24	Hailemariam (2020)	Internal audit effectiveness, public sector	Study in Ethiopia	Audit quality and management support improve audit functions.

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25	Turetken, et al. (2020)	Operationaliz ation of internal audit effectiveness and influencing factors	Literature review	Identified various indicators used to measure internal audit effectiveness and factors that potentially influence it, providing a comprehensive understanding of internal audit effectiveness.
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### 2.3. Research Gap

The usefulness of internal audit in avoiding fraud in a variety of corporate contexts is well examined in the body of extant literature. Research constantly stresses the significance that elements as audit independence, auditor competency, and a strong audit scope are in supporting fraud prevention measures (Lonto et al., 2023; Okoli, 2012). It is also growing in popularity that effective technology utilization along with effective audit planning and execution are essential elements of modern fraud prevention tactics (Lonto et al., 2023).

However, when concentrating solely on Microfinance Institutions (MFIs), a significant research gap becomes clear. The business surroundings, scale, and specific risks that MFIs face significantly impact actual execution and effectiveness of internal auditing, even though its basic principles are uniform. Several previous studies have been able to generalize results from bigger, more established financial institutions that operate under different regulatory frameworks and have unique customer base, transaction volumes etc. This creates a gap in our understanding regarding why internal audit operates effectively to prevent fraud.

The particular risks that microfinance institutions face make them apart from conventional financial institutions, which makes context-specific research even more important. These comprise of:

- High volume of small value transactions often made in the form of cash increases the risk of cash embezzlement by the staffs.
- Major of the microfinance operates in the rural areas with limited infrastructures, making monitoring and control more difficult to detect fraud.

There are therefore few empirical studies that especially look into the detailed "Effectiveness of Internal Audit in Preventing Fraud in MFIs by thoroughly investigating

the relationship of Scope, Competence, Independence, Audit Planning and Execution, and Use of Technology within this specialized sector, even though studies demonstrate the general impact of internal audit features on fraud prevention (Lonto et al., 2023). Research frequently addresses particular issues or provides general recommendations. By providing clear, empirical data based on the real-world circumstances and fraud patterns associated with microfinance, this thesis aims to close this crucial gap and offer useful data for regulators, development organizations, and MFIs looking to accomplish their dual missions to enhance financial integrity.

## **CHAPTER - III**

### **RESEARCH METHODOLOGY**

This chapter outlines the systematic approach adopted to conduct the research. It provides a detailed explanation of the methods used to gather, analyze, and interpret data relevant to the research objectives. The chosen methodology ensures that the findings are reliable, valid, and applicable to the research context. It includes the overall research strategy, data collection methods, sampling techniques, and tools used for analysis. By clearly defining each step of the process, this chapter ensures transparency and replicability of the study. The methodology was selected based on the nature of the research problem and the objectives to be achieved.

#### **3.1. Research Design**

This study employed descriptive and casual research design to assess the effectiveness of internal audits in preventing fraud in microfinance companies. This methodology has been chosen to provide the comprehensive understanding of effectiveness of internal audit in preventing fraud within microfinance companies

The main purpose of using descriptive research design is to accurately and systematically describe the characteristics of internal audit function in microfinance companies with the focus on their independence, competency, scope, planning and execution of audits, and use of technology. It describes the current state of dependent variable. As mentioned, Likert scale questionnaire is used for descriptive objectives.

The main purpose of using casual research design is to determine the cause and effect relationship between dependent variable (fraud prevention) and independent variables (Scope, Competence, Independence, Audit Planning & Execution, Use of Technology). It identifies the relationship, test hypothesis and predict the outcomes in preventing fraud in microfinance companies.

#### **3.2. Population and Sample**

The population of this research comprises employees working within licensed microfinance institutions (MFIs), particularly those assigned to internal audit, finance, compliance, and risk management departments. These individuals are considered to possess relevant knowledge and experience necessary to respond accurately to the research instruments regarding internal auditing and fraud prevention mechanisms.

A purposive sampling technique was initially employed to identify microfinance institutions that operate across various regions and are representative in terms of size, operational scope, and governance structure. From these institutions, a stratified random sampling method was used to ensure proportionate representation from each key department (internal audit, finance, compliance, risk).

A total of 484 respondents were selected and successfully completed the quantitative questionnaire. The explanation of population has further described in the demographic characters in next chapter. The selection criteria included employees from different levels and departments who have an understanding or involvement in internal audit activities. Care was taken to include staff from both urban and rural branches of various microfinance companies, thereby increasing the generalizability of the findings within the sector. The sample also represents a mix of experience levels and educational backgrounds, which provides a comprehensive understanding of how internal audit effectiveness varies across demographic and institutional contexts. This diverse sample composition enhances the depth and reliability of the insights drawn from the research.

