

# The Role Of Audit Committees In Strengthening Governance And Risk Management In Banks: Evidence From Nepal

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## Abstract

*Corporate governance and risk management are both critical for the effectiveness and sustainability of banking and financial institutions. Audit Committees play a vital role in risk oversight, ensuring financial integrity and contributing to the overall stability of banking institutions. They are responsible for overseeing financial reporting, ensuring regulatory compliance, and monitoring risk management mechanisms. This study investigates the impact of Audit Committees on governance and risk management practices within Nepalese banks.*

*The research utilizes secondary data from annual reports and directives issued by Nepal Rastra Bank. Through the application of Confirmatory Factor Analysis and multiple regression models, the study reveals a positive relationship between the role of the Audit Committee and key risk management factors. A proactive approach to risk assessment by the committee emerges as a significant contributor to effective risk governance. The study also identifies areas for policy improvement, emphasizing the need for stronger integration of audit oversight into risk-related decision-making processes.*

*This study adds to the limited empirical literature on corporate governance in the South Asian banking system. Strengthening the independence, accountability, and technical capability of audit committees is necessary to improve institutional resilience and restore stakeholder confidence in the banking sphere.*

**Keywords:** Audit Committee; Corporate Governance; Risk Management; Internal Control; Board Oversight; Nepalese Banking Sector; Regulatory Compliance; Financial Reporting; Operational Risk; Emerging Markets.

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## 1. INTRODUCTION

The modern banking environment is fraught with uncertainty. Because of the volatile landscape, the requirement for robust internal governance mechanisms has increased. The Audit Committee is an important part of corporate governance. The integrity and stability of banking establishments are ensured by the oversight of the Audit Committee, which is a crucial supporting committee of the board of directors [1].

Governance and audit oversight failures were exposed by the Silicon Valley Bank collapse. The Sarbanes-Oxley Act was enacted in the United States. The model not only mandated the formation of audit committees but also emphasized their independence. The Basel committee of banking supervision (BCBS) urged banks to give Audit Committees the authority to challenge decisions [2].

The principles of corporate governance emphasize that audit committees reduce agency conflict, enhance transparency, and promote long-term assurance of stakeholders [3][7]. As corporate governance evolved globally, the function of Audit Committees expanded to include ethical oversight, strategic evaluation, and reputational risk management. Domestic governance practices in Nepal are being aligned with international standards.

The audit committees of financial institutions in Nepal must be composed of non-executive board members. The committees are tasked with regular review and monitoring of internal audits, compliance protocols, budgetary allocation, and risk control. The Nepal Rastra Bank's Unified Directives allow Audit Committees to enforce regulatory measures and ensure alignment with institutional goals [4]. However, practical implementation lags behind regulatory intent due to limited institutional capacity.

Some cases where Audit Committees failed to take corrective action on audit remarks, did not adequately oversee high-risk portfolios, or lacked financial or regulatory expertise have been cited in NRB's report [5]. A lack of tenure protection in several banks has eroded the independence of Audit Committees. Post-merger integration issues are complicating their effectiveness. Concerns have been raised about governance and risk in the Nepalese banking sector.

Academic research supports the relationship between Audit Committees and improved risk management outcomes. Gulzar et al. concluded that Audit Committees with diverse expertise reduced operational and credit risks [6]. Similarly, Basuony et al. found that financial institutions with Audit Committees experienced fewer financial irregularities [1]. However, there is limited empirical literature available in the context of Nepal.

The idea that effective Audit Committees serve a broader set of stakeholders is supported by stakeholder theory. Ensuring ethical behavior, proper disclosure, and internal control are among the core responsibilities of Audit Committees. Weak Audit Committee oversight can lead to profit misstatements [8]. The risk management role of Audit Committees has become increasingly strategic in the face of cyber threats [9].

The 2008 financial crisis was attributed to poor corporate governance [10]. It was pointed out that Audit Committees failed to question management decisions. There is a growing need for further research on Audit Committees in developing countries.

The survey will examine the function of Audit Committees in the improvement of governance and risk management in Nepalese banks. Information from public disclosures and regulatory reports is combined into a single dataset. The Audit Committee's impact on the risk management component is investigated using Confirmatory Factor Analysis and multiple regression analysis.

