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# Nepal Report on the Observance of Standards and Codes Accounting & Auditing

June 2015

GGODR  
SOUTH ASIA



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## CURRENCY EQUIVALENTS

(Exchange Rate Effective = February 28, 2015)

Currency Unit = Nepalese Rupee (NPR)

US\$ 1.00 = NPR 98.64

## Fiscal Year

July 17 – July 16

## Abbreviations and Acronyms

ACCA	Association of Certified Chartered Accountants
ASB	Accounting Standards Board
AuSB	Auditing Standards Board
BAFIA	Bank and Financial Institution Act
CPE	Continuing Professional Education
DfID	Department for International Development (United Kingdom)
GDP	Gross Domestic Product
GNI	Gross National Income
IAASB	International Auditing and Assurance Standards Board
IAESB	International Accounting Education Standards Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICAN	Institute of Chartered Accountants of Nepal
IDA	International Development Association
IES	International Education Standard
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standard
ISA	International Standard on Auditing
ISQC	International Standard on Quality Control
NAS	Nepal Accounting Standard
NEPSE	Nepal Stock Exchange
NFRS	Nepal Financial Reporting Standard
NPSAS	Nepal Public Sector Accounting Standard
NRB	Nepal Rastra Bank (Central Bank)
NSA	National Standard on Auditing
NSQC	Nepal Standard on Quality Control
PEFA	Public Expenditure and Financial Accountability
ROSC A&A	Report on the Observance of Standards and Codes, Accounting and Auditing
SEBON	Securities Board of Nepal
SME	Small and medium-sized entity
SMO	Statement of Membership Obligations
SOE	State-owned entity

# Nepal Report on the Observance of Standards and Codes Accounting & Auditing



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Regional Vice President  
Country Director  
Country Manager  
Senior Practice Director  
Practice Director  
Practice Manager  
Task Team Leader

---

Annette Dixon  
Johannes C. M. Zutt  
Takuya Kamata  
Mario Marcel  
Samia Msadek  
Fily Sissoko  
Yogesh Bom Malla

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The review was conducted through a participatory process involving the World Bank Country Office in Nepal and various in-country stakeholders representing government, the professional accountancy organization, standard-setting bodies, regulators, audit firms, academia, and the business community.

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Cover and Back Photo: World Bank Nepal/David Waldorf

# Executive Summary

## Background

- 1. This Report on the Observance of Standards and Code, Accounting and Auditing (ROSC A&A) provides an assessment of accounting, financial reporting, and auditing requirements and practices in Nepal.** The report uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks and draws on international experience and good practice approaches in the field of accounting and auditing to assess the quality of financial reporting and make policy recommendations.
- 2. The ROSC A&A addresses two strategic objectives in Nepal's FY14-FY18 Country Partnership Strategy—poverty reduction and shared prosperity.** The ROSC aims to support the Government of Nepal in preparing a country action plan in line with further enhancing the quality of corporate financial reporting as a means to facilitate improvement of the business climate and foster business development. Financial transparency and disclosures enhance a country's ability to attract foreign investment. Empirical evidence and several studies made during the last decade show that there is an inverse relationship between financial transparency and disclosure and market risk; the lower the quality of financial transparency and disclosure, the higher the market risk and the higher the cost of capital. Improving accountability and transparency is one of the Government's highest priorities and is an area of focused support for the private and financial sectors, underpinning development and sustainable economic growth. Also, the final policy recommendations in the ROSC target small and medium-size entities and state-owned entities that form the backbone of Nepal's economy.
- 3. As a result of ongoing political instability over the last decade, Nepal's economy in general and the banking sector specifically have passed through challenging times.** There are 273 companies listed on the Nepal Stock Exchange (NEPSE) with an approximate market capitalization of US\$10.17 billion,<sup>1</sup> which represents approximately 48 percent of GDP. As of February 2015, there were 30 commercial banks operating in the Nepalese banking system, of which the 5 largest commercial banks held some 34 percent of the total banking assets (US\$16.14 billion). Nepal's banking sector has had mixed fortunes in the last few years. The sector faced a liquidity crunch a few years ago but now has the converse problem of excess liquidity.
- 4. As Nepal moves toward further reforms, liberalization, and deregulation of its business environment, enhanced financial transparency and improved accounting and auditing practices must support the emerging business environment.** High-quality financial reporting is a factor in attracting both foreign and domestic investments. Continued strengthening and development of high-quality financial reporting, high-quality private-sector accounting and auditing, and a strong governing regulatory framework will bring benefits to Nepal and its citizens.

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<sup>1</sup> Nepal Stock Exchange, February 2015.



## A. Statutory Framework

5. **The Companies Act of 2006 provides the basic requirements relating to financial reporting for all companies incorporated in Nepal.** The Companies Act requires the preparation, presentation, publication, and disclosure of financial statements. The Act also requires the audit of all companies by a member of the Institute of Chartered Accountants of Nepal (ICAN) holding a Certificate of Practice. All registered companies, about 125,000 in total,<sup>2</sup> are required to prepare and audit their financial statements following accounting standards pronounced by Nepal's competent body, the Accounting Standards Board (ASB), under the prevailing law. The challenge of this requirement is the impact on the quality due to capacity constraints in preparing and auditing the financial statements. Also, small and medium-size entities (SMEs) do not have separate standards to accommodate their size and therefore face a greater financial reporting burden. SMEs are a large part of the Nepal economy.
6. **The NEPSE operates as the country's sole stock exchange under the Securities Act of 2007.** The main function of NEPSE is to provide a platform for trading securities. The Securities Board of Nepal (SEBON) acts as the apex regulator for the securities markets in Nepal under the Securities Act of 2007.
7. **The Bank and Financial Institutions Act (BAFIA) of 2006 regulates banks and financial institutions.** The BAFIA requires that banks and financial institutions be incorporated as a public limited company with the Office of the Company Registrar; and obtain approval from the central bank, the Nepal Rastra Bank (NRB), prior to carrying on financial transactions pursuant to BAFIA. The audit of financial institutions are required to be conducted by an auditor appointed by the annual shareholder general meeting from among NRB-enlisted auditors. The Nepal Rastra Bank has full powers to regulate and systematize the functions and activities of banks and financial institutions, which include financial reporting, in accordance with NRB directives. The challenge of this regulation is that many NRB-issued directives are in conflict with the generally accepted accounting principles, including IFRS/IAS and NFRS/NAS.
8. **The Insurance Board is the Insurance Regulatory Authority of Nepal constituted under the Insurance Act of 1992.** The Insurance Board is mandated to systematize, regularize, develop, and regulate the insurance industry.
9. **The Audit Act of 1991 requires state-owned entities (SOEs) to follow accounting standards as directed by the Auditor General.** The Auditor General is required to conduct an audit of wholly owned SOEs. The auditor of substantially owned SOEs (defined as those where the Government owns more than 50 percent of the shares or assets) is to be appointed in consultation with the Auditor General to conduct an audit in accordance with the prevailing laws relating to such a body.

## B. Accounting and Auditing Profession

10. **The ICAN, established as an autonomous body by the Government under the Nepal Chartered Accountants Act of 1997, regulates and monitors the accounting and auditing profession in Nepal.** One of the objectives of ICAN is to pronounce Nepal Financial Reporting Standards (NFRS) drafted by the Accounting Standards Board and Nepal Standards on Auditing (NSA) drafted by the Auditing Standards Board (AuSB). The ICAN has two types of professional membership allowed under the law: Chartered

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<sup>2</sup> Office of Company Registrar

Accountant and Registered Auditor. Chartered Accountants are those who have completed and passed the three levels in the Chartered Accountancy Program. Registered Auditors are those who were licensed by the Office of the Auditor General prior to the enactment of the Nepal Chartered Accountants Act of 1997. The challenge for ICAN is its limited capacity, particularly when faced with effective implementation of NFRS rollout, meeting IFAC membership obligations, and ensuring ICAN members are adequately trained. And the profession is challenged by not having an enforceable quality assurance system for auditing.

11. **The Companies Act of 2006 prescribes the independence of auditors in Nepal.** Section 111 restricts auditors from being appointed for more than three (consecutive) one-year terms in performing the audit of a public company. Section 112 describes all instances in which an auditor would be disqualified from acting.
12. **The ICAN adopted the IESBA-issued Code of Ethics for Professional Accountants in 2010.** The ICAN has constituted a Peer Review Board to regulate the profession of Chartered Accountants and has issued a Statement on Peer Review with an intention to further enhance the quality of professional work of practicing Chartered Accountants. The Nepal Chartered Accountants Act of 1997 requires ICAN to enforce compliance by professional accountants and auditors with the prevailing standards and laws through a Disciplinary Committee.

### C. Accounting Education and Training

13. **An average of 25 Chartered Accountants qualify from ICAN in a year.**<sup>3</sup> Another 35 from other countries obtain ICAN membership. These numbers are substantially short of meeting the market demand for trained accountants by audit firms, private industry, banking and financial sector, and government institutions. The universities in Nepal do not offer many courses on accounting and auditing due to a lack of demand and interest in these disciplines. The curricula, textbooks, and instructors are not updated to meet the global changes in accounting and auditing. The challenge is the serious capacity shortage and knowledge gap for accounting professionals in Nepal, which has a direct affect on Nepal's economic development.