### **3.3. Data Collection Methods**

#### **3.3.1 Questionnaires**

Structured questionnaires were developed and distributed to the 484 participants to gather quantitative data. The instrument consisted of closed-ended questions and Likert-scale items (ranging from 1 = Strongly Disagree to 5 = Strongly Agree). The questionnaire covered several thematic areas, including:

#### **Existence and frequency of internal audits**

Independence and objectivity of auditors

Scope and depth of audit procedures

Integration of audit findings into management actions

Perceptions of audit effectiveness in detecting and deterring fraud

### **3.4. Data Analysis Techniques**

#### **3.4.1 Quantitative Data Analysis**

The survey data was coded and entered into Statistical Package for the Social Sciences (SPSS) for analysis. The following statistical techniques were employed:

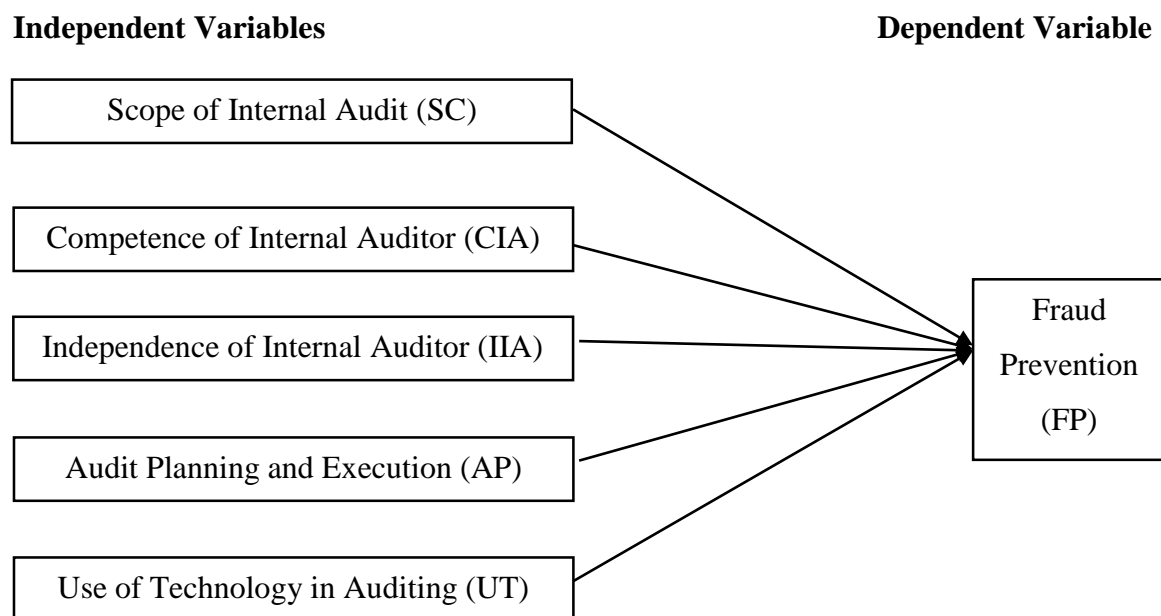
Descriptive Statistics: Used to summarize data (e.g., frequencies, percentages, means, and standard deviations) to provide an overview of the internal audit practices and perceived effectiveness.

Correlation Analysis was used to determine the strength and direction of relationships between internal audit variables and perceived fraud prevention outcomes.

Multiple Regression Analysis was conducted to assess how multiple independent variables (e.g., audit independence, frequency, scope) predict the dependent variable (fraud prevention effectiveness).

### 3.5. Conceptual Framework

The framework identifies the independent variables (factors influencing internal audit effectiveness) and the dependent variable (fraud prevention in MFIs), with arrows indicating the directional relationships between them. Below is a detailed explanation of the framework, expanded upon with references to align with the research context, and incorporating the elements from the diagram: Use of Technology, Audit Planning, Independence & Competence of Internal Audit (I.A.), Scope of I.A., and Execution of I.A.



(Source: Lonto et al., 2023; Shamki and Alhajri, 2021)

#### 3.5.1. Purpose of the Conceptual Framework

The framework aims to investigate how internal audits contribute to fraud prevention in microfinance companies by identifying key factors that enhance audit effectiveness and examining their impact on fraud prevention outcomes. It provides a theoretical structure to

guide the research, formulate hypotheses, and design the methodology, considering the unique fraud risks and operational challenges in MFIs, such as decentralized operations and vulnerable client bases.

### **3.5.2. Conceptual Framework Structure (Based on the Diagram)**

The framework is structured around Independent Variables (factors influencing internal audit effectiveness) and the Dependent Variable (fraud prevention in MFIs). The diagram shows five independent variables—Use of Technology, Audit Planning, Independence & Competence of I.A., Scope of I.A., and Execution of I.A.—all directly influencing the dependent variable, Fraud Prevention in MFIs.

#### **A. Independent Variables: Factors Influencing Internal Audit Effectiveness**

These are the key determinants that impact the ability of internal audits to prevent fraud in MFIs, as identified in the diagram.

##### **Use of Technology**

The integration of technology, such as data analytics and automated monitoring systems, enhances the internal audit's ability to detect fraud in real-time. In MFIs, where operations are often decentralized, technology can identify patterns like ghost loans or duplicate disbursements by analyzing transaction data (Krishnan & Yu, 2012). For example, real-time dashboards can flag irregularities in loan repayments, enabling auditors to act swiftly.

##### **Audit Planning**

Effective audit planning ensures that audits are risk-based and prioritized to address high-risk areas in MFIs, such as loan portfolio management and cash handling (Asare & Wright, 2012). Proper planning involves assessing fraud risks specific to MFIs, like falsified records or employee collusion, and allocating resources accordingly. For instance, scheduling frequent audits for rural branches with high cash transactions can deter fraud.

##### **Independence & Competence of Internal Audit**

Auditor independence ensures unbiased reporting, particularly when investigating fraud involving senior staff, while competence ensures auditors have the skills to detect fraud (IIA, 2017). In MFIs, independence can be supported by direct reporting to the board, and competence can be enhanced through training on MFI-specific fraud schemes, such as ghost clients.

### **Scope of Internal Audit**

The scope of the internal audit defines the areas and activities it covers, such as loan disbursements, client verification, and cash handling processes (Cohen & Sayag, 2010). In MFIs, a comprehensive scope should include field visits to rural branches and audits of client interactions to ensure ethical practices, protecting vulnerable clients from fraud like hidden fees.

