

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)**Republic of Korea****ACCOUNTING AND AUDITING**

June 30, 2004

Contents

Executive Summary

- I. Introduction
 - II. Institutional Framework
 - III. Accounting Standards as Designed and as Practiced
 - IV. Auditing Standards as Designed and as Practiced
 - V. Perception on the Quality of Financing Reporting
 - VI. Policy Recommendations
- Annex 1. Comparison between the 2002 Sarbanes-Oxley Act and recent legislations in Korea
Annex 2. Abbreviations and Acronyms

EXECUTIVE SUMMARY

This report provides an assessment of accounting and auditing practices in the Republic of Korea (Korea). Korean Accounting Standards, which have been established by an independent standard setting body, the Korea Accounting Standards Board (KASB), are largely consistent with International Financial Reporting Standards (IFRS). Korean Auditing Standards, which have been established by the Korean Institute of Certified Public Accountants (KICPA), are a translation of the International Standards on Auditing. The statutory regulator's audit engagement reviews have been strengthened in the last few years. However, opportunities still exist for noncompliance with established accounting and auditing standards.

The policy recommendations of this report focus on strengthening the monitoring and enforcement of established accounting, reporting, and auditing requirements. Additionally, recommendations have been made to enhance auditor independence, improve audit quality, and strengthen reviews of audit engagement and auditing firms. The KASB needs to make additional efforts to remove discrepancies between the local accounting standards and the IFRS; the objective should be full convergence with the IFRS. The KICPA needs to issue additional practice guidance to help implement auditing standards. The audit committee needs to be mandated for smaller listed companies, and its role needs to be strengthened. The statutory regulator should consider strengthening sanctions against violators of standards and rules and put in place an improved arrangement for efficient and effective oversight of auditors of public companies and monitoring of accounting firms.

The assessment was prepared by Behdad Nowroozi from the East Asia and Pacific Region of the World Bank. The assessment is based on the template completed by Professor Youngsoon Cheon and Professor Il-Sup Kim (Consultants) and on the findings of due diligence missions carried out in November 2003 and April 2004, as well as on the input of Mr. Robert Mednick (Consultant). The report was prepared under the guidance of Mr. Ron Points. We would like to express our gratitude to the Financial Supervisory Service, Financial Supervisory Commission, KICPA, KASB, and Ministry of Finance and Economy for their cooperation and contribution.

I. INTRODUCTION

1. This report is based on a review of accounting and auditing practices in the Republic of Korea (Korea). The review is a part of the World Bank and International Monetary Fund joint initiative on Reports on the Observance of Standards and Codes (ROSC).¹ The review process involved an assessment of actual practices and analysis of effectiveness of the mechanisms for ensuring compliance with the formal standards. The review used a diagnostic template developed by the World Bank to facilitate the assessment. The assessment results, complemented by the findings of a due diligence exercise conducted by World Bank staff, were used in preparing this report.²

2. Since 1997, the Korean government has taken significant measures to improve accounting and auditing standards and practices and to strengthen underlying institutions responsible for setting standards and ensuring compliance. Major steps taken include (a) improving the legislative and regulatory framework to enhance enforcement of accounting and auditing standards, (b) establishing an independent accounting standard setting body that issues accounting standards on the basis of International Financial Reporting Standards (IFRS), and (c) issuing new auditing standards that in substance are a translation of International Standards on Auditing (ISA). Furthermore, the Korean government has recently taken measures to enhance independence of external auditors.³ For example, the three-year auditor tenure was introduced for the listed companies to protect auditors from unjustified terminations; the six-year auditor rotation will become mandated to enhance independence of auditors for fiscal years starting January 1, 2006; and under the newly revised legislation the external auditor is prohibited from providing certain non-audit services for the audit client. In conjunction with elements of strengthened corporate governance, such as independent directorship and audit committees, these reforms are expected to contribute to production of high-quality corporate financial reporting in Korea.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

3. **The Act on External Audit of Stock Companies (EAA) mandates a joint stock company with total assets of at least 7 billion Korean Won, or KRW, (approximately US\$6.3 million) to file audited financial statements annually.**⁴ A joint stock company subject to the statutory audit requirement should file audited annual financial statements with the Securities and Futures Commission (SFC) through the on-line DART SYSTEM within two weeks after the annual general shareholder meeting, which must be held within 90 days after the fiscal year-end. As of December 31, 2002, 10,408 joint stock companies were subject to such audit requirements. The

¹ A corporate governance ROSC, completed in September 2003, provides details about corporate governance practices and the corporate environment in Korea.

² The due diligence missions were carried out in November 2003 and April 2004.

³ The legislation, enacted in December 2003, is summarized in Annex 1 in the form of a comparison with the 2002 Sarbanes-Oxley Act. The recent changes, however, did not include establishment of a Public Company Accounting Oversight Board (PCAOB) to oversee auditors of public companies and issuance of auditing standards.

⁴ 1 USD is equivalent to approximately 1,100 KRW.

EAA requires that the financial statements be prepared in accordance with the accounting standards to be established by the Financial Supervisory Commission (FSC), which in turn has delegated the standard setting responsibility to the Korea Accounting Standards Board (KASB), an independent private accounting standard setting body duly recognized by the EAA. Although the Commercial Code prescribes certain provisions applicable to preparation of the financial statements, the EAA prevails over the Commercial Code when there is a conflict between the EAA and Commercial Code. A joint stock company that has more than one subsidiary is required to prepare audited consolidated financial statements in addition to the parent-only financial statements. In addition, a business group (frequently referred to as *chaebol*) with total assets of 2 trillion KRW (approximately US\$1.8 billion) or more is required to prepare audited and file combined financial statements.