### D. Accounting and Auditing Standard-setting

14. **The Accounting Standards Board is an independent statutory body with the responsibility to set accounting standards for the preparation and presentation of financial statements in Nepal.** The Accounting Standards Board is primarily responsible for setting accounting and financial reporting standards for business enterprises in line with IFRS. The ICAN pronounced on September 13, 2013, that 40 NFRS/NAS, 8 Standard Interpretation Committee (SIC) statements, and 15 International Financial Reporting Interpretation Committee (IFRIC) statements would be effective from July 16, 2014, (except for NFRS-9, Financial Instruments, which will be applicable from July 16, 2015) in phased manner. The Accounting Standards Board is also in the process of developing NFRS for SMEs; SMEs make up 99 percent of businesses in Nepal. The challenge is whether ICAN and the Accounting Standards Board have the sufficient means to implement NFRS/NAS. Several stakeholders suggested that support from the business community might be required, including a proactive role of regulating agencies and government, for effective implementation of NFRS/NAS.

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<sup>3</sup> Figure provided by ICAN, based on average data of four years.

15. **To deal with the development of auditing standards, the Government of Nepal constituted the Auditing Standards Board in March 2003 under the Nepal Chartered Accountants Act of 1997.** The Auditing Standards Board has formulated 32 NSAs based on ISA, 3 guidance notes, 1 practice statement, and the Nepal Framework for Assurance Engagements. ICAN adopted the Nepal Standards on Quality Control (NSQC 1) developed in line with International Standards on Quality Control (ISQC 1), and a voluntary system of peer review was implemented. The challenge is that many entities, which the Company Act requires to be audited, are small and financially unable to meet the standards set by the Auditing Standards Board.

## **E. Enforcing Accounting and Auditing Standards**

16. **The Office of the Company Registrar has a range of powers under the Companies Act of 2006 and is primarily responsible for its enforcement.** However, due to lack of resources, the Office of the Company Registrar only compiles the audited financial statements, which are submitted by registered companies, and performs no reviews or investigations to ensure compliance with the standards and law. SEBON is mandated by the Securities Act to regulate and investigate noncompliance with the standards, laws, and regulations of listed companies; but due to lack of resources, no investigation or enforcement actions have been taken to ensure compliance. For financial institutions, the Nepal Rasta Bank has the mandate under BAFIA 2006 to regulate, investigate, and enforce compliance with relevant standards, laws, and regulations. The Nepal Rasta Bank requires that management of banks and financial institutions submit drafts of the financial statements for NRB approval prior to issuance of the final report. The Insurance Board has the mandate under the Insurance Act of 1992 to systematize, regularize, develop, and regulate the insurance industry. The Insurance Board requires the management of the insurance company to submit the audited financial statements along with the directors' report, internal audit report, preliminary audit report, management's response, and the long-form audit report for its approval. The challenge is that all of the regulators—Office of the Company Registrar, SEBON, Nepal Rastra Bank, and Insurance Board—have limited capacity to regulate and investigate noncompliance.

## **F. Key Policy Recommendations**

17. **Nepal should establish a multidisciplinary National Steering Committee to champion and coordinate the accounting and auditing reforms.** The recommendations require a holistic approach to implementation, and in this regard the National Steering Committee should advise policymakers and regulators. Based on the successful experience of other countries, this report recommends that the Steering Committee develop a country action plan that clearly sets out the key actions and allocates responsibilities for implementing the necessary reforms. The plan should include an itemized budget indicating resources necessary for successful implementation. The Government, policymakers, and development partners should work together to secure those resources so as to achieve the common goal of enhancing the quality of corporate financial reporting in Nepal.

### ***Statutory Framework***

18. **Review provisions of the Companies Act of 2006 to include a size threshold for companies required to have their financial statements audited.** The Law currently requires all companies, irrelevant of size, to

be audited. The threshold should establish that companies—public interest entities and non-public interest entities—above a certain size should be audited, and those below the threshold should present financial statements in a compilation format (as described in the NSAs). The current requirement has two effects: (a) it represents an unnecessary burden for micro and small entities where there is less public interest in an audit and (b) it is impractical for smaller companies to comply with the law given capacity constraints.

- 19. Make requirements uniform and consistent for all companies under the regulatory bodies.** The financial reporting and auditing provisions and requirements are different under different laws such as the Companies Act and Audit Act and regulatory regulations such as directives from the Nepal Rastra Bank and Insurance Board. The Nepal Rastra Bank and Insurance Board currently have regulatory requirements that conflict with the preparation of financial statements under NFRS/NAS. Banks and insurance companies should prepare their financial statements following NFRS/NAS with reconciliations to regulatory requirements presented in the notes to the financial statements, if required. In addition to the auditor's opinion on the general purpose financial statements, regulators may choose to require an opinion on regulatory compliance to be issued by the auditors.
- 20. Adopt accounting standards for SMEs based on IFRS for SMEs issued by IASB.** The Accounting Standards Board should define SMEs; that definition can later be adopted by other laws.

### ***Accounting and Auditing Profession***

- 21. Establish an enforceable Quality Assurance System for audit firms.** A system of mandatory quality assurance for audit firms that audit listed companies, insurance companies, banks, and financial institutions should be established under the direction of ICAN and under the oversight and supervision of a Board formed by ICAN, Nepal Rastra Bank, Insurance Board, Office of the Auditor General, SEBON, and Office of the Company Registrar.
- 22. Strengthen the enforcement mechanism.** High-quality corporate financial reporting depends on effective enforcement mechanisms. Merely adopting international accounting and auditing standards is not enough. The enforcement mechanism must stress the regulators' transparent and unbiased decision-making, quick and confidential investigative process, and effective means for rectifying detected noncompliance, together with imposing appropriate sanctions. Three important links exist in the enforcement sequence: (a) directors and top management must ensure that financial statements are prepared in compliance with the established standards; (b) auditors must act independently and judiciously to give their opinion whether the financial statements comply with applicable accounting standards and represent a true and fair position of the enterprise's financial condition; and (c) regulators, both self-regulatory organizations and statutory regulators, must implement arrangements for the efficient monitoring of regulatory compliance and consistently take appropriate actions against violators.
- 23. Strengthen regulators' capacity.** Ineffective regulatory regimes provide a false sense of security to stakeholders. Capacity building should focus on technical personnel, practical training of reviewers, administrative support, and the necessary logistics support. It is recommended that the Office of the Company Registrar, Nepal Rastra Bank, Insurance Board, and SEBON recruit professionally qualified and

experienced personnel and retain trained staff to effectively deal with accounting and financial reporting-related issues involved in the supervision of regulated entities. It is necessary to establish proper incentives for attracting well-trained and top-quality personnel, including professional accountants, into regulatory bodies. A sustained capacity-building effort would have to be undertaken to ensure continued effective capacity levels.

- 24. Ensure better coordination among regulatory bodies for improving compliance practices.** The regulatory bodies in Nepal need better coordination in order to function cohesively in order to ensure sustainable, high-quality corporate financial reporting. The Government could undertake this leadership role to promote and coordinate coordination within the regulatory bodies.
- 25. Strengthen the capacity of the ICAN.** The ICAN capacity needs to be strengthened to ensure effective implementation of NFRSs rollout, enhance its members' training program, and meet IFAC membership obligations. There may be a case for a twinning arrangement with a more advanced professional accounting organization.

### ***Accounting and Auditing Standards-setting***

- 26. Strengthen the capacity of the Accounting Standards Board and the Auditing Standards Board to ensure an effective standard-setting process and be able to review the international standards being revised or developed.** The ASB and AuSB Boards also need to keep the standards current with the changes made in IFRS and ISA. The ASB and AuSB Board members work only on part-time basis. And the Boards are limited by resource constraints. These hindrances restrict the timely adoption of new standards, including the revision of standards.

### ***Education and Training***

- 27. Introduce an awareness program for the implementation of NFRS/NAS.** The Government should lead the effort in collaboration with ICAN, regulatory bodies, and the private sector, including SMEs, to design an awareness program on implementation of NFRS/NAS.<sup>4</sup>
- 28. Make continuing professional education a mandatory requirement for ICAN members who are not in public practice.** This requirement would be in conformity with IFAC-issued IES 7, Continuing Professional Development; and SMO 2, International Education Standards for Professional Accountants issued by IAESB.
- 29. Revise and update university-conducted accounting and auditing curricula.** ICAN should take a lead in working with universities to revise their curricula in line with IAESB, utilizing up-to-date materials to train professionals in auditing and accounting and prepare graduates for Chartered Accountancy. This will over time help to bridge the knowledge and capacity gap. The ICAN should also enhance its monitoring of the accreditation of higher-education institutes to ensure quality education and facilities for the development of aspiring Chartered Accountants.

<sup>4</sup> Under IDA's Development Policy Credit program, the World Bank is closely working with DfID to enable the authorities to achieve several policy actions that include NFRS-related activities.

- 30. Upgrade skills of Registered Auditors.** ICAN should also look at the possibility of upgrading the skills of the over 7,000 Registered Auditors to enable them to provide services as Chartered Accountants. A study should be carried out to assess demand/supply gap of present and future requirements of qualified accountants in the country. Based on this study, the strategy should be developed to meet the requirements.