### **Execution of Internal Audit**

The execution of audits involves the practical implementation of audit plans, including the use of fraud detection techniques like surprise cash counts, client verification visits, and data analysis (Hogan et al., 2008). In MFIs, effective execution might include reconciling loan records to detect falsification or conducting unannounced audits to deter employee collusion.

### **B. Dependent Variable: Fraud Prevention in Microfinance Companies (MFIs)**

This is the primary outcome variable, representing the effectiveness of internal audits in preventing fraud in MFIs.

### **Fraud Prevention in MFIs**

The ultimate goal of internal audits is to prevent fraud, such as loan misappropriation, ghost clients, and falsified records, which are prevalent in MFIs due to their operational structure (Power, 2013). Effective audits reduce fraud opportunities by identifying control weaknesses (e.g., lack of segregation of duties in loan approvals) and detecting fraud early through mechanisms like data analytics and field audits. This also includes broader outcomes like improved governance, operational efficiency, and stakeholder trust, as fraud prevention strengthens the MFI's overall integrity.

### **3.5.3. Conceptual Framework Diagram (Expanded Explanation)**

The diagram illustrates the following relationships:

Independent Variables (Use of Technology, Audit Planning, Independence & Competence of I.A., Scope of I.A., Execution of I.A.) → Dependent Variable (Fraud Prevention in MFIs).

#### **Relationships:**

Use of Technology → Fraud Prevention: Technology enables real-time fraud detection, such as identifying duplicate loans, directly reducing fraud incidents in MFIs.

Audit planning → Fraud Prevention: Strategic planning ensures audits target high-risk areas, deterring fraud through focused oversight.

Independence & Competence of I.A. → Fraud Prevention: Independent and skilled auditors are more likely to detect and report fraud, enhancing prevention efforts.

Scope of I.A. → Fraud Prevention: A broader scope ensures all fraud-prone areas (e.g., rural branches, client interactions) are audited, reducing fraud opportunities.

Execution of I.A. → Fraud Prevention: Effective execution through techniques like surprise audits and data analysis directly prevents fraud by increasing detection rates.

#### **3.5.4. Application to Microfinance Companies**

The framework is tailored to the specific challenges of MFIs:

Decentralized Operations: Technology and audit execution (e.g., field visits, remote monitoring) address fraud risks in rural branches (Knechel & Sharma, 2012).

Client Vulnerability: A comprehensive audit scope ensures ethical practices, protecting low-income clients from fraud like hidden fees (Hermanson et al., 2011).

Regulatory Environment: Effective audit planning and execution ensure compliance with strict regulations while addressing fraud risks (Beasley et al., 2000).

This conceptual framework, based on the provided diagram, provides a clear structure for researching the effectiveness of internal audits in preventing fraud in MFIs. It highlights the direct influence of technology, planning, independence, scope, and execution on fraud prevention, offering a foundation for empirical testing and practical insights into improving audit practices in the microfinance sector. The framework is grounded in academic literature, ensuring theoretical rigor and relevance to the MFI context.

## CHAPTER IV

### RESULTS AND DISCUSSION

#### 4.1. Demographic Characteristics of the respondents

Understanding the demographic profile of the respondents is essential to provide context to the analysis and ensure that the perspectives captured represent a diverse range of experiences and roles within microfinance institutions (MFIs). The survey included a total of 484 respondents from various microfinance organizations across Nepal. The demographic variables assessed include gender, age group, educational qualification, current position, years of experience, and whether their institution has a proper audit department and the frequency of audit practices.

##### Gender Distribution

The survey received responses from 484 individuals, distributed across three gender categories:

**Table 2**

*Gender Group*

<b>Gender</b>	<b>Frequency</b>	<b>Percentage</b>
Male	335	69.21
Female	149	30.79
<b>Total</b>	<b>484</b>	<b>100</b>

*(Source: Survey 2025)*

Male respondents represent the majority of the sample (69.21%). This suggests that a significant portion of insights and opinions about the internal audit's effectiveness may primarily reflect male perspectives.

Female respondents make up a substantial portion (30.79%), providing a fairly balanced gender representation that strengthens the generalizability of the results across male and female viewpoints.

Since gender may influence how individuals perceive organizational controls and risk, this demographic breakdown can help identify if perceptions of internal audit effectiveness vary across gender lines.

**Table 3***Age Group*

<b>Age Group</b>	<b>Frequency</b>	<b>Percentage</b>
Below 25 years	19	3.93
25–34 years	260	53.72
35–44 years	165	34.09
45 years and above	40	8.26
<b>Total</b>	<b>484</b>	<b>100</b>

(Source: Survey 2025)

The age distribution reveals that the majority of respondents, 53.72%, are between 25 and 34 years old representing the large segment often in early to mid-career stages, commonly involved in field or operational roles in microfinance, followed by 34.09% aged 35 to 44 who are mainly comprising the middle management and well experienced staff as were targeting mainly to branch managers and higher level staff. Participants below 25 years' account for 3.93%, while those 45 and above make up 8.26%. This indicates most respondents are in their prime working years, providing valuable insights for studies focused on professional experiences.