State-owned, foreign equity, and private institutions face different governance challenges within Nepal's banking system. The role of the Audit Committee is becoming more central as more banks undergo structural changes due to mergers. By examining Audit Committee effectiveness across ownership models and levels of institutional maturity, this study offers empirical insights that are relevant to both academic discourse and policy intervention.

## **2. LITERATURE REVIEW**

Corporate governance and risk management are intertwined disciplines in the regulatory landscape of banking institutions. The internal control system and risk management practices of financial institutions are overseen by the Audit Committee. Key global and regional studies are explored in the literature review.

### **2.1 Global Understanding of Audit Committees**

The function of Audit Committees has evolved significantly, positioning them as key players in ensuring risk oversight, financial integrity, and the overall stability of banking institutions. Their responsibilities span from strategic risk oversight to detailed operational review [11]. Regulatory reforms such as the Sarbanes-Oxley Act in the United States and similar initiatives across Europe have institutionalized the role of Audit Committees within corporate governance structures.

According to the Basel Committee on Banking Supervision (BCBS), Audit Committees should consist of competent members who possess the expertise to effectively oversee financial disclosures, ensure regulatory compliance, and assess risk management frameworks [2]. In this capacity, Audit Committees not only strengthen internal controls but also foster a culture of transparency and accountability within organizations [12][13]. Furthermore, their independence and objectivity are essential in maintaining investor confidence and enhancing institutional resilience against financial and operational risks.

## **2.2 Risk Management in Corporate Governance**

Governance involves more than regulatory compliance—it integrates strategic risk management to ensure long-term sustainability and value creation. It emerged as a response to business failures and a broader dissatisfaction with the way many firms operate [9]. Effective corporate governance requires identifying, evaluating, and mitigating various types of risk, including financial, operational, compliance, reputational, and especially in today's context, cybersecurity threats.

Banks, in particular, must understand how different types of risk—such as credit risk, market risk, and operational risk—interact with investment strategies and affect both the company's performance and shareholder value [7]. Risk management is thus integral to sustainable decision-making.

In the era of rapid digital transformation, organizations face an increasing threat from cyberattacks, making it imperative for Audit Committees to assess financial integrity and engage in robust strategic risk assessments [14]. Risk-taking is acknowledged as an inherent component of governance structures; therefore, the emphasis is not on eliminating risk, but on ensuring it is well-understood and properly managed [16].

The 2008 global financial crisis serves as a critical example where effective audit oversight could have mitigated institutional failures. Audit Committees that were active and risk-aware during this period supported better financial resilience, while weak governance—characterized by limited risk foresight and ineffective audit mechanisms—was linked to catastrophic collapses of major financial institutions [17].

Ultimately, the role of risk management in corporate governance is evolving to accommodate complex global challenges, requiring a forward-looking and integrated approach to boardroom decision-making.

## **2.3 Audit Committees in Emerging Economies**

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Recent studies underscore the evolving role of Audit Committees in addressing emerging risks. For instance, a 2023 report by the Center for Audit Quality highlights that cybersecurity has become a top priority for Audit Committees, with 62% having primary oversight of cybersecurity risk [18]. Additionally, the Federal Deposit Insurance Corporation (FDIC) proposed guidelines in 2023 establishing standards for corporate governance and risk management, emphasizing the importance of Audit Committees in overseeing risk management frameworks [19].

Ultimately, the role of risk management in corporate governance is evolving to accommodate complex global challenges, requiring a forward-looking and integrated approach to boardroom decision-making.

## 2.4 The Nepalese Context

Research on corporate governance and risk management within the Nepalese banking sector remains limited. Thapa et al. [15] identified structural weaknesses in governance practices, particularly highlighting inconsistencies in Audit Committee (AC) independence and a lack of implementation of audit recommendations. In many institutions, the role of the AC remains largely ceremonial, with minimal influence over core decision-making processes.