4. **The Securities and Exchange Act mandates companies with publicly held securities to file quarterly reports with the FSC and Korea Stock Exchange (KSE) within 45 days from the end of each quarter.** Quarterly reports include quarterly and cumulative quarterly financial statements. The Securities and Exchange Act further mandates that the quarterly financial statements of listed companies with total assets of 1 trillion KRW or more be reviewed by the external auditor.⁵

5. **A company that is subject to the EAA should appoint an external auditor within four months from the commencement of the fiscal year.** One exception is listed companies, which must sign a 3-year audit contract (i.e., the external auditor for a listed company should be retained for at least 3 consecutive years). Appointment of the external auditor should be approved by a statutory internal auditor, auditor appointment committee, or audit committee. The audit committee is required for listed companies with assets of 2 trillion KRW or more, and the auditor appointment committee is required for listed companies with assets less than this threshold. The auditor appointment committee is the committee established for the sole purpose of approving the appointment of the external auditor pursuant to the requirement of the EAA. However, if listed companies with assets less than 2 trillion KRW voluntarily establish the audit committee, the audit committee replaces the auditor appointment committee. The Commercial Code mandates the establishment of a statutory internal auditor for joint stock companies, with the exception of companies that have established an audit committee. (The audit committee, if it is established, replaces the statutory internal auditor.) The authority to approve the appointment of the external auditor is summarized in Table 1:

Table 1. Requirement for Establishment of Audit Committee by Type of Company

<i>Listed companies</i>		<i>Unlisted companies</i>
<i>With assets of 2 trillion KRW or more</i>	<i>With assets less than 2 trillion KRW</i>	
The audit committee required	Auditor appointment committee required, unless the audit committee is voluntarily established	Statutory internal auditor is required, unless the auditor appointment committee is voluntarily established

⁵ As of December 2002, there were 677 companies listed on the Korea Stock Exchange and 829 companies listed on KOSDAQ.

6. **The Securities and Futures Commission designates the statutory auditor for firms meeting the criteria for auditor designation.** The FSC-issued Rules on External Audit and Accounting prescribe the auditor designation criteria. The criteria include companies with high debt-equity ratios (i.e., 150 percent or more of the average debt-equity ratio of listed companies in the same industry) as well as companies that have significant financial transactions with management and major shareholders, that illegitimately changed the external auditor, or whose CEO owned a controlling voting interest (50 percent for unlisted companies and 25 percent for listed companies). Criteria also include companies whose financial statements were found not in compliance with generally accepted accounting principles in Korea as a result of audit quality review conducted by the Financial Supervisory Service (FSS), the administrative arm of the SFC. The designation of the external auditor is intended to enhance the independence of external auditors.⁶

7. **The EAA amended in December 2003 mandates companies subject to the external audit requirement to maintain an internal accounting control system.** Under the EAA, the requirement for maintaining an effective internal accounting control system will be effective in 2005. The statutory internal auditor and external auditor are required to evaluate and report on the internal accounting control system. The EAA also added a provision that prohibits retaliation against a whistleblower who provides the SFC, external auditor, or statutory internal auditor with information about violations of established standards, rules, and regulations.

8. The SFC has the responsibility to enforce accounting, reporting, and auditing requirements for all companies subject to the EAA. As part of the enforcement process, the FSS, an administrative arm of the SFC, reviews selected audit engagements for listed companies. The audit engagement review is referred to as "the audit quality review" since the process involves review of the audit report, audit working papers, and documents prepared by the client, if necessary. The FSS reports results of the audit quality review to the SFC, which, in turn, takes sanctions against the company, its management, external auditors, and individual auditors of audit engagements in the event of noncompliance with the accounting, reporting, and auditing requirements. The SFC has delegated the audit quality review responsibility for unlisted companies to the KICPA. The KICPA has its own staff to conduct the review. The KICPA reports the results of the reviews for unlisted companies to the SFC, which takes appropriate sanctions against the company, its management, external auditor, and individual auditors involved in the audit engagement in the event of noncompliance with the accounting, reporting, and auditing requirements.

9. **The National Assembly revised the Securities and Exchange Act in December 2003.** The revised Securities and Exchange Act requires that the audit committee of a listed company have at least one member who is an expert in accounting or finance, and that the audit committee of a company whose stock is listed on the KSE or KOSDAQ be chaired by an independent director. Additionally, the chief executive officer and chief financial officer (or officers performing similar functions) must certify documents periodically filed with the FSC, such as annual and quarterly reports. Also, a listed company is prohibited from making a personal loan or lending securities to,

⁶ The statistics for auditor designation during 1999-2003 are as follows: 277 firms (3.8% of total firms subject to the EAA) in 1999, 148 firms (1.86% of total) in 2000, 163 firms (1.85% of total) in 2001, 162 firms (1.63% of total) in 2002, and 153 firms (1.37% of total) in 2003.

and providing collateral or debt guarantee for major shareholders, directors, statutory internal auditor, officers, and members of the audit committee. The revised Securities and Exchange Act focuses on improving corporate governance of listed companies and enhancing responsibility of their management.

10. **The National Assembly passed legislation to allow the filing of the Security-related Class Action Lawsuit Act passed in December 2003.** The new Security-related Class Action Lawsuit Act aims to strengthen investor protection by allowing minority shareholders collectively to bring a lawsuit for accounting irregularities; untruthful disclosures in prospectus, annual reports, and quarterly reports; and illegal insider trading or stock price manipulation, provided that the shareholders meet certain requirements to file a lawsuit.⁷ The new Act also places a restriction of 3 lawsuits in 3 years that any person can file or an attorney can represent in order to minimize frivolous lawsuits.