## I. The ROSC and Country Background

### I.A ROSC A&A Program

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1. **This Report on the Observations of Standards and Codes, Accounting and Auditing (ROSC A&A) provides an assessment on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting in Nepal.** As one of eleven components of a joint initiative of the IMF and World Bank, the ROSC A&A uses International Financial Reporting Standards (IFRS)<sup>1</sup> and International Standards of Auditing (ISA)<sup>2</sup> as benchmarks for the assessment. Conducting the assessment involves a review of both mandatory requirements and actual practices and draws on international experience and good practice approaches in the field of accounting and auditing regulation.
2. Since its inception in early 2000, the ROSC A&A program has conducted evaluations of the accounting and auditing environment in more than 100 countries around the world. The ROSC A&A initiative has, in general, two major purposes:
  - To evaluate the quality of national accounting and auditing standards, mainly by comparing them with IFRS and ISA, and assessing compliance with those standards; and
  - To assist the country in developing an action plan for improving the institutional framework that underpins its corporate financial reporting and auditing regime.

To meet these objectives, the scope and application of the standards needs to be assessed in the framework of the country's overall development strategy, and recommendations for improvements need to be tailored to the country's specific circumstances.

### I.B Economic and Financial Context

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3. **Nepal is a multi-party system, federal republic.** The Interim Constitution of Nepal, enacted on January 15, 2007, defines three organs of governance: (a) the Executive, with power vested in the Council of Ministers and headed by the Prime Minister; (b) the Legislative, which consists of a unicameral Legislature-Parliament; and (c) the Judiciary, consisting of three tiers (Supreme Court, Appellate Courts, and District Courts). Nepal's per capita GNI is US\$717. The country has an estimated population of 28 million with an estimated 2.5 million people living in Kathmandu Valley, which is growing at 4 percent per year, one of the fastest metropolitan population growths in South Asia.
4. **Nepal's political developments continue to overshadow and impede its economic development.** While the Government of Nepal has tackled some of the bottlenecks (particularly with respect to budget preparation and execution) that hampered public policy in FY14, it will need to continue and expand this effort in the coming years. The economy needs to be top priority of the Government for Nepal to proceed

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<sup>1</sup> IFRS refer to both International Financial Reporting Standards issued by the International Accounting Standards Board and the International Accounting Standards issued by the International Accounting Standards Committee.

<sup>2</sup> ISA are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants.

on a high-growth trajectory. With elections to the Second Constituent Assembly, both public and private investments are expected to recover from the low levels seen in recent years. However, increased political stability and a short-term economic recovery alone would not be enough to put Nepal on a solid growth path. Over the medium term, political stability needs to be followed by structural reforms that tackle enduring sources of fragility, including financial sector consolidation, public financial management reform, investment climate improvements, development of accounting and auditing standards in line with IFRS and ISA, reform in laws and practices, and a strategy to address the gradual erosion of Nepal's external competitiveness.

5. **Nepal's macroeconomic framework as well as the fiscal and monetary policies pursued by the Government are broadly sound.** Economic growth has been modest but stable in the past decade. The country's economy is largely insulated from external shocks (given the small export base and poor financial integration). The budget surplus reflects to some extent spending bottlenecks, particularly for capital but also the government's sustained efforts to strengthen tax administration and to control the growth of recurrent spending (despite ample fiscal space). For the second consecutive year (FY14), Nepal was the only country in South Asia to have recorded a budget surplus. Total public debt has fallen to historically low levels. While monetary policy has remained accommodative in recent years, this has not fueled inflationary pressures (as prices are overwhelmingly driven by inflation in India) and has corresponded to a consistent effort to support credit growth and financial sector strengthening.
6. **Economic performance is largely dependent on exogenous factors.** Growth is mainly driven by the services sector and to a lesser extent agriculture (with performance in the former supported by remittance inflows in the latter determined by weather patterns). By contrast, industrial growth has been lackluster and the share of manufacturing in GDP shrank to a modest 6.6 percent in FY14 from 8 percent a decade ago. In FY14, overall growth at market prices reached 5.5 percent reflecting both (a) a base effect after a disappointing performance in FY13 (3.9 percent) and (b) positive developments in agriculture and services. Services growth (6.1 percent) was mainly accountable to wholesale and retail trade, while agricultural output reflected the impact of a favorable monsoon and timely availability of agricultural inputs during peak planting season. Industrial growth however reached a low 2.7 percent in spite of renewed construction activity and favorable exchange rate development (overall depreciation of the rupee).
7. **There are 273 companies listed on the Nepal Stock Exchange (NSE) with an approximate market capitalization of US\$10.17 billion (as of February 2015), which represents approximately 48 percent of GDP.** As of February 2015, there were 30 commercial banks operating in the Nepalese banking system, of which the 5 largest commercial banks held some 34 percent of the total banking assets (US\$16.14 billion). There were 26 insurance companies as of February 2015. In the first quarter of FY15, insurance companies in total issued approximately US\$79.72 million in premiums.
8. **Nepal's banking sector has been a weak link in the economic development of the country.** The sector faced a liquidity crunch a few years ago but now has the converse problem of excess liquidity. As a result of the continuing political instability over the last decade, Nepal's economy in general and the banking sector specifically have encountered challenging times. With Nepal's unstable political process and an uncertain future, investors are reluctant to invest in any large projects, and there is little demand for loans for big



projects. As remittances have become an important factor of the Nepal's economy, the country must learn to manage excess liquidity. At the same time, the commercial banks are also not able to finance big projects due to a lack of aggregate lending capacity.

9. **The Government of Nepal is putting in place financial reforms designed to place the financial sector on a sound foundation for the future.** Two of the critical areas of the reform include strengthening of the legal and regulatory framework for effective bank resolution and increasing the transparency of the financial system. The financial sector is the engine of growth of any economy. An effective financial sector mobilizes and allocates resources productively and efficiently, fosters investment, increases employment opportunities and productivity, and helps in achieving growth targets and attaining overall macro-economic development.
10. **Prior to the enactment of the Insurance Act of 1968, there was no regulatory body that supervised the insurance industry in Nepal.** Under the Insurance Act of 1968, Beema Samiti (the Insurance Board) was established as the insurance supervisory authority. The real expansion of the insurance industry in Nepal took place during the 1990s following the financial sector reform and liberalization of the economy by the Government. The new government policy gave emphasis to the involvement and growth of the insurance industry in the private sector. As a result, many companies came into the private sector, including foreign equity. The Insurance Act of 1968 and the Insurance Rules of 1969 were replaced by the Insurance Act of 1992 and Insurance Regulation of 1993, respectively. The main aim of the Insurance Act of 1992, following the Act of 1968 that it replaced, was to re-establish the Insurance Board to systematize, regularize, develop, and regulate the insurance industry in Nepal.
11. **Nepal introduced a non-contributory social pension scheme in 1995 that provides universal old-age retirement benefits.** This universal pension scheme is the first in the region. As a result of this, the private pension sector has not evolved in Nepal. The Government introduced a contributory pension scheme for government employees in 2007, but it could not be implemented.
12. **Under the Securities Act of 2006, the Government of Nepal established the Securities Board of Nepal (SEBON) on June 7, 1993, as an apex regulator of the securities markets in Nepal.** The Nepal Stock Exchange Limited (NEPSE) is the country's only stock exchange. In February 2015, the equity market capitalization of the companies listed in the NEPSE was approximately US\$10.17 billion. As of February 2015, the number of listed companies was 273, which includes commercial and development banks; and hydropower, insurance, and finance companies. The NEPSE is regulated by SEBON. NEPSE is owned by the Government of Nepal (58.66 percent), the Nepal Rastra Bank (34.60 percent), Nepal Industrial Development Corporation (6.12 percent), and other members (0.62 percent).
13. **Inflows of foreign direct investment declined sharply (a 68 percent drop) from US\$103.30 million in FY13 to US\$32.50 million in FY14 (0.50 percent of GDP).** A puzzling factor is the discrepancy between both domestic and foreign investment commitments—which increased sharply—and actual realizations. In FY14, about NPR 20.10 billion were committed as foreign direct investment of which only 15 percent materialized.<sup>3</sup> The drop in foreign direct investment is mainly due to the election of the Second Constituent Assembly in the middle of FY14 and the delay in formation of the elected government.

<sup>3</sup> All currencies shown in Nepal rupees (NPR) can be converted to US dollar equivalency by using the currency rate shown on page ii.

## I.C Summary

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14. **All the key economic sectors in Nepal rely on high-quality financial information, which requires high-quality private sector accounting and auditing.** As Nepal moves toward further reforms, liberalization, and deregulation to enhance its business environment, the support of enhanced financial transparency and improved accounting and auditing practices will be imperative. High-quality financial reporting could be a factor in attracting both foreign and domestic investments. Continued strengthening and development of financial reporting, accounting and auditing, and the governing regulatory framework will bring benefits to Nepal and its citizens. In this context, this ROSC A&A sets out policy recommendations (Chapter IV) to enhance the quality of corporate financial reporting and foster a financial reporting platform conducive to sustainable private and financial sector growth, thus increasing access to global financial markets and other tools of the market economy.

## II. Accounting and Auditing Framework

**15. This section discusses the statutory framework affecting the accounting and auditing regime in Nepal.** It should be noted that there are several laws and regulations, as discussed below, requiring proper accounts to be maintained and financial reports to be produced by private sector organizations and institutions, and or such accounts and reports to be audited by licensed auditors. These laws include:

- The Companies Act, 2006
- The Bank and Financial Institutions Act , 2006
- The Audit Act, 1991
- The Securities Act, 2007
- The Income Tax Act, 2002
- The Insurance Act, 1992

**16. There is no clear definition for small and medium-size entities (SMEs) in law, and SMEs do not have separate standards to be followed for preparing financial statements.** As a result, SMEs in Nepal currently face, and will continue to face, a relatively greater financial reporting burden. Generally, SMEs are companies of small size and with no public accountability. They exist in all sectors except for financial and insurance.

