

**NEPAL STANDARD ON AUDITING 250**  
**CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF**  
**FINANCIAL STATEMENTS**

(Effective for audits of financial statements for periods beginning on or after  
01 Shrawan 2065 corresponding to 17 July 2008.)

**CONTENTS**

	Paragraphs
Introduction .....	1-8
Responsibility of Management for the Compliance with Laws and Regulations. ....	9-10
The Auditor’s Consideration of Compliance with Laws and Regulations.....	11-31
Reporting of Noncompliance .....	32-38
Withdrawal from the Engagement .....	39-40
Compliance with International Standards on Auditing.....	41
Effective Date .....	42
Appendix: Indications that Noncompliance may have occurred	

Nepal Standard on Auditing (NSA) 250, “Consideration of Laws and Regulations in an Audit of Financial Statements” should be read in the context of the “Preface to the Nepal Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the application and authority of NSAs.

## Introduction

1. The purpose of this Nepal Standard on Auditing (NSA) is to establish standards and provide guidance on the auditor's responsibility to consider laws and regulations in an audit of financial statements.
2. **When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements.** However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.
3. The term "noncompliance" as used in this NSA refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by its management or employees. For the purpose of this NSA, noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity's management or employees.
4. Whether an act constitutes noncompliance is a legal determination that is ordinarily beyond the auditor's professional competence. The auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute noncompliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute noncompliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.
5. Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations of this country determine the form or content of an entity's financial statements or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are only subject to the many laws and regulations that generally relate to the operating aspects of the business (such as those related to occupational safety and health and equal employment). Noncompliance with laws and regulations could result in financial consequences for the entity such as fines, litigation, etc. Generally, the further removed noncompliance is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of it or to recognize its possible noncompliance.

6. Nepal accounting and auditing standards are likely to be more specific as to the relevance of laws and regulations to an audit.
7. This NSA applies to audits of financial statements and does not apply to other engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.
8. Guidance on the auditor's responsibility to consider fraud and error in an audit of financial statements is provided in NSA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements."

### **Responsibility of Management for the Compliance with Laws and Regulations**

9. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management.
10. The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of noncompliance:
  - Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
  - Instituting and operating appropriate internal control.
  - Developing, publicizing and following a code of conduct.
  - Ensuring employees are properly trained and understand the code of conduct.
  - Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
  - Engaging legal advisors to assist in monitoring legal requirements.
  - Maintaining a register of significant laws with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function.
- An audit committee.

## The Auditor's Consideration of Compliance with Laws and Regulations

11. The auditor is not, and cannot be held responsible for preventing noncompliance. The fact that an annual audit is carried out may, however, act as a deterrent.
12. An audit is subject to the unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with NSAs. This risk is higher with regard to material misstatements resulting from noncompliance with laws and regulations due to factors such as the following:
  - There are many laws and regulations, relating principally to the operating aspects of the entity, that typically do not have a material effect on the financial statements and are not captured by the entity's information systems relevant to financial reporting.
  - The effectiveness of audit procedures is affected by the inherent limitations of internal control and by the use of testing.
  - Much of the audit evidence obtained by the auditor is persuasive rather than conclusive in nature.
  - Noncompliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, senior management override of controls or intentional misrepresentations being made to the auditor.
13. **In accordance with NSA 200, "Objective and General Principles Governing an Audit of Financial Statements" the auditor should plan and perform the audit with an attitude of professional skepticism recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations.**
14. In accordance with specific statutory requirements, the auditor may be specifically required to report as part of the audit of the financial statements whether the entity complies with certain provisions of laws or regulations. In these circumstances, the auditor would plan to test for compliance with these provisions of the laws and regulations.
15. **In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework.**
16. In obtaining this general understanding, the auditor would particularly recognize that some laws and regulations may give rise to business risks that have a fundamental effect on the operations of the entity. That is, noncompliance with

certain laws and regulations may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, noncompliance with the requirements of the entity's license or other title to perform its operations could have such an impact (for example, for a bank, noncompliance with capital or investment requirements).

17. To obtain the general understanding of laws and regulations, the auditor would ordinarily:
  - Use the existing understanding of the entity's industry, regulatory and other external factors;
  - Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations;
  - Inquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
  - Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments; and
  - Discuss the legal and regulatory framework with auditors of subsidiaries in other countries (for example, if the subsidiary is required to adhere to the securities regulations of the parent company).
18. **After obtaining the general understanding, the auditor should perform further audit procedures to help identify instances of noncompliance with those laws and regulations where noncompliance should be considered when preparing financial statements, specifically:**
  - (a) **Inquiring of management as to whether the entity is in compliance with such laws and regulations; and**
  - (b) **Inspecting correspondence with the relevant licensing or regulatory authorities.**
19. **Further, the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.**

20. Such laws and regulations would be well established and known to the entity and within the industry; they would be considered on a recurring basis each time financial statements are issued. These laws and regulations, may relate, for example, to the form and content of financial statements, including industry specific requirements; accounting for transactions under government contracts; or the accrual or recognition of expenses for income taxes or pension costs.
21. Other than as described in paragraphs 18-20, the auditor does not perform other audit procedures on the entity's compliance with laws and regulations since this would be outside the scope of an audit of financial statements.
22. **The auditor should be alert to the fact that audit procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible noncompliance with laws and regulations to the auditor's attention.** For example, such audit procedures include reading minutes; inquiring of the entity's management and legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of classes of transactions, account balances, or disclosures.
23. **The auditor should obtain written representations that management has disclosed to the auditor all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing financial statements.**
24. In the absence of audit evidence to the contrary, the auditor is entitled to assume the entity is in compliance with these laws and regulations.

