Korean Experience: IFRS adoption and New Regulation for Firm Transparency

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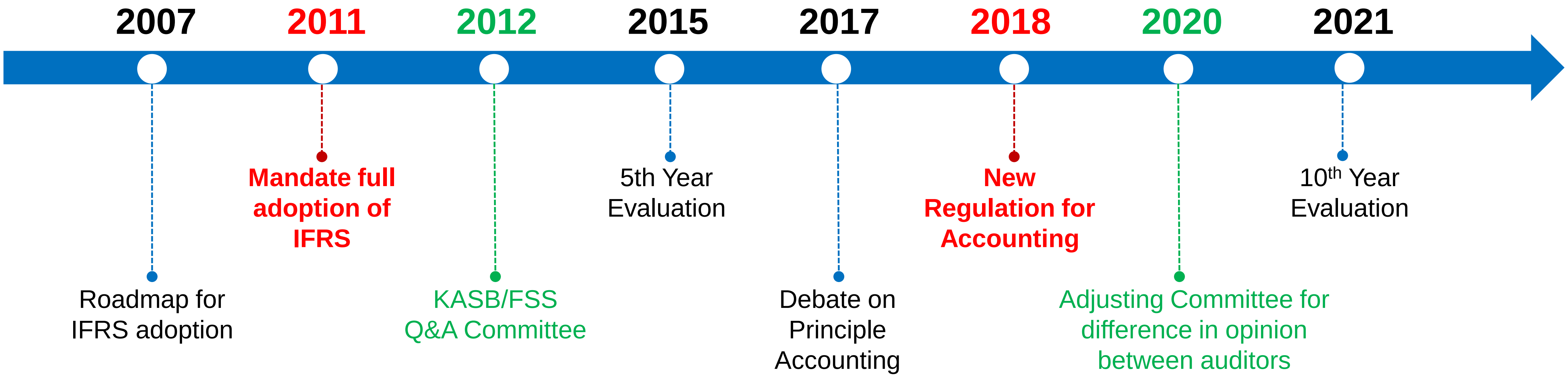
01 Major events relating to Korean accounting



Since adoption of K-IFRS in 2011, there has been

- two major regulation changes:
  - IFRS
  - Corporate Governance (External and internal audit)
- three big research issues in academia
  - IFRS adoption evaluation in 5th and 10th year
  - Debates on principle-basis accounting

1. Objective of IFRS Adoption

Korea	EU
1. Respond to the global trend of unification of accounting standard	1. Improving transparency and comparability of accounting information
2. Promote and show confidence in the quality of accounting information by introducing a more stringent and internationally recognized IFRS;	2. Facilitating the internal market by applying a single accounting standard among EU countries
3. Reducing the cost of accounting information for companies to expand overseas through a global single standard	3. Improving the efficiency of capital markets and reducing the cost of capital
4. Improving internal and external confidence in domestic accounting and reducing Korea Discount	4. Increased investor protection and confidence in capital markets.

- Simply put, Korea expects **signaling effect** of IFRS regarding the quality of accounting information by introducing IFRS which is regarded as more strict accounting standard than existing Korean GAAP (K-GAAP)
  - Strictness and high costs were important for strong signal effect,
  - leading to full adoption of IFRS
- On the other hand, EU needs for accounting system to facilitate internal market with launch of EU
  - Comparability was important while maintaining flexibility of accounting standards for diverse jurisdiction

2. Issues of IFRS vs K-GAAP

Standards	K-IFRS	K-GAAP
1. Approach	• Principle Basis	• Rule-basis
2. Main Statement	• Consolidated	• Separate
3. Measurement	• Fair Value	• Historical costs & fair value
4. Presentation	• Managerial discretion	• Guided format

1. K-GAAP used to benchmark US GAAP with small modification, thus it is likely Rule-Basis
2. Consolidated F/S was main difference between K-GAAP and IFRS
   - Main reason for firms to object IFRS for high costs
3. Although there has been lots of discussion regarding fair value, little attention was given to it as building up accounting system was main issue

Although there are some difference between IFRS and K-GAAP, academia believes that those differences were not that big

- K-GAAP was already strict enough and
- Korea want to confirm the quality of accounting information

1. Practical Issues

- Presentation
  - Several firms use brief form of financial statement without operating income
    - Raise issues of comparability of F/S
    - Korean government requires firms to present operating income in addition to IFRS

- Fair value measurement
  - How to measure fair value when there is no active market
  - IFRS does not provide detailed guideline for fair value measurement, so practitioners are concerned about situation when their estimation has large error

- Interpretation and application of IFRS
  - Issues of classification of perpetual bonds (capital or liabilities)
  - IFRS is slow in responding to specific accounting issues