B. The Profession

11. **The KICPA organized under the Certified Public Accountant (CPA) Act is the only national accounting association in Korea.** As a self-regulatory organization, the KICPA is responsible for monitoring and supervising certified public accountants. The Ministry of Finance and Economy (MOFE) oversees the KICPA. Only a certified public accountant registered with the Ministry of Finance and Economy is eligible to be a KICPA member. As of December 31, 2002, the KICPA had 6,439 registered certified CPAs, of which 4,594 were active in public practice.

12. **In the past, there was a shortage of certified public accountants given that 10,408 companies are subject to the statutory audit requirement.** In order to reduce a shortage of certified public accountants, the government increased the number of candidates passing the CPA examination each year from about 500 in the past to at least 1,000 since 2001. Many of them have not been able to find positions at accounting corporations or joint audit teams, however. In order to ease this problem, the CPA Act (amended in December 2003) shortened the time period from at least 2 years to 1 year of practical experience that is required before an individual can register as a CPA. Still, accounting corporations and joint audit teams cannot afford to hire all of the growing number of CPAs that is due to the low audit fees in Korea compared to other countries. It is unclear at this point whether, or to what extent, efforts to increase number of CPAs will affect quality.

13. **There is no arrangement for recognition of foreign accountancy qualifications.** There are restrictions on foreign accountants' and firms' ability to provide external audit services in accordance with the EAA, and to act as tax filing agents under the tax laws.

14. **Accounting firms are required to either set aside funds (joint indemnity fund) with the KICPA or to purchase professional indemnity insurance.** The joint indemnity funds operated by the KICPA consist of the down payment and an annual injection of funds. The down-payment

⁷ In order to bring a class action lawsuit, the number of shareholders who suffered loss must be at least 50 persons and they must own collectively at least 0.01 percent of the company's equity ownership.

requirement is 250 million KRW for large accounting firms with 100 or more CPAs and 50 million KRW for smaller accounting firms with less than 100 CPAs. In addition to the down-payment, accounting firms are required to inject 4 percent of their total audit fee revenue each year until the fund reaches 20 percent of average total audit fees of the current year and the immediately preceding 2 years. Alternatively, accounting firms may purchase professional indemnity insurance. The Presidential Decree of the EAA requires that the coverage of the insurance be the larger of 3 billion KRW or the product of 50 million KRW multiplied by the number of CPAs of the accounting firm (i.e., maximum coverage equals the larger of (a) 3 billion KRW or (b) 50 million KRW × the number of CPAs).

15. The EAA (amended in December 2003) stipulates a mandatory rotation of the external auditor after 6 consecutive years of engagement in order to enhance the auditor independence. The auditor rotation requirement shall be effective from fiscal year 2006. The EAA also mandates the external auditors to maintain audit working papers for at least 8 years after the audit engagement is completed.

16. The audit partner of an accounting firm is prohibited from being engaged in the audit services for the same client for more than 5 consecutive fiscal years (3 consecutive fiscal years if the client is a listed company) under the EAA provisions. Furthermore, two-thirds of the audit staff must be rotated every 3 fiscal years.

17. The CPA Act (amended in December 2003) prohibits the external auditor from providing certain types of non-audit services. Non-audit services prohibited by the amended CPA Act are bookkeeping or other services related to the accounting records of the audit client; compilation of financial statements of the audit client; financial information systems design and implementation; internal audit outsourcing services; and other non-audit services that can cause conflicts of interest, as prescribed by the Presidential Decree.

18. The CPA Act mandates members of the KICPA to follow the Code of Professional Ethics issued by the KICPA in May 2003. The new KICPA-issued Code is largely consistent with the Code of Ethics for Professional Accountants issued by the International Federation of Accountants (IFAC) in 2001. The KICPA may request the Minister of Finance and Economy to impose sanctions against members who do not comply with its by-laws, including the Code of Professional Ethics. Since issuance of the Code, there have been no reports of the KICPA taking measures against its members.

19. An external auditor must be either a joint audit team consisting of three or more certified public accountants or an incorporated accounting firm, called an accounting corporation, consisting of 10 or more certified public accountants. A joint audit team or accounting corporation must register with the Korean Institute of Certified Public Accountants (KICPA) to provide external audit services. As of October 31, 2003, 65 accounting corporations and 370 joint audit teams were registered with the KICPA for the provision of external audit services.

20. Financial statements need to be approved by shareholders at the annual general meeting. External auditors are required to perform audit in accordance with auditing standards

established by the KICPA and approved by the FSC. The audited financial statements need to be submitted to annual general shareholder meetings for approval, if the company is subject to the external audit requirement under the EAA. The auditor is required to answer questions of shareholders on matters related to the audit of financial statements at the shareholder meeting.

C. Professional Education and Training

21. **Prerequisites for becoming a registered certified accountant are passing the CPA examination and completion of at least one year of practice at the training organization as prescribed by the Presidential Decree of the CPA Act.** The Ministry of Finance and Economy has a legal responsibility to conduct the CPA examination, but has delegated the responsibility for administering the exam to the FSS. The CPA examination is composed of two stages and is administered once a year. Only those who pass the first-stage examination are eligible to take the second-stage examination.⁸ The second-stage exam may be taken twice. Practical training may take place at accounting firms, joint audit teams, the KICPA, the FSS, and any institution that the Minister of Finance and Economy approves upon the recommendation by the KICPA. A candidate is required to spend at least 3 years if he/she gains practical experience with a training organization other than accounting corporations, joint audit teams, the KICPA and the FSS. The practical training requirements are administered by the KICPA.

22. **The CPA Act mandates the KICPA to conduct and monitor continuing professional education (CPE) for its members.** The KICPA requires that candidates who pass the CPA examination attend the 200-hour training course organized by the KICPA training center in addition to practical experience of 3 years with the training organization before registering with the Minister of Finance and Economy.⁹ Subjects of the training course organized by the KICPA training center include most areas recommended by IFAC, including accounting, auditing, performance evaluation, taxation, and professional ethics. The KICPA also requires at least 30 hours of CPE credits for practicing accountants who are from accounting firms or joint audit teams and at least 15 hours of CPE per year for other practicing accountants.