**Table 4***Education Qualification*

<b>Educational Qualification</b>	<b>Frequency</b>	<b>Percentage</b>
Intermediate (10+2)	19	3.93
Bachelor's Degree	277	57.23
Master's Degree	128	26.45
Professional Qualification (e.g., CA, ACCA)	43	8.88
Other (please specify)	17	3.51
<b>Total</b>	<b>484</b>	<b>100</b>

(Source: Survey 2025)

The distribution of educational qualifications among respondents indicates that most, 57.23%, possess a Bachelor's degree and Master's degree constitute 26.45% indicating that most respondents have undergraduate-level education, typical for operational and administrative roles and also a well-educated workforce with advanced knowledge in finance or management, while 8.88% have professional certifications like CA or ACCA

indicate a presence of respondents with specialized expertise in accounting/audit—important for assessing internal audit effectiveness. Respondents with Intermediate (10+2) education account for 3.93%, and 3.51% have other unspecified qualifications. This shows that the majority of participants are well-educated, with a significant number holding higher education degrees.

**Table 5**

*Current Position Group*

<b>Current Position</b>	<b>Frequency</b>	<b>Percentage</b>
Internal Auditor	53	10.95
Finance Officer	24	4.96
Branch Manager	163	33.68
Risk/Compliance Officer	29	5.99
Other (please specify)	215	44.42
<b>Total</b>	<b>484</b>	<b>100</b>

*(Source: Survey 2025)*

The respondents' current positions are varied, with Branch Managers comprising the largest group at 33.68% likely reflecting their key role in overseeing field operations and dealing with fraud risks firsthand. Internal Auditors represent 10.95%, and Risk/Compliance Officers make up 5.99% ensuring the data reflects firsthand insights from risk and audit perspectives. Finance Officers account for 4.96% of the participants who are involved in financial controls. Additionally, 44.42% hold other roles not specifically listed. This demonstrates a wide range of job roles, with many respondents occupying managerial positions in their organizations.

**Table 6**

*Experience Group*

<b>Years of Experience</b>	<b>Frequency</b>	<b>Percentage</b>
Less than 1 year	29	5.99
1–3 years	206	42.56
4–6 years	205	42.36
More than 6 years	44	9.09
<b>Total</b>	<b>484</b>	<b>100</b>

*(Source: Survey 2025)*

The respondents' years of experience indicate that most have a moderate level of professional exposure. Specifically, 42.56% have worked for 1 to 3 years, and 42.36% have 4 to 6 years of experience. Together, these groups make up over 84% of the sample. Those with less than 1 year of experience represent 5.99%, while 9.09% have more than 6 years. This shows that the majority of participants have a balanced mix of both new and more experienced professionals in their roles.

**Table 7**

*Proper Audit Department*

<b>Response</b>	<b>Frequency</b>	<b>Percentage</b>
Yes	435	89.88
No	28	5.79
Not sure	21	4.34
Total	484	100

*(Source: Survey 2025)*

The responses about the existence of a formal audit department indicate that most participants, 89.88%, reported having an established audit department within their organization. Meanwhile, 5.79% stated that no such department exists, and 4.34% were unsure. This implies that a large majority of organizations involved in the study have a structured audit function, which plays a crucial role in maintaining strong internal controls and preventing fraud.

**Table 8**

*Audit Frequency*

<b>Audit Frequency</b>	<b>Frequency</b>	<b>Percentage</b>
Monthly	9	1.86
Quarterly	34	7.02
Annually	357	73.76
Irregularly	84	17.36
Total	484	100

*(Source: Survey 2025)*

The data on audit frequency shows that most organizations conduct audits annually, with 73.76% of respondents indicating this schedule. Quarterly audits are reported by 7.02%, while 17.36% conduct audits irregularly. Only a small portion, 1.86%, perform audits

monthly. This suggests that annual audits are the most common practice among the organizations surveyed, with some variation in how frequently audits are carried out.

#### 4.2. Reliability Test

The reliability test is critical in determining the stability and consistency of a measurement equipment or research tool used in a study. This inspection is essential for ensuring the accuracy and authenticity of the collected data. Essentially, reliability refers to how well an instrument produces consistent data throughout time or under varying situations.

Cronbach's Alpha Reliability Test was used in checking the reliability of the data through SPSS software. Cronbach's alpha is a dependability (or consistency) coefficient, not a statistical test. Cronbach's alpha coefficients range from 0 to 1, with a value less than 0.60 indicating poor internal consistency reliability and a value in the range of 0.90 to 0.99 indicating strong internal consistency reliability. Cronbach's alpha should be 0.7 or higher, according to Nunnally (1978). Commonly accepted guidelines for interpreting Cronbach's alpha and results of reliability test results are:

Above 0.9: Excellent	0.8 – 0.9: Good
0.7 – 0.8: Acceptable	0.6 – 0.7: Questionable
0.5 – 0.6: Poor	Below 0.5: Unacceptable

A Cronbach's alpha above 0.7 has been the standard in social science research.

**Table 9**

*Cronbach's Alpha Score*

Study Variables	Number of item	Cronbach's Alpha
SC	5	0.760
CIA	5	0.819
IIA	5	0.846
AP	5	0.807
UT	4	0.858
FP	5	0.834

*(Source: SPSS)*

Table 9 explains the proper Cronbach's alpha score for each dependent and independent variable. As shown in the table, all six variables in this research exceeded the minimum threshold of 0.70, indicating acceptable to high internal consistency. The Scope of Internal Audit had an alpha of 0.760, suggesting that the items measuring this construct are relatively consistent. Similarly, Competence of Internal Audit and Independence of Internal

Audit reported alphas of 0.819 and 0.846, respectively, both of which indicate strong internal consistency among their items. Furthermore, Audit Planning and Execution had a Cronbach's Alpha of 0.807, while the Use of Technology in Auditing had a slightly higher alpha of 0.858, reflecting very good reliability. Finally, the dependent variable, Fraud Prevention, achieved an alpha value of 0.834, confirming that the items effectively measure the construct of fraud mitigation.