### II.A Statutory Framework

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**17. The Companies Act of 2006 provides the basic requirements relating to financial reporting for all companies incorporated in Nepal.** The Companies Act requires the preparation, presentation, publication, and disclosure of financial statements as well as an audit of all companies by a member of the Institute of Chartered Accountants of Nepal (ICAN) who holds a Certificate of Practice. Section 109 of Chapter 7 of the Act prescribes the form, content, and minimum disclosure requirements of financial statements in the accompanying Regulation, which is not in the format prescribed by the Nepal accounting standards, NFRS/ NAS. As prescribed by the Act, the responsibility for maintaining a company's books of account and records resides with the directors and officers of the company. The Act also requires that the following financial statements be prepared by the board of directors: (a) a balance sheet at the last date of the financial year, (b) a profit and loss account for the financial year, and (c) a description of cash flow for the financial year. The Act also requires that these financial statements be approved by the board of directors and be audited.

**18. Chapter 8 of the Companies Act of 2006 mandates that every company incorporated under the Act shall appoint an auditor to audit its accounts.** The auditor shall be appointed from among those licensed to carry out audits under the prevailing law. Sections 164 and 165 of the Act require the creation of an Audit Committee by any listed company having paid up capital of NPR30 million or more, or by a company which is fully or partially owned by the Government. The Audit Committee will recommend the names of potential auditors for appointment, fix the remuneration and terms and conditions of the appointed auditor, and present the recommendation at the general annual meeting for the ratification thereof. The shareholders

appoint the auditor at the annual general meeting; upon selection, the auditor's name is forwarded to the Office of the Company Registrar within 15 days of the date of such appointment. Furthermore, the Audit Committee is expected to review and supervise whether the company auditor has observed the conduct, standards, and directives prescribed by the competent body; to devise the accounting policy of the company; and to comply with the requirement of preparing a long-form audit report. The Audit Committee is also required to review the accounts and financial statements, internal financial control system, and risk management system.

**19. The Companies Act of 2006 was enacted by the Government of Nepal to foster dynamic economic development by promoting investment in industry, trade, and business.** The duty to administer the Act lies with the Office of the Company Registrar. Under the Act, three types of companies can be established in Nepal:

- **Private limited company** - requires only one minimum shareholder or promoter;
- **Public limited company** - requires at least seven shareholders and promoters; and
- **Non-profit company** - requires at least five promoters and any number of members after incorporation.

A minimum, paid-up capital of NPR 10 million is required to register a public limited company. Private limited companies and non-profit companies do not have any minimum capital requirement.

**20. According to the Companies Act of 2006, all registered companies are required to prepare and audit their financial statements following accounting standards pronounced by the competent body under the prevailing law.** The applicable Act requires all registered companies to file yearly a set of audited financial statements with the Office of the Company Registrar. Such a comprehensive requirement has an adverse impact on the quality of the financial statements and the audits performed, given the capacity constraints in ability to prepare such financial statements and audit them. There are about 125,000 registered companies in Nepal.

**21. The NEPSE operates as the sole stock exchange in Nepal under the Securities Act of 2007.** The NEPSE was initially established by the Government as a non-profit organization and later converted in 2008 into a for-profit corporation. The main function of NEPSE is to provide a platform for trading securities. Other than its prime function, NEPSE also performs the following:

- Enlists corporate as well as government securities such as shares, preferred shares, development bonds, and corporate bonds;
- Supervises and regulates its members;
- Provides clearing and settlement facilities for traded securities;
- Facilitates timely dissemination of information; and
- Acts as the front-line regulator for members.

On June 4, 2008, NEPSE initiated an over-the-counter market with the approval of SEBON to facilitate trading of shares of companies that were de-listed or are not listed on the NEPSE. On February 26, 2015, 645,501 shares were traded in NEPSE with a turnover of US\$1.88 million. Table 2.1 lists the top 5 companies in Nepal as per market capitalization.

Table 2.1: Top 5 Companies as Per Market Capitalization

Company Name	Capitalization in US\$*
Nepal Doorsanchar	0.96 billion
Nabil Bank	0.71 billion
Nepal Life Insurance	0.53 billion
Standard Chartered	0.45 billion
Chilime Hydropower Co	0.44 billion

\* Figures as of February 2015.

- 22. Under the Securities Act of 2007, the SEBON regulates and manages activities of the securities markets and persons involved in the securities business.** In order to ensure compliance with securities law, Section 85 of the Act grants SEBON the authority to investigate, inspect, and monitor corporate bodies that have listed their securities. The Act prescribes publication of quarterly financial statements in a concise form, but such financial statements are not prepared in accordance with applicable Nepal accounting standards, NFRS/NAS. The Act also requires that financial statements be audited within a specified time; the Security Board may appoint an auditor if an audit is not conducted or an auditor is not appointed. The Act is silent with respect to accounting requirements of listed companies. The Companies Act of 2006 requires all companies to have an annual general meeting of shareholders; and, in the case of listed companies, they must send an abstract of their financial statements to every shareholder along with the notice of the annual general meeting. The abstract should be prepared on the basis of the annual financial statement of the company and the directors' report. Instead of sending the abstract, the company may alternatively publish it at least twice in a national daily newspaper at the time of publishing of the notice of the meeting.
- 23. The Bank and Financial Institutions Act of 2006 regulates banks and financial institutions.** The Act requires that banks and financial institutions be incorporated as a public limited company with the Office of the Company Registrar and obtain approval from the Nepal Rastra Bank (NRB) prior to carrying on financial transactions pursuant to the Act. The audit of financial institutions should be conducted by an auditor appointed by the annual shareholder general meeting from among those auditors enlisted by the Nepal Rastra Bank. Banks and financial institutions must appoint a Chartered Accountant; and micro credit development banks could appoint a Chartered Accountant or a Registered Auditor. External auditors are appointed for a term of only one year. External auditors require rotation once every 3 years for public limited companies as per the Companies Act; the Nepal Rastra Bank also requires the rotation of auditors of financial institutions every 3 years. Banks and financial institutions must obtain the approval of the Nepal Rastra Bank prior to declaring and distributing dividends. Table 2.2 shows the number of banks and financial institutions by class in Nepal.

Table 2.2: Banks and Financial Institutions in Nepal

Type of Institution	Number of Institutions
Commercial banks (Class A)	30
Development banks (Class B)	81
Finance companies (Class C)	51
Micro Credit Development banks (Class D)	35

- 24. The Nepal Rastra Bank has full powers to regulate and systematize the functions and activities of banks and financial institutions, which include financial reporting, in accordance with NRB directives.** Sections 58, 59, and 60 of the Banks and Financial Institutions Act of 2006 direct banks and financial institutions to maintain accounting records in accordance with universally accepted principles (IFRS/IAS prior to adoption of NFRS/NAS) and to prepare a balance sheet, profit and loss account, cash flow statement, and other financial statements in required format and in accordance with such procedures as may be prescribed in directives by the Nepal Rastra Bank.
- 25. In addition, the Banks and Financial Institutions Act of 2006 requires the financial statements to be audited no later than 5 months after the fiscal year-end and then submitted to the Nepal Rastra Bank.** The auditor is also required to submit a long-form audit report on compliance with the prevailing regulatory requirements. The Nepal Rastra Bank may extend a period of submission of audited financial statements for three months upon receipt of a request with a reasonable justification. The Nepal Rastra Bank may appoint an auditor if the bank or financial institution fails to have its accounts audited even within the extended period. Two directors, the chief executive officer, and the auditor should sign the audited financial statements. The NRB Directive No. 4 requires all financial institutions after audit completion and within five months from closure of the fiscal year to publish its annual report containing the balance sheet, profit and loss account, and cash flow statement, including schedules relating to such financial statements. The Companies Act requires listed companies to only publish an abstract of the financial statements in lieu of sending them to every shareholder prior to the annual meeting.
- 26. Many of the NRB-issued directives are in conflict with generally accepted accounting principles, including IFRS/IAS and NFRS/NAS.** The following are examples of such conflicting directives:
- Interest income must be recognized on a cash basis and not on an accrual basis as required under the accounting standards.
  - The reserve for non-performing loans must be recognized and computed using regulatory requirements based on the period of overdue loans and other conditions as prescribed in the NRB Directive, rather than as required under accounting standards.
  - Auditor's independence is not preserved since the Nepal Rastra Bank requires the submission of draft financial statements for its approval prior to issuance of the final auditor's report (Directive No. 4).