D. Setting Accounting and Auditing Standards

23. **The EAA prescribes the FSC as the final authority to set accounting standards, and has allowed the FSC to delegate the standard-setting responsibility to an independent private-sector organization.** Prior to 2000, the FSC established the financial accounting standards in Korea. With the endorsement of the FSC, the Korea Accounting Institute (KAI) was established in 2000 with the responsibility for setting the Korean financial accounting standards (KFAS). The law

⁸ With the exception of experience for certain years as financial officers in government, professions, etc.

⁹ One to two years in audit firms or three years in nonaudit institutions to qualify as being auditor of the companies subject to the External Audit Law.

does not require compliance with IFRS officially. However, the KFAS are largely consistent with the IFRS, since the KAI/KASB employs IFRS as its benchmarks.

24. **The KAI consists of 5 bodies--the General Membership, Board of Directors, Korea Accounting Standards Board (KASB), Korea Accounting Standards Advisory Council (KASAC), and Research Department.** The General Membership consists of 15 organizations that fund the KAI. The Board of Directors consists of the president of the KAI, standing director of the KAI, and 9 non-standing directors elected from the General Membership. The KASB consists of the chairman, who is the president of KAI; the standing director of KAI; and 5 non-standing members; KASB has the responsibility for issuing, revising, and interpreting accounting standards. The KASAC is composed of the KAI standing director and 19 non-standing members; it is responsible for giving advice to the KASB. The KAI receives funding from general membership fees and a percentage of commissions from listed companies.

25. **EAA mandates the KICPA to set auditing standards subject to approval by the FSC. The KICPA has authorized the Auditing Standard Committee of the KICPA to issue auditing standards on its behalf.** The Auditing Standard Committee is composed of the vice president of the KICPA and 10 non-standing members. The law does not require compliance with the International Standards on Auditing. However, the Korean translation of the ISA was adopted as national standards in February 1999. Although the Auditing Standard Committee follows the due process, the adopted standards are virtually the translation of the ISA. The EAA (amended in December 2003) requires pre-approval by the FSC, whereas the previous version required post-approval by the FSC.

26. **The audit profession has been challenged by a number of high-profile corporate failures in the recent past.** During 1991-2000, only 14 lawsuits were filed against auditors for audit failures. Since the 1997 financial crisis, many high-profile business groups and corporations, including Kia and Daewoo, have gone bankrupt. These large corporate failures triggered multiple lawsuits against external auditors. For example, 13 lawsuits were filed against 4 accounting firms since 2001; this is almost the same number of lawsuits as those brought against auditors during the past 10 years. These lawsuits were filed mainly by creditors. With the enactment of the legislation allowing class action lawsuits by minority shareholders, auditors may experience more frequent and larger-scale litigations after 2004.¹⁰

¹⁰ Audit failure is defined as auditors' failure to fully comply with the local auditing standards. Sanctions that can be taken against accounting firms include recommending the MOFE to cancel the registration of the accounting firm, suspend partial or entire operations of the accounting firm up to one year; excluding from auditor designation up to three years; restricting audit service for specific companies up to five years; requiring additional contributions to the indemnity funds; and other necessary measures, such as correction order, request for submission of a memorandum (in which the auditor should promise to comply faithfully with the Auditing Standards), and warning. Sanctions against individual auditors include recommending the MOFE to cancel the CPA license, suspend the license up to two years; restricting audit service up to one year; restricting audit service for specific companies up to five years; requiring professional education up to twenty hours; and other necessary measures, such as correction order, request for submission of a memorandum (in which the auditor should promise to comply faithfully with the Auditing Standards), and warning.

E. Ensuring Compliance with Accounting and Auditing Standards

27. **The current regulatory enforcement mechanisms may result in compliance in form, rather than in substance.** While the FSS audit quality review is intended to identify accounting manipulations or irregularities, the level of sanctions against violators may not be adequate to deter companies from engaging in accounting manipulations or irregularities.

28. **EAA mandates the KICPA to set auditing standards subject to approval by the FSC. The KICPA has authorized the Auditing Standard Committee of the KICPA to issue auditing standards on its behalf.** The Auditing Standard Committee is composed of the vice president of the KICPA and 10 non-standing members. The law does not require compliance with the International Standards on Auditing. However, the Korean translation of the ISA was adopted as national standards in February 1999. Although the Auditing Standard Committee follows the due process, the adopted standards are virtually the translation of the ISA. The EAA (amended in December 2003) requires pre-approval by the FSC, whereas the previous version required post-approval by the FSC.

29. **The FSS conducted the review of audit quality of 2.9 to 6.7 percent of listed firms during 1998 through 2002.** As a result of audit engagement reviews, the FSS identified about 5 to 48 percent of the audit engagements reviewed as less than fully compliant with the accounting, reporting, and auditing requirements in the period of 1998-2002. During 2000-2002, the KICPA conducted the review of audit engagements of less than 5 percent of unlisted firms and identified 40 (out of 284), 43 (out of 322), and 18 (out of 184) audit engagements as less than fully compliant with the accounting, reporting, and auditing requirements. These figures account for 10 to 14 percent of the audit engagements reviewed.

30. **The SFC has delegated to the KICPA the responsibility to conduct review of accounting firms.** The objectives of review of accounting firms are to review the adequacy of accounting firms' operations, including quality control within the accounting firms and members' compliance with the firm's policies and procedures. Since June 2003, when the responsibility was delegated, the KICPA has completed the first review of the Big-4 accounting corporations. The inspection is conducted on-site and not less frequently than once every 5 years, unless it becomes impractical.