### 4.3.Descriptive Statistics

Descriptive analysis organizes and displays data to help identify general patterns and trends. It uses statistical tools such as averages, measures of central tendency, variation, and frequency distributions. In a research thesis, it provides a summary of participants' characteristics and main variables, serving as the groundwork for deeper statistical analysis.

**Table 10**

*Descriptive Statistics*

	Minimum	Maximum	Mean	Std. Deviation
SC	2.40	5.00	3.9413	.40518
CIA	2.20	5.00	3.7500	.52819
IIA	1.60	5.00	3.3368	.75355
AP	2.20	5.00	3.6500	.55495
UT	1.50	5.00	3.4334	.74477
FP	2.00	3.80	1.9252	.56078
Valid N (listwise)				

(Source: SPSS, N=484)

Results from Table 10 indicate that respondents generally expressed favorable views across the independent variables, with mean scores ranging from 3.34 to 3.94. The scope of internal audit again had the highest average score (M = 3.94, SD = 0.41), reflecting strong agreement on its significance within the organization. Competence (M = 3.75, SD = 0.53) and planning (M = 3.65, SD = 0.55) also received relatively high ratings. In contrast, fraud prevention scored the lowest mean (M = 1.93, SD = 0.56), indicating less favorable perceptions or a different response scale. The greatest variation was observed in independence (SD = 0.75) and use of technology (SD = 0.74), suggesting varied opinions among respondents in these areas. Overall, the descriptive statistics provide a comprehensive overview of participant responses, highlighting areas of consensus as well as differing perceptions related to internal audit functions and fraud prevention.

#### 4.4. Correlation Test

The correlation test is a statistical approach used to evaluate the degree and direction of the relationship between two continuous variables. In this study, it assesses how the independent factors such as internal audit scope, auditor competence, auditor independence, audit planning and execution, and the use of technology are associated with the ability to prevent fraud. Pearson's correlation coefficient ( $r$ ), which ranges from -1 to +1, is used to determine this relationship. A positive value implies that both variables increase together, while a negative value indicates an inverse relationship. This analysis helps determine whether improvements in internal audit practices contribute to enhanced fraud prevention.

**Table 11**

*Karl Pearson's Correlation Analysis between Variables*

	Variable	SC	CIA	IIA	AP	UT	FP
SC	Pearson Correlation	1					
	Sig. (2-tailed)						
CIA	Pearson Correlation	.266**	1				
	Sig. (2-tailed)	.000					
IIA	Pearson Correlation	.174**	.413**	1			
	Sig. (2-tailed)	.000	.000				
AP	Pearson Correlation	.288**	.401**	.413**	1		
	Sig. (2-tailed)	.000	.000	.000			
UT	Pearson Correlation	.309**	.414**	.504**	.578**	1	
	Sig. (2-tailed)	.000	.000	.000	.000		
FP	Pearson Correlation	.012	.136**	.078	.121**	.136**	1
	Sig. (2-tailed)	.799	.003	.087	.007	.003	

\*\* . Correlation is significant at the 0.01 level (2-tailed).

(Source: SPSS)

Table 11 shows the correlation results between various internal audit factors and fraud prevention. The scope of internal audit has almost no relationship with fraud prevention ( $r = 0.012$ ,  $p = 0.799$ ), suggesting that the breadth of audit activities does not directly impact fraud prevention in this study. However, competence, planning, and use of technology within internal audit display small but statistically significant positive correlations with fraud prevention. Competence and technology use both have a correlation of 0.136 ( $p = 0.003$ ), while planning shows a correlation of 0.121 ( $p = 0.007$ ). This indicates that higher

auditor skills, effective planning, and better use of technology are linked to stronger fraud prevention efforts. Independence also has a positive correlation ( $r = 0.078$ ) with fraud prevention, but this is not statistically significant ( $p = 0.087$ ), suggesting a weaker connection. Additionally, strong positive correlations exist among the internal audit variables themselves, such as competence and independence ( $r = 0.413$ ) and planning and technology use ( $r = 0.578$ ), indicating that these aspects tend to improve together. Overall, the results highlight the important role of internal audit quality in enhancing fraud prevention.

#### 4.5. Regression Test

Regression analysis is a statistical technique used to evaluate how various independent variables influence a single dependent variable. It helps in identifying the strength and significance of these influences. In this study, regression analysis is utilized to determine how different components of internal auditing - such as scope of audit, competence of internal auditor, independence of internal auditor, audit planning and execution and use of technology- affect the ability to prevent fraud in microfinance institutions. This method provides insights into the effectiveness of internal audit practices by highlighting which factors play a key role in reducing fraudulent activities (Gujarati & Porter, 2009).

**Table 12**

*Model Summary*

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.174 <sup>a</sup>	.030	.020	.55515

a. Predictors: (Constant), FP, SC, IIA, CIA, AP, UT

(Source: SPSS)

Table 12 reveals a positive association between the independent variables and the dependent variable, with an R value of 0.174. The R Square value of 0.030 means that 3.0% of the variation in the dependent variable is explained by the predictors. While this indicates a modest explanatory power, the model still offers valuable insights into the factors affecting the outcome. The Adjusted R Square of 0.020, which adjusts for the number of predictors, suggests the model maintains consistency. The standard error of 0.55515 reflects the average gap between predicted and actual values, highlighting opportunities for further improvement in future studies.