- 27. The Insurance Act of 1992 and Regulation of 1997 lack provisions for the application of appropriate accounting and auditing standards of the insurance industry.** As the Insurance Regulatory Authority of Nepal, the Insurance Board is constituted to systematize, regularize, develop, and regulate the insurance industry in Nepal under the Insurance Act of 1992. Insurance companies are required to maintain accounts and records in a format following the accounting policies relating to insurance premium accounting on a cash basis as prescribed by the Insurance Board pursuant to the Insurance Act and Regulation, which contradicts the provisions of the accounting standards. Financial statements are to be published within six months of the fiscal year-end and a copy is to be submitted to the Insurance Board. The Insurance Board may extend a period of submission of the financial statements for one month on receipt of a request from an insurance company. The directive prescribes the appointment of an auditor, who has ICAN fellow membership, for the audit of an insurance company that has annual insurance premium income of more than NPR100 million. The audited financial statements and audit report are to be submitted to the Insurance Board no later than 10 months from the fiscal year-end as per Section 25 of the Insurance Act, whereas they should be submitted within 6 months for approval as per the directive issued by Insurance Board. The auditor is also required to submit a long-form audit report on compliance with prevailing regulatory requirements. Requirements for external auditors are governed by the Companies Act of 2006. The Insurance Board provides for no specific auditing standards or requirements.
- 28. The Audit Act of 1991 requires state-owned entities (SOEs) to follow accounting standards as directed by the Auditor General and the audits of wholly owned SOEs to be conducted by the Auditor General.** The auditor of substantially owned SOEs is appointed in consultation with the Auditor General and conducts an audit in accordance with the prevailing laws relating to such a body. “Substantially owned” is defined as those SOEs where the Government owns more than 50 percent of the shares or assets. The Auditor General has issued directives to SOEs to follow NFRS for preparation of the financial statements. If the Auditor General is constrained by time and resources to audit the wholly owned SOEs, they could appoint an auditor who holds a license under the prevailing laws. According to the Audit Act, the methods as prescribed by the Auditor General in cases of wholly owned SOEs need to be followed under the direction, supervision, and control of the Auditor General. The Act also prescribes the scope of audit in the case of wholly and substantially owned SOEs. The audits of wholly owned SOEs must be conducted annually, and a report must be submitted to the President. Substantially owned SOEs must submit a copy of the audit report to the Auditor General. The Auditor General may issue directives to the relevant organization with respect to any irregularities or noncompliance observed in the audit report of substantially owned SOEs. Due to delays in the submission of financial statements and a lack of updated accounts, not all SOEs are being audited annually.
- 29. The Income Tax Act of 2002 specifies the reporting of income and expenses.** Section 22 of the Income Tax Act and the Income Tax Regulation (Rule 8) require recognition of income and expenses in accordance with NFRS/NAS and international accounting principles and practices when there is no NFRS/NAS subject to the recognition criteria specified in the provisions of this Act.

## II.B Accounting and Auditing Profession

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**30. Under the Nepal Chartered Accountants Act of 1997, the Government of Nepal established ICAN as an autonomous body to regulate and monitor the accounting and auditing profession in Nepal.** The 17-member ICAN Council comprises 10 persons elected by Chartered Accountants, 4 persons elected by Registered Auditors, and 3 persons nominated by the Government. The ICAN became a member of the South Asian Federation of Accountants (SAFA) in 1997 and the Confederation of Asian and Pacific Accountants (CAPA) in 1998. It became an IFAC associate member in 2003 and then a full member in 2008. One of the objectives of the ICAN is to pronounce NFRS as drafted by the Accounting Standards Board (ASB) and Nepal Standards on Auditing (NSA) as drafted by the Auditing Standards Board (AuSB). The ICAN is mandated by law to institute the following objectives:

- Assume the role of a regulatory body in order to encourage its members to constitute an accounting profession acting within the code of conduct as laid down so as to make the accounting profession transparent;
- Develop, protect, and promote the accounting profession by ensuring its members and practicing accountants understand their responsibility toward the profession;
- Provide quality professional education to accounting professionals in accordance with international norms and practice;
- Develop mechanisms of registration, examination and evaluation and of professionals in accordance with international norms and practices; and
- Support the government with constructive suggestions toward the formulation and revision of legislation on commerce, trade, accounting, and revenue.

To achieve the objectives, ICAN has developed a strategic plan for FY15-17 based on IFAC requirement and local context. The strategic plan is focused on 7 key domains: (1) *Public & Government*, (2) *Members & Accounting Profession: Ethics & Capacity Development*, (3) *Members & Accounting Profession: Market Development*, (4) *Students*, (5) *International Relations & Global Positioning*, (6) *Leadership & Influence*, and (7) *Institutional Development & Sustainability*.

**31. The ICAN has two types of professional memberships allowed under the law: Chartered Accountants and Registered Auditors.** There are approximately 750 Chartered Accountants licensed by ICAN, of which approximately 270 are in public practice. Chartered Accountants must complete and pass three levels in Chartered Accountancy Program. There are approximately 7,000 Registered Auditors (B, C, or D class) licensed by the ICAN. Registered Auditors were licensed by the Office of the Auditor General prior to enactment of the Nepal Chartered Accountants Act of 1997. The ICAN issues Certificates of Practice to all qualifying Chartered Accountants in public practice. A Chartered Accountant who has a Certificate of Practice for five years or more can apply to become a Fellow Chartered Accountant. Members who wish to renew their Certificate of Practice are required to comply with continuing professional education (CPE) requirements established by the ICAN. The current requirement is 15 credit hours a year and 60 credit hours in three years for Chartered Accountants and B-class Registered Auditors. For C- and D-class Registered Auditors, the requirement is 10 credit hours in a year and 40 credit hours in three years. However, members attaining age 65 do not require continuing professional education. Accountants not in public practice also do not have CPE requirements.



- 32. The independence of auditors in Nepal is partly prescribed by the Companies Act of 2006.** Section 111 restricts auditors from being appointed for more than three (consecutive) one-year terms in performing the audit of a public company. Section 112 describes all instances in which an auditor would be disqualified from acting.
- 33. In 2010, ICAN adopted the IESBA-issued Code of Ethics for Professional Accountants, which were applied in 2011.** IFAC's report on the ICAN Action Plan that shows compliance with the IFAC Statements of Member Obligation (SMOs) is summarized in Table 2.3:

Table 2.3: ICAN Compliance with IFAC Statements of Member Obligation

SMO NO.	Description	Compliance	Effective Date
SMO 1	Quality Assurance (mandatory)	<ul style="list-style-type: none"> <li>ICAN adopted a voluntary Quality Assurance Review Program under the Peer Review System.</li> <li>The AuSB developed and ICAN issued NSQC-1 in line with ISQC-1. In addition, AuSB also developed Quality Control for an Audit of Historical Financial Statements (NSA 220) in line with ISA 220; the standards were issued by ICAN.</li> <li>ICAN established an independent Peer Review Board. The Peer Review Board developed a Peer Review Manual.</li> </ul>	2007
SMO 2	International Education Standards (IES) for Professional Accountants issued by IAESB	<ul style="list-style-type: none"> <li>ICAN implemented education and training of professional accountants through the Chartered Accountant Program. The program requires 3 levels of accounting and auditing knowledge proficiency that must be demonstrated through a series of examinations. The program also requires 3 years experience training under a practicing chartered accountant at the 3rd level of the program.</li> <li>Members in practice must comply with 15 hours of mandatory CPE per year and a minimum of 60 hours of verifiable CPE over 3 years.</li> <li>ICAN revised the Chartered accountancy curriculum in line with the IES</li> </ul>	2012
SMO 3	International Standards issued by IAASB	<ul style="list-style-type: none"> <li>AuSB is by law the standard-setter in Nepal for audit and attestation standards.</li> <li>AuSB has developed 32 NSAs in line with ISAs.</li> <li>ICAN has pronounced these standards to be applied mandatorily.</li> <li>AuSB has also developed 10 new NSAs that are expected to be implemented and issued by the ICAN by 2014</li> </ul>	2008

Table 2.3: ICAN Compliance with IFAC Statements of Member Obligation

SMO NO.	Description	Compliance	Effective Date
SMO 4	IESB Code of Ethics for Professional Accountants	<ul style="list-style-type: none"> <li>• ICAN Council adopted the IESBA Code of Ethics for its members, enforceable from 2011.</li> <li>• ICAN included ethics as topic of the compulsory CPE for its members.</li> </ul>	2011
SMO 5	International Public Sector Accounting Standards (IPSASs)	<ul style="list-style-type: none"> <li>• The Government entrusted the ASB with responsibility to develop a Financial Reporting Under the Cash Basis of Accounting Standard for the public sector.</li> <li>• ASB has developed Nepal Public Sector Accounting Standards in line with IPSASs.</li> </ul>	2009
SMO 6	Investigation and Discipline	<ul style="list-style-type: none"> <li>• ICAN has established an investigative and disciplinary system for its members.</li> <li>• Disciplinary Committee was formed with 7 members to investigate and recommend action to be taken with regards to complaints against member misconduct and / or violation of acts, rules, and the code of ethics of ICAN.</li> <li>• Monitoring Committee was established by ICAN to monitor possible noncompliance of codes, standards, rules, and requirements.</li> </ul>	2009
SMO 7	IFRS issued by IASB	<ul style="list-style-type: none"> <li>• ASB was established by law as the accounting setter in Nepal. ASB has developed a new set of standards (NFRS/NAS) in convergence with IFRS, which being implementation by ICAN in a phased timeframe.</li> </ul>	See Table 2.4

**34. The ICAN constituted a Peer Review Board to regulate Chartered Accountants.** An ICAN-issued Statement on Peer Review intends to further enhance the quality of professional work of practicing Chartered Accountants. The main objective of peer review is to ensure that in carrying out their attestation services assignments ICAN members (a) comply with the mandatory technical standards and (b) have in place proper quality control systems. The members of the Peer Review Board are constituted from ICAN Council members and other ICAN members but not from other regulatory authority and stakeholders. The Peer Review System is a voluntary Quality Review Program and IFAC-issued SMO 1 requires that it must be mandatory (see Table 2.3).