31. **The type of sanctions taken against the company, management, external auditors, and individual auditors varies depending upon the degree of noncompliance.** For example, the SFC may recommend that shareholders discharge management and directors who are responsible for noncompliance. Also, the SFC may ban issuance of securities up to 1 year, designate the external auditor up to 3 years, and take other necessary measures, such as orders for corrective action, warnings, and requests for submission of a memorandum in which the company promises to comply faithfully with accounting standards. With regard to audit firms, the SFC may recommend that the MOFE cancel the registration of the audit firm or suspend the accounting firm from practice up to 1 year; exclude the audit firm from auditor designation up to 3 years; restrict audit services for particular companies up to 5 years; require additional accumulation to the joint indemnity fund; and other necessary measures, such as orders for corrective action, requests for

submission of a consent letter in which the auditor promises to comply faithfully with auditing standards. With regard to individual auditors, the SFC may recommend that MOFE revoke the license or suspend the license for a fixed period up to 2 years; restrict audit services for specific companies up to 5 years; require additional CPE up to 20 hours; and take other necessary measures, such as orders for corrective action and warnings. Sanctions taken against unlisted companies, management, external auditors, and individual auditors are in general less severe than those taken against listed companies.

32. **The external auditor who discovers material violations of laws and regulations is required to report the fact to the shareholder meeting and notify the statutory internal auditor or audit committee of the fact.** Moreover, the external auditor is required to notify the statutory internal auditor or audit committee of the company's noncompliance with accounting standards. This requirement has been seldom fulfilled in practice.

33. **The KSE mainly monitors compliance with disclosure requirements.** The KSE designates a listed company that does not satisfy fair disclosure requirements as an unfaithful disclosure corporation and notifies the FSS and investors of such facts.¹¹ The KSE maintains a list of listed companies that intentionally have violated disclosure requirements set out by the law and regulations or that have been designated twice as unfaithful disclosure corporations over 2 consecutive years. The KSE includes in the list companies that have received a qualified audit opinion due to the scope limitation for the latest fiscal year. A company that has received an adverse or disclaimer opinion on its financial statements for the latest fiscal year or a qualified opinion due to the scope limitation for the previous two fiscal years is delisted from the KSE. The KSE does not perform other monitoring or enforcement activities on financial reporting, accounting, and auditing matters requirements of listed companies.

34. **Monitoring and enforcement of general-purpose external financial accounting and auditing standards applicable to the banks and other financial institutions are the same as those applicable to non-financial companies.** The SFC, as an authority to monitor and enforce general-purpose external financial accounting, reporting, and auditing requirements for banks, does not differentiate banks from companies in other industries in the enforcement process. The sanctions applicable to management, directors, company, and external auditors of banks in the event of noncompliance with the accounting, reporting, and auditing requirements are the same as those applicable to management, directors, company, and external auditors of non-financial companies.

35. **The accounting, reporting, and auditing requirements for general-purpose financial statements of banks are the same as those for non-financial companies.** Banks are required to prepare financial statements in compliance with the Accounting Standards for Banking Industry set

¹¹ Fair disclosure regulations require corporations to report to KSE before making information available exclusively to specific groups/persons who can access the information more easily than the public. Any listed corporation violating the fair disclosure obligation is designated as unfaithful disclosure corporation. Criteria for designation as unfaithful disclosure corporation include cases of not disclosing important corporate information by the disclosure deadline, cases of reversing or denying the whole contents of disclosure already made, and cases of altering significant portion of the contents of disclosure already made.

by the KASB.¹² Annual financial statements of banks need to be audited and quarterly reports of banks (regardless of size) need to be reviewed by the external auditors. The procedure to appoint an external auditor is the same as that for non-financial companies. There is no restriction on auditors who are eligible to audit banks with total assets less than 800 billion KRW. However, only accounting firms that have at least 100 CPAs and are affiliated with internationally recognized accounting firms are eligible to audit banks with total assets of 800 billion KRW or more.

II. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

36. **The Korean financial accounting standards are largely consistent with IFRS.** However, some inconsistencies do exist between the KFAS and IFRS. The most significant difference is on consolidation. Consolidated financial statements are the primary financial statements under the IFRS but not under the KFAS. Additionally, Special Purpose Entities (SPEs) are often not consolidated. However, efforts are underway to reduce differences between the Korean and international standards.¹³

37. **Results of audit engagement reviews conducted by the FSS and KICPA indicate several cases of noncompliance with important accounting requirements.** From results of audit quality reviews conducted during 2001 and 2002, three areas are noted. The first area is disclosures of related party transactions. Out of 100 and 102 audit engagements in 2001 and 2002, 33 (32 percent) and 26 (26 percent) audit engagements, respectively, did not comply with requirements for disclosure of related party transactions. The second area is valuation of marketable (investment) securities; 19 (19 percent) and 18 (18 percent) audit engagements in 2001 and 2002, respectively, did not comply with accounting standards for valuation of marketable (investment) securities. The third area is accounting for assets including inventory, accounts receivable, and Property, Plant, and Equipment; 26 (26 percent) and 27 (27 percent) audit engagements in 2001 and 2002, respectively, did not comply with accounting standards for asset valuation or classification.

38. **A ROSC review of the most recent financial statements of 30 non-financial listed companies, 8 largest commercial banks, and 3 largest insurance companies indicates an overall compliance with most disclosure requirements.** However, the scope of ROSC review did not cover accounting records and/or working papers of external auditors; and noncompliance with

¹² These standards are consistent with IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*.