Recent empirical studies have further examined the impact of corporate governance attributes on risk management practices. Dhital et al. [20] found that larger audit committees and the presence of risk management committees are associated with lower non-performing loans and operational risks in Nepalese commercial banks. This suggests that enhancing the size and functionality of these committees can contribute to more effective risk oversight. Nepal Journals Online

Similarly, Nepali [21] demonstrated that increased frequency of audit committee meetings correlates with improved bank performance and reduced risk-taking behavior. This underscores the importance of active and engaged audit committees in promoting financial stability. RII Open Journals

Furthermore, Hada [22] highlighted that board diligence, characterized by regular meetings and active participation, significantly affects the level of non-performing loans, indicating a direct link between governance practices and risk management outcomes. Nepal Journals Online

These findings collectively emphasize the critical role of robust and independent audit committees in enhancing risk governance within Nepalese financial institutions. Strengthening the structure and function of these committees, along with ensuring their active engagement in oversight activities, can lead to more effective risk management and improved financial performance.

**Table 1: Comparative Summary of Key Literature**

Study / Source	Context / Country	Focus Area	Key Findings	Relevance
Bender [11]	UK / Global	AC and risk boundary	AC acts between board and operational risk	Conceptual framing

BCBS [2]	Global	Governance standards	Recommends AC independence, skill, risk monitoring	Regulatory framework
OECD [13][7]	Global	Governance principles	AC crucial to disclosure and accountability	Policy basis
Gulzar et al. [6]	Pakistan	Empirical – risk reduction	AC effectiveness linked to credit/operational risk reduction	Emerging market evidence
Basuony et al. [1]	Gulf Region	Empirical – performance	ACs improve profitability, reduce fraud	Performance impact
Al-Baidhani [8]	Middle East / Global	Descriptive study	Culture, independence affect AC outcomes	Implementation constraints
Caraiman & Mates [9]	Europe	Governance– Risk link	Strategic role of AC in risk governance	Digital/strategic alignment
Kirkpatrick [14]	OECD / Global	Governance failure	Weak ACs central to 2008 crisis	Crisis cause and reform need
Thapa et al. [15]	Nepal	Governance structures	ACs exist but often ineffective in practice	Local empirical gap

## 2.5 Literature Gaps

There is a significant body of research on the role of Audit Committees in governance, but limited evidence from the Nepalese banking context. There is a clear need for studies that:

- Quantify the correlation between Audit Committee actions and risk outcomes.
- Examine structural and institutional factors affecting Audit Committee effectiveness.
- investigate how audit oversight is used to enforce regulation.

Structured primary data and statistical methods are necessary to examine the impact of Audit Committees on risk management in Nepalese banks.

## 3. RESEARCH OBJECTIVES

- To assess the role of audit committees in enhancing corporate governance in Nepalese banks.

- To examine the impact of audit committee effectiveness on the risk management framework.

#### **4. RESEARCH METHODOLOGY**

The inquiry design, information aggregation procedure, sampling technique, and statistical methods used to examine the function of the Audit Committee are outlined in this subdivision.

##### **4.1 Research Design**

Both primary and secondary information sources are integrated into the inquiry design. The intent of the survey is to evaluate the relationship between the Audit Committee and the Risk Management Factor. The possibility is tested using indexes derived from a questionnaire in the analysis.

##### **4.2 Population and Sampling**

The survey universe includes all the licensed commercial banks in Nepal. Size, structure, and years of operation were used in the sampling framework. The sample population was selected from 10 commercial banks to represent a cross-section of the Nepalese banking sector.

- Rastriya Banijya Bank Ltd. (RBB)
- Nabil Bank Ltd. (NABIL)
- Nepal SBI Bank Ltd. (NSBI)
- Everest Bank Ltd. (EBL)
- Machhapuchhre Bank Ltd. (MBL)
- Kumari Bank Ltd.
- Laxmi Sunrise Bank Ltd.
- Agriculture Development Bank Ltd. (ADBNL)
- Citizens Bank International Ltd.
- Sanima Bank Ltd.

The sample distribution size for 1,020 professionals was determined using the Cochran formula. A total of 221 valid responses were obtained from the risk management and credit departments.