**35. The Nepal Chartered Accountants Act of 1997 requires ICAN to enforce compliance by professional accountants and auditors with the prevailing standards and laws through a Disciplinary Committee.** The function of the Committee, having quasi judiciary power, is to investigate any complaint filed against a member for violations of practice with respect to professional standards, ethics, and laws. According to ICAN, to date 54 cases have been investigated, of which 6 were dismissed, 13 resulted in penalties, 32 are

in abeyance because of delay in obtaining information, and 3 are still under investigation. In addition, the banking, securities, insurance, and company registrar regulators are empowered under their respective acts, regulations, and directives to investigate and penalize violations with the laws and regulations.

## II.C Accounting Education and Training

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36. **The ICAN offers education and training for Chartered Accountants under the Chartered Accountancy Program, comprising three levels of education: CAP I, Foundation; CAP II, Intermediate; and CAP III, Final.** All candidates must take the 3 parts, except graduates who meet ICAN-set criteria may be exempt from CAP I. Candidates must pass the Chartered Accountancy Examination with an average grade of 50 percent or more for all parts, must complete 3-years practical training (articleship) under the mentorship of a Chartered Accountant in public practice, and must undertake 100 hours each of information technology and general management communication skills training as prescribed by ICAN. There exists a path for Registered Auditors to become Chartered Accountants if they complete two levels of examinations (CAP II and III) and one-year practical training under a Chartered Accountant. However, not many have taken this path.
37. **The Association of Certified Chartered Accountants (ACCA) examinations are conducted by the British Council on behalf of ACCA in Nepal.** There are some private educational coaching institutions, including a college, that provide classes for all levels of ACCA qualification. There are about 500 students undertaking ACCA qualification at different levels. Further, there are about 150 ACCA members working in Nepal, mainly in the private sector. In July 2014, ICAN announced exemption to ACCA members on CAP I and CAP II. However, ACCA members have to complete CAP III and three years of practical training under the supervision of a Chartered Accountant to qualify as a Chartered Accountant. There are no facilities for specific classes and examinations for Certified Public Accountants in Nepal. There are a few Certified Public Accountants in Nepal who earned qualifications abroad.
38. **An average of 25 Chartered Accountants qualify from ICAN in a year.**<sup>4</sup> This figure does not meet the market demand for trained accountants by audit firms, private industry, banking and financial sector, and government institutions. This has created and continues to perpetuate a serious capacity shortage and knowledge gap of accounting professionals in Nepal, which affects Nepal's economic development.
39. **Universities in Nepal do not offer many courses on accounting and auditing due to a lack of student interest in these disciplines.** The curricula, textbooks, and instructors are not updated to meet the global changes in accounting and auditing due to a lack of resources and student interest in these subjects. According to the deans of the business schools at the Tribhuvan University and Kathmandu University, most students are interested in business management courses and not accounting and auditing.
40. **As the economy develops in Nepal, the demand for trained accountants and auditors will continue to grow; under the present system the capacity gap is not likely to improve, but may get worse.** A steering committee of stakeholders (comprising universities, ICAN, regulators, Auditor General, and private sector) should address how to best address and resolve the training and education needs in accounting and auditing in Nepal.

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<sup>4</sup> ICAN figures based on average data of four years

## II.D Accounting and Auditing Standard-setting

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- 41. The Accounting Standards Board is an independent statutory body responsible for setting accounting standards for the preparation and presentation of financial statements in Nepal.** The Accounting Standards Board was established in March 2003 through an amendment to the Institute of Chartered Accountants of Nepal Act of 1997 incorporating the provision for its establishment and operation. The Accounting Standards Board is primarily responsible for setting accounting and financial reporting standards for business enterprises in line with IFRS. The Accounting Standards Board consists of 13 members, comprising a Government-appointed Chairman who is a Fellow Chartered Accountant, and other members representing the Ministry of Finance, Office of the Auditor General, Financial Comptroller General Office, Inland Revenue Department, Office of the Company Registrar, SEBON, and Chartered Accountants and Registered Auditors who are nominated by the Government as recommended by ICAN. The Accounting Standards Board to date has formulated 40 accounting standards (NFRS/NAS) that are in full convergence with IFRS/IAS (2012 edition). However, there are some additional requirement included in NFRS/NAS that need to reflect local needs and practices. Due to lack of resources, the Accounting Standards Board is unable to provide timely feedback on IFRS exposure drafts that are being revised or developed by IASB. The PEFA Secretariat, Nepal, provided financial support through a multi-donor trust fund to the Accounting Standards Board for the revision and development of accounting standards.
- 42. Most businesses in Nepal—that is, approximately 99 percent—are small and medium-size entities (SMEs).** Small and medium-size entities have no clear legal definition or have separate standards to be followed for preparing financial statements. As a result, SMEs in Nepal will continue to face a relatively greater financial reporting burden. Generally, these smaller size companies have no public accountability. They are found in all sectors except for financial and insurance. The Accounting Standards Board is in the process of developing NFRS for SMEs. The Companies Act requires all companies incorporated and registered under the Act to be audited. A great number of these SMEs are not active and may not have maintained accounts as required under the Act. Audit of these entities under the Auditing Standards Board standards is not economically feasible.
- 43. For implementing NFRS/NAS, ICAN and the Accounting Standards Board have been individually and jointly holding training programs, educational initiatives, workshops, and IFRS certification courses to generate awareness and to educate concerned stakeholders.** Discussions with several stakeholders suggest that the efforts of the ICAN and Accounting Standards Board may be insufficient and that support from the business community, including a proactive role of regulating agencies and government, may be required for the effective implementation of NFRS/NAS. Nepal faces several challenges of convergence to IFRS including:
- Changes to the regulatory environment,
  - Lack of trained and experienced human resources,
  - Business performance measurement and educating investors and boards,
  - Greater complexity in the financial reporting process, and
  - Significant one-time costs in training workforce and changing systems.

Under IDA's Development Policy Credit Program, the United Kingdom DfID's NFRS program has also provided intensive NFRS training to 277 officers drawn from Inland Revenue Department, Office of the Auditor General, Nepal Rasta Bank, SEBON, Rastriya Banijaya Bank, and Nepal Telecom using a purpose-built training center in Kathmandu. Training was delivered in three parts: (a) accounting skills to upgrade the capacity of officers to absorb NFRS training (the need to attend this five-week course was determined by testing of training candidates); (b) NFRS theory (five-week course); and (c) NFRS as applied to duties of regulators and tax inspectors (the length of these courses varied according to the specific needs of the recipient institutions).

- 44. The ICAN pronounced on September 13, 2013, that 40 NFRS/NAS, 8 Standard Interpretation Committee (SIC) statements, and 15 IFRIC statements would be effective from July 16, 2014, (except for NFRS 9, Financial Instruments, which would be applicable from July 16, 2015) in the phased manner shown in Table 2.4:**

Table 2.4: Phased Issuance of NFRS

Type	Entities requiring implementation of NFRS	NFRS complied financial
A	1. Listed Multinational Manufacturing Companies, 2. Listed (SOEs) with minimum capital of NPR 5 billion (except banks and financial institutions under BAFIA, 2006).	F/Y2014/2015
B	1. Commercial banks, including state owned commercial banks; 2. All other listed SOEs.	F/Y2015-2016
C	1. All other financial institutions not covered under A & B above; 2. All other SOEs, 3. Insurance Companies, 4. All other listed companies, 5. All other corporate bodies/entities not defined as SMEs or entities having borrowing with minimum of NPR 500 million.	F/Y2016-2017
D	NFRS for SMEs (SMEs as defined and classified by ASB)	F/Y2016/2017

- 45. The Auditing Standards Board was constituted by the Government in March 2003 under the Nepal Chartered Accountants Act of 1997.** The Auditing Standards Board consists of 7 members comprising representatives from the Ministry of Finance, Office of the Auditor General, and Chartered Accountants and Registered Auditors nominated by Government on the recommendation of ICAN. The Board has full discretion in developing and pursuing the technical agenda for setting auditing standards. The Auditing Standards Board to date has formulated 32 NSA based on ISA, 3 guidance notes, 1 practice statement, and the Nepal Framework for Assurance Engagements. The Auditing Standards Board is unable to provide timely feedback on ISA exposure drafts being revised or developed by the IAASB due to a lack of resources.

46. **The ICAN adopted Nepal Standards on Quality Control 1 (NSQC 1) in line with ISQC 1, and a voluntary system of peer review was implemented.** In interviews and discussion with ICAN members, the ROSC team learned that the Peer Review System is not working adequately as planned. As a result, there is no assurance that audit firms are performing audits of historical financial statements in compliance with the auditing standards. Risk assessment, audit sampling and planning, management representations, supervision and documentation of audits, and quality control for audit work have significant gaps that need to be aligned and enforced in line with ISAs.