**Table 13***Analysis of Variance (ANOVAa)*

	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	4.578	5	.916	2.971	.012 <sup>b</sup>
	Residual	147.314	478	.308		
	Total	151.892	483			

a. Dependent Variable: FP

b. Predictors: (Constant), SC, IIA, CIA, AP, UT

*(Source: SPSS)*

Table 13 shows the ANOVA results testing the overall significance of the regression model. The regression sum of squares is 4.578, representing the variation in fraud prevention scores explained by five predictors: technology use, audit scope, competence, independence, and planning. The residual sum of squares is 147.314, indicating unexplained variation. With 5 degrees of freedom for regression and 478 for residuals, mean squares are 0.916 and 0.308, respectively. The F-value of 2.971 and a p-value of 0.012 (less than 0.05) indicate the model is statistically significant, confirming that these predictors collectively explain variations in fraud prevention effectiveness.

**Table 14***Coefficients of Regression Analysis for Dependent Variable*

Model		Unstandardized		Standardized		Sig.
		B	Std. Error	Beta	t	
1	(Constant)	1.448	.283		5.110	.000
	SC	-.076	.067	-.055	-1.136	.257
	CIA	.106	.056	.100	1.899	.058
	IIA	-.017	.041	-.022	-.411	.682
	AP	.054	.023	.053	2.298	.022
	UT	.069	.028	.092	2.466	.014

a. Dependent Variable: FP

*(Source: SPSS)*

Table 14 displays the regression results showing the influence of each independent variable on fraud prevention (FP). The constant value is 1.448, representing the expected fraud prevention score when all predictors are zero. Among the variables, Competence of Internal Audit (CIA) has a positive effect (B = 0.106) and is close to significance (p = 0.058). Audit Planning (AP) and Use of Technology (UT) have significant positive effects on fraud

prevention, with p-values of 0.022 and 0.014, respectively. A well-organized audit plan ensures thorough risk assessment and timely detection of irregularities. Likewise, the effective use of modern technology enhances the accuracy and efficiency of fraud detection efforts. However, Scope of Internal Audit (SC) and Independence of Internal Audit (IIA) show no significant influence, as their p-values exceed 0.05.

#### 4.6. Discussion

This research has examined the effectiveness of internal audit in preventing fraud in microfinance institutions by analyzing five core components: scope, competence, independence, audit planning, and use of technology. Internal audit is widely acknowledged as a key governance tool that enhances risk management and organizational controls. Theoretical frameworks emphasize that internal audits must be independent, competent, and adapt to changing environments to effectively detect and prevent fraud (Mihret & Yismaw, 2020).

The reliability of the dataset was confirmed using Cronbach's Alpha, with all values exceeding the threshold of 0.70, indicating consistent measurement (Tavakol & Dennick, 2011). Correlation results showed positive relationships between the independent variables and fraud prevention, with audit planning and use of technology particularly influential. This result is consistent with Adato (2022) who found that management-supported planning and quality of internal audit significantly improve fraud prevention in microfinance institutions.

The regression analysis revealed a statistically significant model ( $p = .012$ ), though the R Square value (.030) suggests limited explanatory power. Nevertheless, Audit Planning ( $p = .022$ ) and Use of Technology ( $p = .014$ ) had significant positive effects, supporting studies that identify structured audit processes and technological adoption as critical to fraud mitigation which is consistent in line with the review made by Yazid and Suryanto, (2024) and Pham and Nguyen (2022).

Competence of internal audit was nearly significant ( $p = .058$ ), indicating that skilled auditors can improve fraud control. This aligns with the findings from Ta and Doan (2022), Joshi (2021), and Karyawati (2021), who emphasize that auditor competence and interaction with the audit committee significantly enhance audit effectiveness. The scope and independence of internal audit were not significant predictors in the study which disagree from the research by Lonto et al. (2023) and Chevers et al. (2021). These two

research has highlighted that the independence of internal auditor is the key factor in fraud detection.

Further analysis of the unstandardized coefficients shows that Audit Planning and Use of Technology positively contribute to fraud prevention, demonstrating that organizations with better planning and advanced technological tools are more effective at identifying irregularities early which align with Adato (2022). On the other hand, the negative coefficient for scope suggests that merely expanding audit coverage without focus or adequate resources may dilute effectiveness which contrasts with Hazaea et al. (2024), who found that audit practices positively influence the bank's performance in commercial banking contexts. The non-significant role of independence could indicate challenges in enforcing auditor autonomy in some microfinance contexts, limiting its practical impact.

Furthermore, the integration of technology in auditing is evolving rapidly. Technologies such as data analytics, continuous monitoring systems, and artificial intelligence provide auditors with enhanced tools to detect irregularities early. The positive impact of technology also aligns with Patel et al. (2021), emphasizing that digital tools, data analytics, and continuous monitoring enhance internal audit effectiveness. Microfinance institutions that invest in these technologies can achieve more proactive and efficient fraud prevention. However, successful technology adoption requires not only financial investment but also the training of audit staff to utilize these tools effectively.

Overall, these findings confirm that robust audit planning and technological tools are most influential factors for effective fraud prevention in microfinance institutions aligning with several empirical findings from Yazid and Suryanto (2024), Pham and Nguyen (2022) and Adato (2022). Continuous development of audit capabilities and investment in digital tools are recommended to enhance internal controls and safeguard organizational integrity.

## CHAPTER V

### SUMMARY AND CONCLUSION

This chapter provides a comprehensive overview of the study by summarizing the key findings, drawing conclusions based on the analysis, and discussing the practical implications for microfinance institutions. It aims to highlight the contributions of the research and offer recommendations for enhancing the effectiveness of internal audits in preventing fraud.