##### **4.3 Data Collection Methods**

###### **4.3.1 Primary Data**

The primary information was collected using a structured questionnaire. Respondents were senior-level personnel in credit and risk departments. The instrument incorporated multiple types of questions:

- Likert-scale items (5-point scale)
- Multiple-choice and rating-based questions
- Direct opinions on Audit Committee performance

The primary constructs measured were:

- The function of directors in the Audit Committee
- RMF: Risk mitigation, strategic alignment, and reporting quality

This approach ensured comprehensive insight into the perceptions and evaluations of Audit Committee functions from relevant professionals.

#### 4.3.2 Secondary Data

Secondary data was obtained from:

- Published annual reports of the selected banks
- Audit and risk disclosures on bank websites
- NRB directives, supervision reports, and financial stability bulletins
- Scholarly articles and prior empirical studies

These sources helped triangulate the findings and contextualize the primary data within the broader regulatory and institutional framework.

**Table 2: Research Variables**

Variable	Type	Indicators
ROAC (Role of Audit Committee)	Independent	Board involvement in risk, internal audit review, director expertise
RMF (Risk Management Factor)	Dependent	Identification and mitigation of credit, liquidity, and operational risks

#### 4.4 Data Analysis Techniques

The collected data was analyzed using:

- SPSS v25 for descriptive statistics and correlation analysis
- Confirmatory component analysis was done using AMOS
- The role of ROAC (Role of Audit Committee) was determined by multiple linear regression

Regression Model:

$$\begin{aligned} \text{RMF} &= \beta_0 + \beta_1(\text{ROAC}) + \beta_2(\text{OS}) + \beta_3(\text{CEOT}) + \epsilon_{\text{RMF}} \\ &= \beta_0 + \beta_1(\text{ROAC}) + \beta_2(\text{OS}) + \beta_3(\text{CEOT}) + \epsilon \end{aligned}$$

Where:

- ROAC = Role of Audit Committee
- OS = Ownership Structure
- CEOT = CEO Tenure
- RMF = Risk Management Factor
- $\epsilon$  = Error term

Significance of relationships was evaluated using critical ratio (C.R.), p-values, and standardized estimates in SEM outputs. All items in the ROAC construct and RMF were validated with satisfactory CFA loading values ( $r > 0.5$ ).

#### 4.5 Reliability and Validity

- Cronbach's Alpha was used to confirm the consistency of the items
- The model fit indices were used to confirm the validity of the construct
- The face and content validity were verified by banking governance experts

### 5. RESULTS AND DISCUSSION

This section presents the analytical results obtained through CFA (Confirmatory Factor Analysis) and multiple regression modeling, based on primary data collected from 221 respondents across 10 commercial banks in Nepal. These results provide empirical insights into the relationship between the Role of Audit Committee (ROAC) and the Risk Management Factor (RMF) in the Nepalese banking sector.

#### 5.1 Confirmatory Factor Analysis (CFA)

To validate the constructs of ROAC and RMF, CFA was applied to Likert-scale items. Each item's loading coefficient ( $r$ ) and squared correlation ( $r^2$ ) reflect how well it represents the underlying construct.

##### ROAC Construct

As shown in Table 3, items Q\_13 and Q\_14 demonstrated high loading values (0.80 and 0.73, respectively), indicating a strong contribution to the audit committee's effectiveness construct. Items Q\_15 and Q\_16, though having slightly lower loadings, still fall within the acceptable range for construct validity. These results confirm the internal consistency and relevance of the ROAC indicators.

Item	Description	CFA Loading ( $r$ )	$r^2$
Q_13	BOD involvement reduces liquidity risk	0.8	0.63
Q_14	BOD involvement reduces credit risk	0.73	0.54
Q_15	Professional directors reduce operational risk	0.51	0.26
Q_16	Directors lead to robust risk practices	0.45	0.2

Table 3: CFA Loadings for ROAC Items

##### RMF Construct

The critical function of regular rating of risk models by the audited account committee was highlighted by the highest loading value. Q\_11 and Q\_10 also showed moderate to strong loadings, indicating their relevance in explaining the Risk Management Factor (RMF).

Item	Description	CFA Loading ( $r$ )	$r^2$
Q_10	Audit committee's proactive risk identification	0.52	0.27
Q_11	Effective risk communication	0.58	0.34
Q_12	Evaluation of risk framework effectiveness	0.83	0.69

Table 4: CFA Loadings for RMF Items



## 5.2 Regression Analysis

A regression model was used to assess the impact of ROAC. The four audited account committee indicators were evaluated using estimate values, standard errors, critical ratios (C.R.), and p-values.