¹³ In addition to the difference on consolidation, the other differences in accounting treatments and presentations between the IFRS and the KFAS can be summarized as follows: (a) the KFAS require a statement of appropriations of retained earnings, while the IAS require a statement of changes in shareholders' equity; (b) the KFAS do not provide requirements or guidance for financial reporting in hyperinflationary economies, while its counterpart does; (c) the KFAS do not allow revaluation of fixed assets, while the IAS allow and provide specific guidance on revaluation; (d) in the area of consolidated accounts, the KFAS are more specific; (e) for a lease, the KFAS differ from the IAS in that they calculate the carrying value of its receivable and identify the discount rate; (f) while the IAS 19 specifies a detailed set of disclosure items for each type of pension plans, the KFAS do not have such details; (g) in determining reportable segments, the KFAS are more rigid, but do not distinguish the reporting format of primary segment from that of supplementary segment(s); and (h) the IAS prescribe a separate disclosure for income taxes recognized as an extraordinary item or income taxes arising from discontinuing operations, while the KFAS do not.

recognition and measurement standards cannot generally be identified through the mere reviewing of financial statements. A checklist of selected disclosure requirements under Korean accounting standards was used to identify compliance of the 41 sample companies. The following instances of noncompliance were observed: (a) More than half of the sample firms did not disclose segment information at all. Even companies that disclosed segment information did not fully comply with the standards, especially concerning geographical segment information. (b) The Korean standards require disclosure of the effect of the changes in foreign exchange rate, as well as the accounting policies. However, only 7 companies disclosed the effect of changes in foreign exchange rate in compliance with the standards. (c) The Korean standards require disclosure of the interest rate used to determine the amount of borrowing costs eligible for capitalization. However, none of the sample firms complied with the standards. (d) While the Korean standards require disclosure of the description of contingent liabilities, they do not specify the items to be disclosed. As a result, the disclosure of contingencies is very general and simply describes the contingencies without giving information. Out of 30 non-financial companies, 21 companies disclosed information of outstanding litigations. However, no estimation of the possible outcome or financial effects was provided. In contrast, financial institutions are required to recognize and disclose the provision for future losses on commitment to extend credit or guarantee of payment on loans and securities. As a result, all financial institutions disclosed the amount of the contingent liability by category.

39. **There is no accounting standard for a special purpose entity (SPE).** Like in other countries, many Korean companies perform off-balance-sheet transactions using SPEs created at home and abroad. While these types of transactions could cause huge liabilities and risk exposure, there is no Korean accounting standard that requires recognition or disclosure of these transactions. Given that SPEs are legally independent entities, off-balance-sheet liabilities and risk exposures resulting from transactions with SPEs are not included in the financial statements unless SPEs are consolidated. Hence, off-balance-sheet transactions using SPE could be left out of financial statements of the companies engaging in those transactions.

III. AUDITING STANDARDS AS DESIGNATED AND AS PRACTICED

40. **The Korean auditing standards are in conformity with the International Standards on Auditing, since the Korean auditing standards are the Korean translation of ISA.** Since the ISA are revised on an ongoing basis, there are delays in incorporating revised ISA into Korean auditing standards.¹⁴

41. **Practice guidance to amplify auditing standards is lacking, except in a few areas.** The KICPA has issued guidance in 5 areas, 3 interpretations, and audit guidance for non-manufacturing industries in 8 areas in addition to the auditing standards. The audit practice guidance was issued to provide assistance in the areas that are unique in Korea or where ISA is absent, rather than to amplify the existing auditing standards. Interpretations were issued to amplify or illustrate the auditing standards. Industry audit guidance was issued to provide assistance on audits of non-manufacturing industries.

¹⁴ Most recent Korean auditing standards have incorporated ISA 240, 260, 505, 570, and 700..

42. **The survey of and interview with accounting firms affiliated with Big-4 have indicated that audit practice generally complies with auditing standards.** However, the interviews revealed that there are a few areas that are not in full compliance with the standards. These areas include risk assessments and internal control (ISA 400), auditing in a CIS environment (section 401), audit considerations relating to entities using service organizations (ISA 402), considering the work of internal auditing (section 610), and other information in documents containing audited financial statements (ISA 720). Furthermore, results of audit engagement reviews performed by the FSS and KICPA reveal three areas most frequently identified as noncompliance with accounting standards: disclosures of related party transactions, accounting for marketable (investment) securities, and accounting for assets (such as inventory; accounts receivable; and property, plant, and equipment). These results suggest that auditors tend to perform insufficient audit procedures related to disclosures of related party transactions and recognition and measurement of assets.

IV. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

43. Despite the weaknesses identified in the audit quality review and compliance with audit standards, investors are voicing a higher opinion about the quality of information available in the published financial statements, particularly those audited by Big-4 firms than in the past. There is a perception that the quality of audit carried out by Big-4 is significantly different from firms not associated with the Big-4. During discussions with the representatives of audit firms, several areas were cited for improvement: the CPE program administered by the KICPA; the quality of accounting systems, particularly for smaller companies; the level of audit fees; and communications between the independent auditors and the audit committees.

V. POLICY RECOMMENDATIONS

44. The policy recommendations presented in this section emerge from the ROSC review of accounting and auditing practices. The policy recommendations include valuable inputs received from various parties interviewed by World Bank staff conducting the due diligence exercise.¹⁵ These recommendations are aimed at developing an environment for high-quality corporate financial reporting. It is expected that the recommendations presented in this section will be used as inputs for preparing and implementing the action plan for further reform in accounting and auditing areas in Korea.

45. High-quality corporate financial reporting depends on integrated efforts of all parties involved in producing and assuring the financial reporting. There are four important parties involved in producing and assuring corporate financial reporting: (a) the accounting and auditing standard-setters; (b) the preparers of financial statements; (c) the auditors; and (d) the regulators, both statutory and self-regulatory bodies.