## II.E Enforcing Accounting and Auditing Standards

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47. **The Office of the Company Registrar has a range of powers under the Companies Act of 2006 and is primarily responsible for its enforcement.** However, due to a lack of resources, the Office of the Company Registrar only compiles the audited financial statements, which are submitted by registered companies, and does not perform reviews or investigations to ensure compliance with standards and law. Similarly, SEBON is mandated by the Securities Act of 2007 to regulate and investigate noncompliance with standards, laws, and regulations of listed companies; but, due to lack of resources, no investigation or enforcement actions are taken to ensure compliance.
48. **For financial institutions, the Nepal Rastra Bank has the mandate under the Bank and Financial Institutions Act (BAFIA) of 2006 to regulate, investigate, and enforce compliance with relevant standards, laws, and regulations.** The Nepal Rastra Bank requires management of banks and financial institutions to submit drafts of financial statements for NRB approval prior to issuance of the final report. This requirement is enforced to ensure compliance with regulatory requirements, such as NRB requirements for computing loan loss provisions and recognition of income interest on a cash basis (which contradicts NFRS/NAS related to revenue, impairment of assets, and liabilities). The review of the loan loss provisions for financial statement purposes is performed by the Nepal Rastra Bank for approval of declaration and payment of dividends as required under BAFIA. Review, investigation, and enforcement are mainly performed to ensure compliance with the bank and financial institution laws and regulations and not with the accounting and auditing standards.
49. **The Insurance Board is mandated under the Insurance Act 1992 to systematize, regularize, develop, and regulate the insurance industry.** The Insurance Board requires management of the insurance company to submit audited financial statements along with the directors' report, internal audit report, preliminary audit report, management's response, and the long-form audit report for its approval. If the insurance company fails to submit the audit report to the Insurance Board within ten months, or if the audit report has reported any irregularity, or if a complaint is filed with the Insurance Board about irregularity in the insurance industry, the Insurance Board may audit or re-audit, or cause to be audited or re-audited, the concerned insurance company.

## III. Observed Financial Reporting and Auditing Practices

### III.A Status of IFRS adoption in Nepal

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1. **Nepal has converged NFRS/NAS with IFRS/IAS.** The ICAN has developed a roadmap for the transition to NFRS by Nepalese enterprises spanning from 2014 through to 2017 (refer to Table 2.4). Prior to the implementation of NFRS, multinationals, large enterprises, and banks followed NAS and select IFRS/IAS in preparing accounts and financial statements. All other entities followed a format for financial statement preparation prescribed in the Regulation under the Companies Act of 2006 and the guidelines issued by various regulatory bodies, specifically the Nepal Rastra Bank and Insurance Board.

### III.B Review of Financial Statements

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2. **The Nepal ROSC A&A team reviewed a sample of 20 financial statements from commercial banks; insurance companies; an airline; a hotel; and hydropower, manufacturing, and telecommunication companies.** The team found significant differences in the accounting standards and policies adopted vis-à-vis IFRS/IAS (See Annex 1). The team found that noncompliance is extensive. The extent of compliance with the adopted standards under NFRS/NAS will be the subject of a future ROSC A&A update. As observed in this ROSC A&A, the following descriptions of noncompliance are the most critical:

- Disclosure of accounting policies are not adequate as required under the IAS 1.117.
- IAS 1.25 requires the enterprise to make an assessment of going concern and report it in the accounting policies adopted for preparation of financial statements, but most of the enterprises have not disclosed this in their accounting policies.
- Tax liability is reported under the expense method and not the liability method as required under IAS 12.
- Depreciation rates applicable for income purposes are used instead of those required under the accounting standards under IAS 16.50.
- Banks and financial institutions, under regulatory guidelines, recognize interest income on a cash basis instead of accrual basis as required under IAS 18.
- Accruals for provisions related to retirement benefits obligations, required contributions to obligatory pension plans, leave benefits, and others are not recorded and reported in the financial statements at actuarial valuation as required under IAS 19.
- Related party disclosures are not adequately reported, and those reported do not meet the minimum requirements required under IAS 24.
- IAS 36 requires recording and reporting impaired assets but their adjusted value is not accurately reflected in the financial statements.
- Contingent liabilities are not adequately recorded and reported as required under IAS 37.
- IAS 39, Financial Instrument Recognition and Measurement, is not yet effective in Nepal and therefore not followed.
- IAS 40, Investment Property, with regards to disclosures, is not followed.

- IFRS 9, Financial Instruments, with regards to presentation and disclosure, is not yet effective in Nepal and therefore not followed.
- IFRS 13, Fair Value Measurement, has yet to be enforced in Nepal and is therefore not followed in preparation of financial statements.

### III.C Observed Auditing Practices

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3. **Based on the sample of 20 financial statements, the ROSC team observed that the audit firms are conducting audits of historical financial statements in compliance with the auditing standards.** However, it was felt that there were some deficiencies in areas of risk assessment, audit sampling and planning, management representations, supervision and documentation of audits, and quality control for audit work. These deficiencies need to be aligned and enforced in line with ISAs (see Annex 2).

### III.D Perceptions of the Quality of Financial Reporting

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4. **In interviews and discussions with various stakeholders, the ROSC team observed that a majority agreed that most general purpose financial statements in Nepal are not prepared in accordance with the applicable accounting standards.** Rather than following the applicable standards, the financial statements are prepared in compliance with regulatory requirements. There are serious concerns about the quality of financial reporting as revealed from the interviews and discussions with stakeholders and regulators and from the ROSC review of the sample of financial statements. The common view attributes one of the problems to the low-level skills of accounting professionals acting as preparers. Adding to this are the low importance given to financial reporting by the entities, the lack of capacity of the regulators, and the lack of sanctions resulting from poor oversight and enforcement all contributing to widespread noncompliance with the established national standards and reporting requirements.



## IV. Policy Recommendations

1. **The principle-based policy recommendations result from the review and discussions held with stakeholders by the ROSC team.** They are rooted in international good practice approaches and take into account the country context. The principal objective of this ROSC assessment is to assist Nepal authorities and other stakeholders in strengthening the financial and non-financial sectors' financial reporting and auditing practices as a means to support relevant strategic and economic objectives for Nepal. Without attempting to provide a detailed tactical design for reforms, this report suggests policy recommendations to enhance the quality of corporate financial reporting.
2. **The recommendations of this ROSC are interrelated and mutually supportive, designed to collectively improve the financial reporting environment in Nepal.** Good accounting standards, for example, are ineffective if practitioners do not understand how to account for financial transactions as per the standards. A rigorous statutory and regulatory framework is unlikely to be effective if it is not enforced. Some recommendations, although without immediate effect, will still remain high priority if the financial reporting environment in Nepal is to be upgraded to international standards within a reasonable timeframe.
3. **The policy recommendations are based on the assumption that long-term country objectives include thorough modernization of the accounting and auditing professions and development of a business environment conducive for preparation of transparent financial information compliant with international standards.** As set forth in this report, achievement of these objectives requires continuous reorganization and improvement of Nepal's legal framework, institutions, accounting and auditing profession, as well as change in its business culture and education system.
4. **Policies should not be developed and enacted without giving due regard to a country's ability to carry out such policies (both in terms of capacity and resources).** A relatively lenient rule that is robustly and consistently enforced is preferable to a more rigorous one that is unenforceable: the lenient rule can be progressively made more rigorous as the circumstances allow. The policy recommendations, while challenging, can be carried out in the short, medium, and long term and are conducive to Nepal's long-term objectives. A country action plan should be prepared based on these policy recommendations.
5. **Nepal should establish a multidisciplinary National Steering Committee to champion and coordinate the accounting and auditing reforms.** The recommendations require a holistic approach to implementation, and in this regard the National Steering Committee should advise policymakers and regulators. Based on the successful experience of other countries, this report recommends that the Steering Committee develop a country action plan that clearly sets out the key actions and allocates responsibilities for implementing the necessary reforms. The plan should include an itemized budget indicating resources necessary for successful implementation. The Government, policymakers, and development partners should work together to secure those resources so as to achieve the common goal of enhancing the quality of corporate financial reporting in Nepal.

## Statutory Framework

6. **Review provisions of the Companies Act of 2006 to include a size threshold for companies required to have their financial statements audited.** The Law currently requires all companies, irrelevant of size, to be audited. The threshold should establish that companies—public interest entities and non-public interest entities—above a certain size should be audited, and those below the threshold should present financial statements in a compilation format (as described in NSAs). The current requirement has two effects: (a) it represents an unnecessary burden for micro and small entities where there is less public interest in an audit; and (b) it is impractical for smaller companies to comply with the law given capacity constraints.
7. **Make requirements uniform and consistent for all companies under the regulatory bodies.** The financial reporting and auditing provisions and requirements are different under different laws such as the Companies Act and Audit Act and regulatory regulations such as directives from the Nepal Rastra Bank and Insurance Board. The Nepal Rastra Bank and Insurance Board currently have regulatory requirements that conflict with the preparation of financial statements under NFRS/NAS. Bank and insurance companies should prepare their financial statements following NFRS/NAS, with reconciliations in the notes to the financial statements with regard to regulatory requirements, if required. In addition to the auditor's opinion on the general purpose financial statements, regulators may choose to require an opinion on regulatory compliance to be issued by the auditors.
8. **Adopt accounting standards for SMEs based on IFRS for SMEs issued by IASB.** The Accounting Standards Board should define SMEs; that definition can later be adopted to comply with other laws.