2. Academic Issues

- Managerial Discretion
  - Several researches find that managerial discretion has increased after IFRS
    - Presentation, discretionary accruals, fair value measurement, scope of consolidation
  - Traditionally, more discretion means poor quality but IFRS requires more managerial discretion
    - Thus, what does it mean increased managerial discretion?
- Empirical results
  - Researchers did not find strong evidence either increased or decreased quality of accounting information
    - IFRS does not contribute to improve quality of accounting information in Korea or
    - K-GAAP could be already good enough (80% of K-GAAP are similar to IFRS) so the impact of IFRS could be marginal

3. 5th year evaluation and issues of principle based accounting

- Successful adoption even though very strict time constraints for preparation
  - 3 years preparation period from 2007 to 2010, but all listed firms successfully adopt IFRS

- No apparent benefits but apparent costs for firms to adopt IFRS and set up accounting system
  - Little evidence of change in cost of capital, accounting quality
  - In nature, change in accounting standards cannot lead to dramatic change in these issue, which is disappointment to policy makers
  - In addition, K-GAAP is not that bad in quality, so the marginal impact of IFRS cannot be that big

- Perception by information users are important in terms of signaling effect
  - Positive response by international users as evidence by interviews and inflow of finance

- There were issues in implementation of IFRS
  - As IFRS does not provide detailed guideline for fair value measurement and other major managerial discretion
    - Korean government launched supporting committee such as Q&A by KASB and FSS
  - However, because of characteristics of principle-basis accounting, there was big debate on principle-basis approach

1. Debates in applying IFRS

- Practical difficulties in applying IFRS as there is no clear guideline for managerial judgement
  - Fair value measurements for shares without active market
  - Research and Development costs for bio and pharmaceutical industries
  - Revenue recognition over period in construction, ship building industries
  - Profit/Losses during restructuring businesses

- Increased concerns by regulators for conflict IFRS and Korean practice
  - Slow response by IFRS/FRIC enough to meet timeline requirement for firm disclosures by Korean law
  - Amendments/development of standards take long time as IASB reflect all requirements around the world

  - The only way to improve accounting quality is to strengthen the internal & external monitoring of firms

2. Biggest amendment of law, “Act on External Audit of Stock Companies” since 2000s

- Main objective is to improve accounting information quality through
  - Improvement in quality of accounting information through
    - Better internal control
    - Better capability of firms in preparing financial statements

  - Improve effectiveness of external audit through
    - Improve audit independence
    - Higher capability of audit firms and auditors

  - Stronger regulatory role
    - Extend coverage of firms subject to the Law
    - Increase penalty to firms, managers, and auditors

3. Major regulation for stronger monitoring

Capability of firms	• Prohibition of external auditors from making financial statements for client firm • Requirements of early preparation of F/S and submission to regulatory body before external audit
Internal control	• Requirements of supervision of internal audit department by audit committee • **External assurance for internal control system**
Independence of external auditor	• **Routine designation of external auditor** (6 year of free audit engagement and 3 years of designated auditor) • **Standard audit hours** (provide expected audit hours reflecting firm size and risk)
Capability of external auditors	• Limiting external audit for listed firms to auditors satisfying requirements of # of CPA, internal review department
Penalty/Responsibility	• **Increase penalty** for failing external auditing and internal control

1. Standards alone do not solve everything

- It's firms that determine quality of accounting information, not the standards
  - All accounting information is generated by firms, thus it is important to lead firms to produce good quality of information
  - For regulator, sticks (penalty) are easiest way to govern the market but it's carrot (incentives) to move the market

2. Consider costs

- K-IFRS has certainly played the role of signaling about quality of accounting information by Korean firms, but costs of K-IFRS are not small
  - Korea has rule-based legal system thus it is not easy to apply IFRS because it does not provide clear guidelines for certain areas
  - All accounting rule, either rule-basis or principle basis, has pros and cons
    - But, rule-based standards could be less costly for firms if there is not enough infrastructure for accounting

3. Involvement of information users are necessary

- While costs of IFRS and regulation is obvious, benefits are not obvious
  - Costs occurs immediately, but benefits from improved accounting information needs time perceived by market
  - Investors' perception of quality of accounting information is key for the success of new regulation but it is not easy
    - Do investors understand and have interest in accounting information?
      - More and more investors are interested in short-term returns rather than fundamental of firms
    - Who is responsible for education of accounting, firms or government

4. Communications are key

- Sorry but there is no short-cut to Improve quality of accounting information
  - Firms, external auditors, regulators, and investors are all important for this objective
  - Cooperate and communicate among these parties are efforts and time consuming works, but it is the key
  - Practitioners say that Q&A committee, adjusting committee between auditors are helpful

Thank you very much for listening!
Any Questions?

THANK YOU