#### **Audit Procedures when Noncompliance is Discovered**

25. The Appendix to this NSA sets out examples of the type of information that might come to the auditor's attention that may indicate noncompliance.
26. **When the auditor becomes aware of information concerning a possible instance of noncompliance, the auditor should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements.**
27. When evaluating the possible effect on the financial statements, the auditor considers:
  - The potential financial consequences, such as fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation.
  - Whether the potential financial consequences require disclosure.

- Whether the potential financial consequences are so serious as to call into question the true and fair view (fair presentation) given by the financial statements.
28. **When the auditor believes there may be noncompliance, the auditor should document the findings and discuss them with management.** Documentation of findings would include copies of records and documents and making minutes of conversations, if appropriate.
  29. If management does not provide satisfactory information that it is in fact in compliance, the auditor would consult with the entity's lawyer about the application of the laws and regulations to the circumstances and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's lawyer or when the auditor is not satisfied with the opinion, the auditor would consider consulting the auditor's own lawyer as to whether a violation of a law or regulation is involved, the possible legal consequences and what further action, if any, the auditor would take.
  30. **When adequate information about the suspected noncompliance cannot be obtained, the auditor should consider the effect of the lack of sufficient appropriate audit evidence on the auditor's report.**
  31. **The auditor should consider the implications of noncompliance in relation to other aspects of the audit, particularly the reliability of management representations.** In this regard, the auditor reconsiders the risk assessment and the validity of management representations, in case of noncompliance not detected by the entity's internal controls or not included in management representations. The implications of particular instances of noncompliance discovered by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved.

## Reporting of Noncompliance

### To Management

32. **The auditor should, as soon as practicable, either communicate with those charged with governance, or obtain audit evidence that they are appropriately informed, regarding noncompliance that comes to the auditor's attention.** However, the auditor need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.
33. **If in the auditor's judgment the noncompliance is believed to be intentional and material, the auditor should communicate the finding without delay.**

34. **If the auditor suspects that members of senior management, including members of the board of directors, are involved in noncompliance, the auditor should report the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or a supervisory board.** Where no higher authority exists, or if the auditor believes that the report may not be acted upon or is unsure as to the person to whom to report, the auditor would consider seeking legal advice.

#### **To the Users of the Auditor's Report on the Financial Statements**

35. **If the auditor concludes that the noncompliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor should express a qualified or an adverse opinion.**
36. **If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance that may be material to the financial statements, has, or is likely to have, occurred, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.**
37. **If the auditor is unable to determine whether noncompliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should consider the effect on the auditor's report.**

#### **To Regulatory and Enforcement Authorities**

38. The auditor's duty of confidentiality would ordinarily preclude reporting noncompliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statute, law or by courts of law (for example, the auditor is required to report noncompliance by financial institutions to the supervisory authorities). The auditor may need to seek legal advice in such circumstances, giving due consideration to the auditor's responsibility to the public interest.

#### **Withdrawal from the Engagement**

39. The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the noncompliance is not material to the financial statements. Factors that would affect the auditor's conclusion include the implications of the involvement of the highest authority within the entity which may affect the reliability of management representations, and the effects on the auditor of continuing association with the entity. In reaching such a conclusion, the auditor would ordinarily seek legal advice.

40. **As stated in the *Code of Ethics (for Professional Accountants) in public practice issued by The Institute of Chartered Accountants of Nepal, on receipt of an inquiry from the proposed auditor, the existing auditor should advise whether there are any professional reasons why the proposed auditor should not accept the appointment.*** The extent to which an existing auditor can discuss the affairs of a client with a proposed auditor will depend on whether the client's permission to do so has been obtained and/or the legal or ethical requirements that is applicable in relation to such disclosure. If there are any such reasons or other matters which need to be disclosed, the existing auditor would, taking account of the legal and ethical constraints, including where appropriate permission of the client, give details of the information and discuss freely with the proposed auditor all matters relevant to the appointment. **If permission from the client to discuss its affairs with the proposed auditor is denied by the client, that fact should be disclosed to the proposed auditor.**
41. **Compliance with International Standards on Auditing**  
Compliance with this NSA ensures compliance in all material respects with ISA 250 (Consideration of Laws and Regulations in an Audit of Financial Statements)
42. **Effective Date**  
This NSA is effective for audits of financial statements for periods beginning on or after 01 Shrawan 2065 corresponding to 17 July 2008.

### **Public Sector Perspective**

1. *Many public sector engagements include additional audit responsibilities with respect to consideration of laws and regulations. Even if the auditor's responsibilities do not extend beyond those of the private sector auditor, reporting responsibilities may be different as the public sector auditor may be obliged to report on instances of noncompliance to governing authorities or to report them in the audit report.*

## **Appendix**

### **Indications that Noncompliance may have Occurred**

Examples of the type of information that may come to the auditor's attention that may indicate that noncompliance with laws or regulations has occurred are listed below:

- Investigation by government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorized transactions or improperly recorded transactions.
- Media comment.