Path	Estimate	Std. Error	Critical Ratio (C.R.)	Significance (p)
Q_14 < ROAC	1	,Äi	,Äi	,Äi
Q_13 < ROAC	1.073	0.141	7.596	<0.001
Q_16 < ROAC	0.526	0.094	5.628	<0.001
Q_15 < ROAC	0.658	0.104	6.332	<0.001

Table 5: Regression Weights for ROAC Construct Items

### Key insights:

- The central function that Q\_13 and Q\_14 play in reducing recognition risk has been confirmed.
- All items were statistically significant at  $p < 0.001$ , confirming their meaningful contribution to the regression model.

## 5.3 Visual Figures

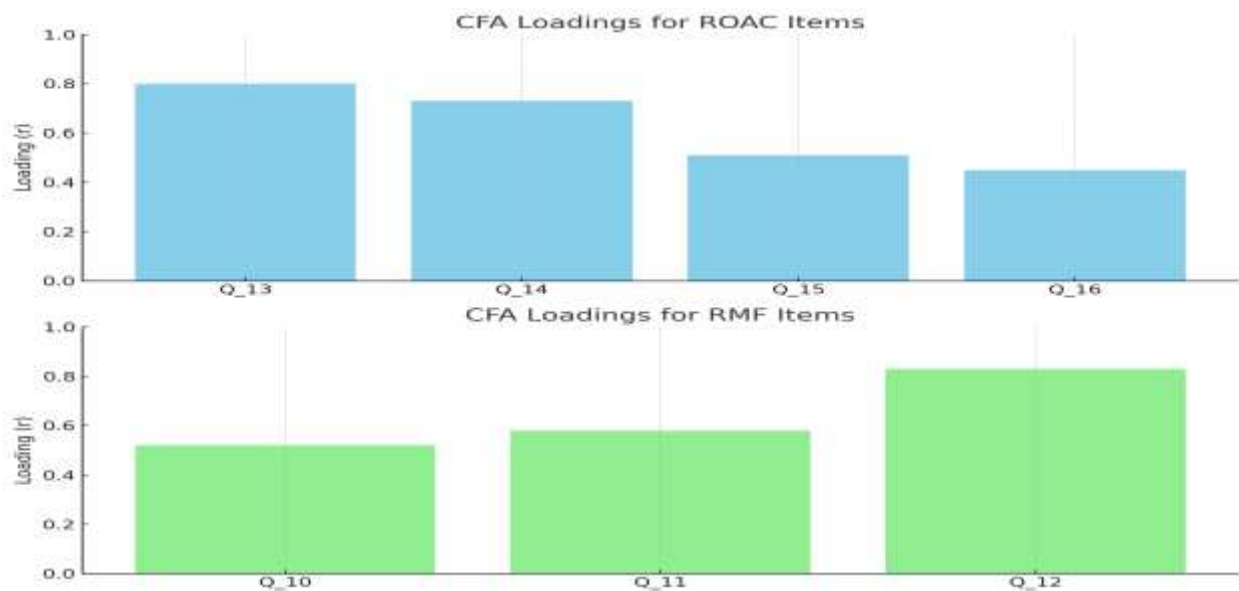
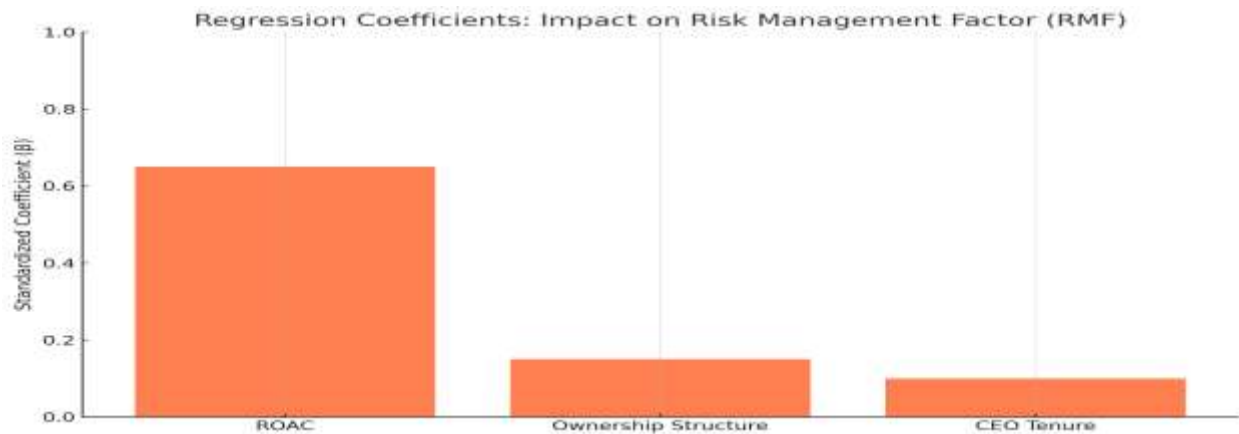