#### **5.1. Summary**

This study explored the role and effectiveness of internal audit functions in preventing fraud within microfinance institutions. The research was grounded in the recognition that fraud poses a significant threat to financial organizations and that robust internal audit mechanisms are essential for strengthening governance, risk management, and control processes. The study concentrated on five key dimensions of internal auditing: scope, competence, independence, audit planning, and the use of technology. These components were selected based on existing theoretical frameworks that emphasize their importance in fostering audit quality and enhancing fraud detection and prevention.

The main objective of this study was to assess the effectiveness of internal audit in preventing fraud in microfinance companies in Nepal. Through the study we can summarize that the certain components of internal audit were directly related with the fraud prevention. It also sought to provide actionable recommendations for auditors, management, and policymakers interested in strengthening internal audit practices to combat fraud more effectively.

To achieve this, the study was designed to collect and survey the perceptions and insights from professionals working within microfinance organizations. The research design involved here is the descriptive and casual research design to explore and assess the effectiveness of internal audit in preventing fraud in MFIs. Additionally, the increasing adoption of technology in auditing was considered vital, reflecting contemporary trends that emphasize data analytics, continuous monitoring, and automation as enablers of more effective fraud detection.

The analysis was conducted by performing the survey in the microfinance companies that assess the relationships among the internal audit components and their impact on fraud

prevention. The study's theoretical underpinning aligns with broader governance and control theories, which assert that internal audit functions must be well-structured, dynamic, and supported by organizational culture to fulfill their intended role. Independence of auditor is further categorized under independence of mind and independence of appearance as per the Nepal Standard on Auditing.

Throughout the research process, several challenges were encountered that are common in studies of this nature. The complexity of fraud as a hidden and evolving phenomenon poses inherent difficulties in measurement and assessment. Moreover, gaining accurate insights from respondents about fraud prevention practices can be sensitive, given the potential reputational risks involved within the peer organization. The study also recognizes the limitations inherent in focusing exclusively on microfinance institutions, which may have distinct characteristics compared to other financial entities. There are also certain limitations of audit which have an impact in fraud detection and prevention within the organization. Strong audit planning and the integration of technology are essential to modern fraud prevention, while auditor competence remains a crucial human element that supports these efforts.

The correlation analysis showed that internal audit components were positively related to fraud prevention, with competence of internal audit, audit planning and use of technology showing stronger associations at 0.01 level of significance. Regression analysis further confirmed that these two variables had significant positive effects on fraud prevention, while competence was nearly significant. Scope and independence did not show a strong influence, indicating a need for better institutional support.

ANOVA results confirmed the overall model was statistically significant, validating the relationship between internal audit practices and fraud prevention. Although the explanatory power was modest, the findings clearly suggest that strong audit planning and the use of technology are key drivers of fraud control in microfinance institutions.

In conclusion, this study highlights the need for microfinance institutions to develop comprehensive internal audit frameworks that emphasize strategic planning, skill enhancement, and technological advancement. By doing so, these organizations can build more resilient defenses against fraud and promote greater transparency and trust. The findings provide a theoretical and practical foundation for future research and for

policymakers aiming to improve fraud prevention strategies through enhanced internal auditing.

## 5.2. Conclusion

This study explored the role of internal audit in preventing fraud within Nepalese microfinance institutions, with a focus on five key components as discussed earlier. The results highlight that while internal audit functions are present in most microfinance institutions, not all elements contribute equally to fraud prevention. The research confirms that effective internal audit mechanisms are essential tools in strengthening institutional integrity and reducing fraudulent activities.

The first objective was to assess the factors that affect internal audit in preventing fraud in microfinance companies. The study revealed that audit planning and the use of technology had the most significant influence. Regression results showed that audit planning ( $p = 0.022$ ) and use of technology ( $p = 0.014$ ) were statistically significant predictors of fraud prevention. This indicates that structured audit procedures and digital tools help improve fraud detection and enhance preventive mechanisms within microfinance operations.

The second objective was to examine the relationship between internal audit effectiveness and fraud prevention. Correlation analysis demonstrated that out of five components, three components had positive relationship with fraud prevention, although the strength varied. This relationship underscores the importance of equipping auditors with modern tools and methods to identify and mitigate fraud risks in real time.

The third objective aimed to analyze the overall effect of internal audit on fraud prevention. The regression model as explained in the analysis of variance (Anova) was statistically significant with  $p$  value of 0.012 (less than 0.05), confirming that internal audit practices do play a measurable role. However, the R-square value (0.030) suggests that while the model is valid, internal audit alone may not explain all variations in fraud prevention outcomes. Nevertheless, competence of auditors ( $p = 0.058$ ) was nearly significant, implying that enhancing auditor skills could improve overall effectiveness.

In conclusion, the analysis confirms that internal audit, especially when driven by well-structured planning and technology, is crucial for reducing fraud in microfinance institutions. Institutions should invest in auditor training, digital use of technology, and strategic audit planning to strengthen fraud prevention frameworks. Although scope and

independence did not show significant impact, their importance may depend on organizational support and internal governance, which could be explored in future research.

### **5.3.Implications**

The results of this study on internal audit effectiveness in fraud prevention offer several important implications for different stakeholders. These insights can support improvements in governance, risk management, and internal control mechanisms across Nepalese microfinance institutions.