## Accounting and Auditing Profession

9. **Establish an enforceable Quality Assurance System for audit firms.** A system of mandatory quality assurance for audit firms that audit listed companies, insurance companies, banks, and financial institutions should be established under the direction of ICAN and under the oversight and supervision of a Board formed by ICAN, Nepal Rastra Bank, Insurance Board, Office of the Auditor General, SEBON, and Office of the Company Registrar.
10. **Strengthen the enforcement mechanism.** High-quality corporate financial reporting depends on effective enforcement mechanisms. Merely adopting international accounting and auditing standards is not enough. The enforcement mechanism must stress the regulators' transparent and unbiased decision-making, quick and confidential investigative process, and effective means for rectifying detected noncompliance, together with imposing appropriate sanctions. Three important links exist in the enforcement sequence: (a) directors and top management must ensure that financial statements are prepared in compliance with the established standards; (b) auditors must act independently and judiciously to give their opinion whether the financial statements comply with applicable accounting standards and represent a true and fair position of the enterprise's financial condition; and (c) regulators, both self-regulatory organizations and statutory regulators, must implement arrangements for the efficient monitoring of regulatory compliance and consistently take appropriate actions against violators.

11. **Strengthen regulators' capacity.** Ineffective regulatory regimes provide a false sense of security to stakeholders. Capacity building should focus on technical personnel, practical training of reviewers, administrative support, and the necessary logistics support. It is recommended that the Office of the Company Registrar, Nepal Rastra Bank, Insurance Board, and SEBON recruit professionally qualified and experienced personnel and retain trained staff to effectively deal with accounting and financial reporting-related issues involved in the supervision of regulated entities. It is necessary to establish proper incentives for attracting well-trained and top-quality personnel, including professional accountants, into regulatory bodies. A sustained capacity-building effort would have to be undertaken to ensure continued effective capacity levels.
12. **Ensure better coordination among regulatory bodies for improving compliance practices.** The regulatory bodies in Nepal need better coordination in order to function cohesively in order to ensure sustainable, high-quality corporate financial reporting. The Government could undertake this leadership role to promote and coordinate coordination within the regulatory bodies.
13. **Strengthen the capacity of ICAN.** The ICAN capacity needs to be strengthened to ensure effective implementation of NFRS rollout, enhance its members' training program, and meet IFAC membership obligations. There may be a case for a twinning arrangement with a more advanced professional accounting organization.

## Accounting and Auditing Standards-setting

14. **Strengthen the capacity of the Accounting Standards Board and the Auditing Standards Board to ensure an effective standard-setting process and to be able to review the international standards being revised or developed.** The two Boards also need to keep the standards current with changes made in IFRS and ISA. The members of these Boards work only on a part-time basis. And the Boards are limited by resource constraints. These hindrances restrict the timely adoption of new standards, including the revision of standards.

## Education and Training

15. **Introduce an awareness program for the implementation of NFRS/NAS.** The Government should lead the effort in collaboration with ICAN, regulatory bodies, and the private sector, including SMEs, to design an awareness program on implementation of NFRS/NAS.<sup>5</sup>
16. **Make continuing professional education a mandatory requirement for ICAN members who are not in public practice.** This requirement would be in conformity with IFAC-issued IES 7, Continuing Professional Development; and SMO 2, International Education Standards for Professional Accountants issued by IAESB.

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<sup>5</sup> Under the IDA's Development Policy Credit program, the Bank is closely working with DfID to enable the authorities to achieve several policy actions that include NFRS-related activities.

- 17. Revise and update university accounting and auditing curricula.** ICAN should take a lead in working with universities to revise their curricula in line with IAESB, utilizing up-to-date materials to train professionals in auditing and accounting and prepare graduates for Chartered Accountancy. This will, over time, help to bridge the knowledge and capacity gap. The ICAN should also enhance its monitoring of the accreditation of institutes to ensure quality education and facilities for aspiring Chartered Accountants.
- 18. Upgrade skills of Registered Auditors.** ICAN should also look at the possibility of upgrading the skills of the over 7,000 Registered Auditors to enable them to provide services as Chartered Accountants. A study should be carried out to assess demand/supply gap of present and future requirements of qualified accountants in the country. Based on this study, the strategy should be developed to meet the requirements.

## Annex 1: International Accounting Standards Adopted by Nepal

IFRS #	Description	Standards	Apply to SMEs?
1	First time adoption of IFRS	IFRS Standards\IFRS 1.pdf	Yes
2	Share-based Payment	IFRS Standards\IFRS 2.pdf	Yes
3	Business Combinations	IFRS Standards\IFRS 3.pdf	Yes
4	Insurance Contracts	IFRS Standards\IFRS 4.pdf	No
5	Non-current Assets held for sale and discontinued Operations	IFRS Standards\IFRS 5.pdf	No
6	Exploration and evaluation of Mineral Resource	IFRS Standards\IFRS 6.pdf	No
7	Financial Instruments Disclosures	IFRS Standards\IFRS 7.pdf	Yes
8	Operating Segments	IFRS Standards\IFRS 8.pdf	No
9	Financial Instruments	IFRS Standards\IFRS 9.pdf	Yes
10	Consolidated Financial Statements	IFRS Standards\IFRS 10.pdf	Yes
11	Joint Arrangements	IFRS Standards\IFRS 11.pdf	No
12	Disclosures of Interests in Other Entities	IFRS Standards\IFRS 12.pdf	No
13	Fair Value Measurement	IFRS Standards\IFRS 13.pdf	No
IAS #	Description	Standard	Apply to SMEs?
1	Presentation of Financial Statements	IFRS Standards\IAS 1.pdf	Yes
2	Inventories	IFRS Standards\IAS 2.pdf	Yes
7	Statement of Cash Flows	IFRS Standards\IAS 7.pdf	Yes
8	Accounting Policies, Changes in Accounting Estimates and Errors	IFRS Standards\IAS 8.pdf	Yes
10	Events After the Reporting Period	IFRS Standards\IAS 10.pdf	Yes
11	Construction Contracts	IFRS Standards\IAS 11.pdf	No
12	Income Taxes	IFRS Standards\IAS 12.pdf	Yes
16	Property Plant and Equipment	IFRS Standards\IAS 16.pdf	Yes
17	Leases	IFRS Standards\IAS 17.pdf	Yes
18	Revenue	IFRS Standards\IAS 18.pdf	Yes
19	Employee Benefits	IFRS Standards\IAS 19.pdf	Yes
20	Accounting for Government Grants and Disclosure of Government Assistance	IFRS Standards\IAS 20.pdf	Yes
21	Effects of Changes in Foreign Exchange Rates	IFRS Standards\IAS 21.pdf	Yes
23	Borrowing Costs	IFRS Standards\IAS 23.pdf	Yes
24	Related Party Disclosures	IFRS Standards\IAS 24.pdf	Yes
26	Accounting and Reporting for Retirement Benefit Plans	IFRS Standards\IAS 26.pdf	No
27	Separate Financial Statements	IFRS Standards\IAS 27.pdf	Yes
28	Investment in Associates and Joint Ventures	IFRS Standards\IAS 28.pdf	Yes
29	Financial Reporting in Hyperinflationary Economies	IFRS Standards\IAS 29.pdf	Yes
32	Financial Instruments Presentation	IFRS Standards\IAS 32.pdf	No
33	Earnings per Share	IFRS Standards\IAS 33.pdf	No
34	Interim Financial Reporting	IFRS Standards\IAS 34.pdf	No
36	Impairment of Assets	IFRS Standards\IAS 36.pdf	Yes
37	Provisions, Contingent Liabilities and Contingent Assets	IFRS Standards\IAS 37.pdf	Yes
38	Intangible Assets	IFRS Standards\IAS 38.pdf	Yes
39	Financial Instruments Recognition and Measurement	IFRS Standards\IAS 39.pdf\IFRS	No
40	Investment Property	IFRS Standards\IAS 40.pdf	Yes

### Acronyms:

IFRS	International Financial Reporting Standard
IAS	International Accounting Standard
SIC	Standards Interpretation Committee (Pre-IFRS)
IFRIC	International Financial Reporting Interpretations Committee
SME	Small and medium-sized entity

## Annex 2: International Standards on Auditing Adopted by Nepal

ISAs #	Description
<b>General Principles &amp; Responsibilities</b>	
200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs
210	Agreeing the Terms of Audit Engagements
220	Quality Control for an Audit of Financial Statements
230	Audit Documentation
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication with those Charged with Governance
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
<b>Risk Assessment and Response to Assessed Risks</b>	
300	Planning an Audit of Financial Statements
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
320	Materiality in Planning and Performing an Audit
330	The Auditor's Responses to Assessed Risk
402	Audit Considerations Relating to an Entity a Service Organization
450	Evaluation of Misstatements Identified during the Audit
<b>Audit Evidence</b>	
500	Audit Evidence
501	Audit Evidence – Specific Considerations for Selected Items
505	External Confirmations
510	Initial Audit Engagements – Opening Balances
520	Analytical Procedures
530	Audit Sampling
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
550	Related Parties
560	Subsequent Events
570	Going Concern
580	Written Representations
<b>Using the Work of Others</b>	
600	Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)
610	Using the Work of Internal Auditors
620	Using the Work of an Auditor's Expert
<b>Audit Conclusions &amp; Reporting</b>	
700	Forming an Opinion and Reporting on Financial Statements
705	Modifications to the Opinion in the Independent Auditor's Report
706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report







**WORLD BANK, Nepal Country Office**

Yak & Yeti Hotel Complex, Durbar Marg,  
Kathmandu, Nepal

P.O. Box 798

Tel: +977 1 4236000

Fax: +977 1 4225112

[www.worldbank.org/np](http://www.worldbank.org/np)

**WORLD BANK**

1818 H Street, N.W.

Washington DC 20433, USA

Tel: 1 202 4731000

Fax: 1 202 477 6391

[www.worldbank.org](http://www.worldbank.org)



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