Figure 1: CFA Loadings for ROAC and RMF Constructs

The most important index for their respective concept is shown in the figure 2.



**Figure 2: Regression Coefficients Influencing RMF**

This figure illustrates the standardized regression coefficients. The possession structure and CEO tenure have minimal personal effects on the dependent variable.

#### 5.4 Summary of Empirical Insights

There is a summary in Table 4.

Construct	Key Indicators	Statistical Findings	Implications
ROAC	Q_13, Q_14	High loadings ( $r > 0.7$ )	Strong board engagement reduces liquidity and credit risk
RMF	Q_12	Highest loading ( $r = 0.83$ )	ACs evaluating risk frameworks improve institutional resilience
Regression	ROAC, Üi RMF	$p < 0.001$	Statistically significant positive impact

**Table 4: Summary of Key Empirical Insights**

Highlights include:

- Strong board engagement significantly mitigates credit and liquidity risks.
- Systematic risk management model rating has improved institutional resiliency.
- The regression analysis shows that ROAC is a positive predictor of risk management effectiveness.

## 6. CONCLUSION AND POLICY IMPLICATIONS

### 6.1 Conclusion

The intent of the survey was to explore the function and role of the audit committee in enhancing risk management practices. The research examined the concept of the Role of Audit Committee (ROAC) and the Risk Management Factor (RMF) from both primary and regulatory sources.

There is a positive relationship between audit committee effectiveness and risk governance outcomes. Specifically:

- The crucial function of board engagement in financial oversight is emphasized by the high component load of the ROAC index.
- The strongest indicator of institutional resiliency was found in the RMF index.
- Audit committee performance is the most important predictor of risk management quality, according to the regression model.

Audited account committees have direct strategic influence and are more than just compliance tools. Their performance significantly affects policies related to risk and overall governance outcomes in the banking sector.

## 6.2 Policy Implications

The following policy recommendations are derived from the study's empirical findings and aim to strengthen governance and risk management through a more effective audit committee:

1. **Strengthen Audit Committee Independence:** Regulator should strictly enforce existing regulatory provisions to ensure the audit committee's independence from executive influence. The qualifications and experience of non-executive directors must be clearly defined, and the performance of the audit committee should be regularly assessed to reinforce its oversight role in governance and risk control.
2. **Enhance Technical Capacity and Training:** To support informed decision-making, the audit committee should receive specialized training in financial reporting, regulatory compliance, and risk modelling. Establishing a centralized certification program would help standardize core competencies across the banking sector and directly contribute to better risk governance.
3. **Institutionalize Performance Audits of the Audit Committee:** The audit committee itself should be subject to structured annual evaluations. Implementing peer reviews and independent third-party audits can improve its operational transparency and ensure alignment with governance and risk oversight best practices.
4. **Promote Transparent Disclosures:** Proceedings and decisions of the audit committee should be disclosed in the bank's annual report. Transparent reporting enhances stakeholder confidence and supports accountability in financial governance and risk management.
5. **Integrate the Audit Committee into Strategic Risk Planning:** The audit committee should be actively involved in strategic functions such as capital allocation, stress testing, and enterprise risk assessments. This integration ensures that risk oversight is embedded in key governance processes, enabling a forward-looking and resilient organizational framework.

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