46. **The accounting standard-setter needs to make further efforts to remove discrepancies between the local accounting standards and the IFRS.** The standard setting objective should be full convergence with the IFRS.¹⁶ However, it may not be practical to require IFRS-equivalent standards for unlisted companies. The international standard for consolidation should be adopted in full as soon as possible. Separate accounting and reporting standards may be required for unlisted private companies that are subject to the statutory external audit requirements. Currently unlisted small and medium firms are exempt from complicated accounting standards, such as accounting for financial instruments, equity method, present value accounting for long-term receivable and payable, accounting for stock options, accounting for long-term constructions, accounting for deferred taxes, and calculation of earnings per share.

47. **Further efforts need to be made to ensure compliance with established accounting standards by the preparers of financial statements.** The newly amended EAA envisions that the requirement for maintaining the internal accounting control system stipulated in the Corporation Restructuring Promotion Act be phased out beyond 2005. However, the scope of the internal accounting control system is limited only to the accounting system. An internal audit function consistent with international best practice needs to be put in place and the audit committee needs to supervise the internal audit arrangement.¹⁷ Furthermore, efforts should be expended to ensure that adequate related party disclosure and reporting is made by companies.

48. **External auditors need to act independently in accordance with established auditing standards to assure that financial statements are prepared in compliance with the established accounting standards.** It is widely believed that often the external auditor may not be independent

¹⁵ Participants include KICPA, KASB, regulators, accounting professors, investment bankers, rating agencies, private sector firms, and accounting professionals.

¹⁶ The KASB plans to revise core Korea accounting standards in accordance with IFRS by December 2005.

¹⁷ The statutory internal auditors required by the Commercial Code do not perform internal audit function in most companies.

of management, which in turn may lead to audit failures. Thus, effective corporate governance measures need to be put in place to ensure auditor independence; this may be achieved by strengthening the role and responsibility of the audit committee in relation with the external audit. The audit committee needs to be required even for smaller listed companies with total assets of less than 2 trillion KRW. The audit committee needs to have authority to appoint the statutory auditor and set audit fees, and the statutory auditor needs to be accountable directly to the audit committee.¹⁸ Independence in the process of auditor appointment may be achieved by empowering the audit committee to appoint and monitor the work of the external auditor. The EAA (amended in December 2003) mandates 6 years mandatory auditor rotation to enhance auditor independence. However, the mandatory auditor rotation may increase the risk of audit failures because of increased audit start-up costs and lack of sufficient knowledge regarding firm-specific risks. Thus, steps need to be taken to make mandatory rotation effective. For example, an arrangement should be made in which the incoming auditor must refer to working papers of the predecessor auditor in the first audit of a particular client.

49. The statutory regulator, the SFC, should consider strengthening sanctions against violators of standards and rules and put in place an improved arrangement for efficient and effective oversight of auditors of public companies and monitoring of accounting firms. The FSS' audit engagement review is perceived as effective in deterring companies from violating established accounting and auditing standards.¹⁹ There is, however, a perception that actions taken against companies as a result of reviews have not been adequate. Hence, sanctions against companies responsible for violating established standards, rules, and regulations may need to be strengthened. Also, improved arrangements for effective monitoring of accounting firms need to be put in place. While the KICPA is responsible for review of accounting firms, it is not clear whether the current arrangement is effective given that the KICPA has not effectively exercised authority over its members. The government may wish to consider establishing an independent body for oversight of audit profession and auditors of public companies.²⁰

50. The KICPA, needs to put in place proper arrangements for efficient monitoring and enforcing of the Code of Professional Ethics. Appropriate actions need to be taken against members who fail to comply with the Code of Ethics. The KICPA should consider upgrading the Code of Ethics to make it consistent with the 2004 IFAC-issued Code of Ethics for Professional Accountants. The KICPA also needs to put in place arrangements (i.e., CPE and training) to enhance audit quality in the following topics: risk assessments and internal controls; auditing in a Commonwealth of Independent States (CIS) environment; audit considerations relating to entities

¹⁸ Currently, audit committee has the authority to approve the statutory external auditor who is appointed by management on behalf of the company.

¹⁹ Interviews with the academicians in Korea also confirmed the effectiveness of the FSS' audit engagement reviews. As a result of the FSS' audit engagement reviews, the SFC recently took sanctions against the SK Global, its management, and its statutory auditor-Young-Wha Corporation (Ernst & Young Korea). The sanctions taken are as follows: against SK Global—restricted issuance of securities for 1 year and designated the statutory auditor for 3 years; against management—recommended discharge of CEO and related executive directors; against audit firm—impose a fine of more than 300 million KRW (approximately US\$250,000) and restrict the conduct of audit on a particular company for 5 years; and against individual auditors—recommended the MOFE to revoke the license of 2 CPAs and suspend the license of 2 CPAs for 1 year.

²⁰ The Sarbanes-Oxley Act of 2002 mandates the Public Company Accounting Oversight Board to conduct inspection of public accounting firms registered with the Board.

using service organizations; consideration of the work of internal auditing; other information in documents containing audited financial statements; disclosures of related-party transactions; and recognition and measurement of assets. The SFC should consider strengthening the monitoring of audit quality in these areas

51. **The level of audit fees needs to be consistent with the quality audit.** The audit committees, rather than management, should set audit fees. Actions need to be taken against those who practice “low-balling.” An appropriate arrangement needs to be in place to prevent too much price-cutting in order to develop new audit clients: for example, requiring standard audit hours and fees, if feasible, or reviewing audit engagements by auditors who practice too much price-cutting.

52. **The KICPA, the auditing standard-setter, needs to issue more practice guidance to help implement auditing standards.** The KICPA also needs to provide adequate guidance on reporting on internal controls.²¹ Further efforts need to be made to upgrade the CPE program of KICPA, particularly in areas such as impairment of assets, accounting estimates, and fraud audit.