#### **For Policymakers**

- Develop the standard audit planning protocols which will help ensure a consistent and structured approach to risk-based auditing.
- Encourage technological integration in auditing by providing guidelines, incentives, or digital infrastructure support which can improve transparency and fraud detection capabilities.
- Establish mandatory qualification criteria and continuous learning requirements for internal auditors to enhance their professionalism and effectiveness.

#### **For Internal Auditors**

- Strengthen audit planning techniques and implement comprehensive and risk focused audit plan that help to detect the fraud in the microfinance.
- Adopt technology driven audit tools like data analytics and audit management software which helps to detect irregularities happening in the microfinance.
- Pursue various skill development training to stay align with evolving audit standards and fraud patterns.

#### **For Microfinance Institutions**

- Establish a dedicated internal audit department to perform regular audit as well as surprise audit if required.
- Provide different level of training needed for internal audit team as required.
- Ensure audit independence and maintain the objectivity and autonomy of internal auditors by providing a supportive structure which is free from external influence or pressure.

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## APPENDIX

### Survey Questionnaire

**Research Topic:** Effectiveness of Internal Audit in Preventing Fraud in Microfinance Companies

Dear Respondent,

This questionnaire is designed to assess the role and effectiveness of internal audits in preventing fraud in microfinance institutions. Your responses will remain confidential and used solely for academic purposes.

### Demographic Information

#### 1. Gender:

- a) Male
- b) Female
- c) Other

#### 2. Age Group:

- a) Below 25 years
- b) 25–34 years
- c) 35–44 years
- d) 45–54 years
- e) 55 years and above

#### 3. Educational Qualification:

- a) Intermediate (10+2)
- b) Bachelor's Degree
- c) Master's Degree
- d) Professional Qualification (e.g., CA, ACCA)
- e) Other (please specify): \_\_\_\_\_

#### 4. Current Position in the Organization:

- a) Internal Auditor
- b) Finance Officer
- c) Branch Manager
- d) Risk/Compliance Officer

e) Other (please specify): \_\_\_\_\_

**5. Years of Experience in the Microfinance Sector:**

- a) Less than 1 year
- b) 1–3 years
- c) 4–6 years
- d) More than 6 years

**6. Does your organization have a dedicated internal audit department?**

- a) Yes
- b) No
- c) Not sure
- d) Prefer not to answer

**7. How frequently are internal audits conducted in your organization?**

- a) Monthly
- b) Quarterly
- c) Biannually
- d) Annually
- e) Irregularly

**8. Who does the internal audit department report to?**

- a) General Manager/CEO
- b) Board of Directors
- c) Audit Committee
- d) Other (please specify): \_\_\_\_\_

**Scope of Internal Audit**

**9. Internal audit covers all the significant operational and financial area suspected to fraud.**

- a) Strongly Disagree

- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**10. Internal audit regularly reviews the effectiveness of internal controls designed to prevent fraud.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**11. The internal audit function has access to all necessary information and departments to conduct comprehensive fraud assessments.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**12. Scope of internal audit increases as certain fraud is being observed in some specific areas of microfinance.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**13. The scope of the internal audit is flexible and can be adjusted to effectively address and respond to emerging and evolving fraud risks within the organization.**

- a) Strongly Disagree

- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

### **Competence of Internal Audit**

**14. Internal auditors possess sufficient knowledge and expertise in fraud detection and prevention.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**15. Internal audit team receives regular training and seminar for identification of emerging fraud cases in microfinance.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**16. Internal auditors have a good understanding and knowledge regarding operation of business in microfinance and its related fraud risk.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**17. Internal audit department have adequate resources to effectively identify and combat the fraud related activities.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**18. Internal auditors are able to effectively communicate their findings and recommendations related to fraud risks.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

#### **Independence of Internal Audit**

**19. Internal auditors are influenced by management or other departments when conducting their work**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**20. Internal audit conclusions are regarding fraudulent activities of microfinance are made very objectivity and transparently.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**21. Internal audit has unrestricted access to all records, personnel, and physical properties relevant to their audits**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**22. Internal audit has the authority to communicate directly with external auditors and regulators without management's pre-approval.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**23. There are proper organizational structures and policies in place to ensure the independence of auditors from management influence**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

#### **Audit Planning and Execution**

**24. The internal audit plan is regularly updated to reflect new or emerging fraud risks.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**25. Internal audit uses a risk-based approach to prioritize audit areas for fraud detection.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**26. The internal audit team effectively manages its time and resources during audits to focus on key fraud risks.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**27. Internal auditors effectively interview staff and management to gather information on potential fraud.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**28. Risk assessment is a key and integral part of the audit planning process to identify areas vulnerable to fraud.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

### **Use of Technology in Auditing**

**29. Internal audit utilizes data analytics tools to identify large set of data of microfinance.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**30. The use of technology enhances the efficiency and effectiveness of internal audit's fraud prevention efforts.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**31. Internal audit updates its technology often to keep up with new ways of committing fraud.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**32. Real-time monitoring tools and techniques are integrated into the audit process to promptly detect and address fraudulent activities.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree

e) Strongly agree

### **Fraud Prevention**

**33. There are clear rules and procedures in place to prevent fraud in my organization.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**34. The work done by internal auditors helps in finding and reducing fraud.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**35. The management takes fraud cases seriously and responds quickly.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**36. Surprise checks and reviews are done often to reduce the chances of fraud.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

**37. All staff attend regular training sessions on how to recognize, prevent and report fraud.**

- a) Strongly Disagree
- b) Disagree
- c) Neutral
- d) Agree
- e) Strongly agree

PAPER NAME

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PREVENTING FRAUD IN MICROFINANCE  
COMPANIES**

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