53. **The FSS and KICPA need to provide guidance on the appropriate frame of reference for assessing internal controls.** The COSO framework in the United States is recognized as the frame of reference for assessing internal controls by external auditors under Section 404 of the Sarbanes Oxley Act.

54. **Further efforts will be required to improve the effectiveness of audit committees and replace statutory auditors with audit committees for smaller listed companies.** A critical element of such improvement is establishment of effective internal audit function in listed companies.

²¹ The COSO framework is recognized as a frame of reference for internal control reporting by PCAOB.

ANNEX 1.
Comparison between the 2002 Sarbanes-Oxley Act and recent legislations in Korea

<i>2002 Sarbanes-Oxley Act</i>	<i>Recent legislations in Korea</i>
Sec. 101-107 Establishment of the Public Company Accounting Oversight Board	- No equivalent provision pertaining to the Oversight Board - The Act on External Audit of Stock Companies amended in December 2003 increased a period that a statutory auditor should maintain audit work papers from 5 years to 8 years.
Sec. 108, 109 Accounting standards and funding	- No equivalent provision - Korea Accounting Institute, a private standard-setter, has a responsibility to establish Korean accounting standards.
Sec. 201 Prohibit non-audit services	- The CPA Act amended in December 2003 prohibits the statutory auditor from providing certain types of non-audit services contemporaneously with the audit. Non-audit services prohibited by the amended CPA Act are as follows: Bookkeeping or other services related to the accounting records of the audit client; preparation of financial statements of the audit client; financial information systems design and implementation; internal audit outsourcing services; other non-audit services that can cause conflicts of interest, as prescribed by the Presidential Decree
Sec. 203 Audit partner rotation	- The Act on External Audit of Stock Companies mandates the rotation of the coordinating audit partner of an accounting firm every 5 years (3 years if the client is a listed company).
Sec. 206 Conflicts of interest	- The Decree on the CPA Act amended in January 27, 2004, prohibits an accounting firm from performing audit service for a company if any of the company's officers (or the spouse of the officer) was employed by that accounting firm and participated in audit of the company during the 1-year period preceding the date of the initiation of the audit.
Sec. 207 Study of mandatory rotation of registered public accounting firms	- The Act on External Audit of Stock Companies amended in December 2003 requires a mandatory rotation of a statutory auditor in every 6 consecutive years from the fiscal years beginning after December 31, 2005, with a few exceptions.
Sec. 302 Corporate responsibility for financial reports	- The Securities and Exchange Act amended in December 2003 requires that the principal executive officer and chief financial officer or officers performing similar functions certify documents periodically filed with the FSC, such as annual reports, semiannual reports, and quarterly reports.
Sec. 402 Enhanced conflict of interest provisions	- The Securities and Exchange Act amended in December 2003 prohibits a listed company from making a personal

<i>2002 Sarbanes-Oxley Act</i>	<i>Recent legislations in Korea</i>
	loan or lending securities to, and providing collateral or debt guarantee for principal shareholders, directors, statutory internal auditor officer, and members of the audit committee.
Sec. 403 Disclosures of transactions involving management and principal stockholders	- The Securities and Exchange Act amended in December 2003 clarifies prohibition on personal loans to executives and requires disclosures of management compensation in annual reports.
Sec. 404 Management assessment of internal controls	- The Act on External Audit of Stock Companies amended in December 2003 mandates companies subject to the statutory audit requirement to maintain an internal accounting control system. The Act also requires the statutory internal auditor to assess internal control system and the statutory external auditor to attest to, and report on, the assessment made by the statutory internal auditor.
Sec. 407 Disclosure of audit committee financial expert	- The Securities and Exchange Act amended in December 2003 requires that at least one member of the audit committee of a company has expertise in the accounting or finance area and that the audit committee of a security company with stock listed on the KSE or KOSDAQ be chaired by an independent member of the board of directors.
Sec. 806 Protection for employees of publicly traded companies who provide evidence of fraud	- The Act on External Audit of Stock Companies amended in December 2003 stipulates protection for a whistleblower who provided the SFC, external auditor, or statutory internal auditor with information about violations of established standards, rules and regulations.
	- The Security-related Class Action Lawsuit Act enacted in December 2003 strengthened investor protection by allowing minority shareholders collectively to bring a lawsuit for accounting irregularities, untruthful disclosures in prospectus, annual reports, and quarterly reports, and illegal insider trading, or stock price manipulation, provided that the shareholders are qualified to file a lawsuit. The new Act also restricts the number of lawsuits that any person can file or an attorney can represent to 3 lawsuits in 3 years in order to minimize frivolous lawsuits.

Note: An important element of the Sarbanes-Oxley Act of 2002 is establishment of the Public Company Accounting Oversight body. The recent changes in Korea do not include establishment of such a body. This aspect of Sarbanes-Oxley Act is, however, being considered by the Korean authorities.

ANNEX 2. ABBREVIATIONS AND ACRONYMS

ROSC	Reports on the Observance of Standards and Codes
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
EAA	(Act on) External Audit of Stock Companies
SFC	Securities and Futures Commission (Korea)
FSC	Financial Supervisory Commission (Korea)
KASB	Korea Accounting Standards Board
KSE	Korea Stock Exchange
FSS	Financial Supervisory Service (Korea)
KICPA	Korean Institute of Certified Public Accountants
CPA	Certified public accountant
MOFE	Ministry of Finance and Economy (Korea)
IFAC	International Federation of Accountants
CPE	Continuing professional education
KAI	Korea Accounting Institute
KFAS	Korean financial accounting standards
KASAC	Korea Accounting Standards Advisory Council
SPE	Special purpose entity
COSO	Committee on Sponsoring Organization