

FSC TO OVERHAUL ACCOUNTING REGS TO EASE BURDEN ON SMEs WHILE ENSURING ACCOUNTING TRANSPARENCY

The FSC prepared measures to overhaul the accounting regulations to make them more SME-friendly and to support SMEs better comply with the accounting and external audit regulations. The key measures include (a) exempting small-sized listed firms (less than KRW100 billion in asset) from external audit requirement for their internal accounting control systems, (b) launching and operating an accounting support center for SMEs at the Korea Exchange (KRX), (c) reducing the scope of large unlisted firms that are subject to the same accounting regulations in place for listed firms and (d) applying a simplified auditing standard for non-listed small firms.

In line with the regulatory improvements, the FSC will also strengthen the responsibility of executive officers over internal control of accounting practices and raise incentives for whistleblowing on accounting frauds within a company. For this, disclosure on the internal accounting control system will be improved substantially and the reward amount for whistleblowers will be increased significantly (by three times).

BACKGROUND

The accounting and external auditing regulations in Korea have been designed and developed with the focus on large listed companies¹ where the need for investor protection is high. SMEs have been subject to similar accounting and external auditing regulations with the large companies despite their smaller scale in terms of the size of interested parties like investors. This has resulted in relatively higher compliance burden on SMEs. As such, it has been pointed out that there is more cost than benefit in applying the same accounting regulations to SMEs. Moreover, it should be taken into account that the accounting reform of 2018 imposes financial burdens more on SMEs which usually have relatively lower profitability.

The government has listened to headaches of SMEs, discussed with experts and interested parties and reached the following proposals. An in-depth discussion followed at the 3rd financial regulatory reform meeting on September 30.

KEY DETAILS OF MEASURES

I. LOWERING THE BURDEN OF APPLICATION OF ACCOUNTING STANDARDS

a) Scope of consolidated financial statements

(As of Now) Beginning from the fiscal year 2022, for unlisted parent firms, the

¹ Large-sized listed companies make up 1.5% or 496 out of 33,250 companies subject to external audit.

scope of subsidiary firms subject to the requirement of consolidated financial statements has been expanded² from only those regulated under the Act on External Audit of Stock Companies to all subsidiaries.

(TO BE IMPROVED) For ordinary unlisted parent firms that have a relatively small size of stakeholders, an adjustment will be made to confine the scope of subsidiary firms whose financial statements should be consolidated only to those that fall under the purview of the Act on External Audit of Stock Companies.

b) Exchange of opinions between company and auditor

(As of Now) There have been numerous cases where designated auditors refuse to communicate with companies and instead request external consulting during the process of carrying out external audits and modifying their financial statements.

(TO BE IMPROVED) Best practice guidelines³ to promote exchange of opinions between companies and their auditors will be prepared and distributed. In addition, the use of no-action letter will be encouraged if necessary.

c) Accounting for securities with a refix option

(As of Now) Under the current K-IFRS (International Financial Reporting Standards), RCPS (Redeemable Convertible Preference Shares) with a refix option are categorized as debt, which distorts profits and losses of listed firms. RCPS with a refix option are considered as capital of unlisted companies that are subject to the accounting standard of K-GAAP (Generally Accepted Accounting Principles). However, after listing on a stock exchange, the accounting standard being applied to the companies switches to K-IFRS and its RCPS with a refix option are treated as liabilities. Therefore, even when a listed company is on a steady growth trajectory, its stock may be designated as administrative issue.⁴

(TO BE IMPROVED) Profits and losses resulting from RCPS with a refix option will be indicated separately on financial statements through footnote disclosures. The KRX's listing reviews will be conducted based on financial statements excluding those profits and losses.

d) Operation of an accounting support center designed for SMEs

The KRX will launch an accounting support center specifically designed to support SMEs, which will respond to inquiry on accounting standards, offer consulting on financial statements preparation and offer help with difficulties related to audit contracts.

² K-GAAP (Korea's Generally Accepted Accounting Principles) has been revised to ensure transparency between a parent company and its subsidiaries and consistency between K-GAAP and K-IFRS (Korea's International Financial Reporting Standards).

³ Permitted: Relaying specific opinion about the handling of accounting presented by a company.

Prohibited: Direct involvement in the preparation of a company's financial statements by an auditor.

⁴ An increase in stock price following an improvement in management performance leads to an increase in RCPS debt → This has a negative impact on company's profits and losses for the current term.

II. IMPROVING UNREASONABLE REGULATIONS ON ACCOUNTING AND AUDITING

a) Easing burden of auditor certification on internal accounting control system⁵

(As of Now) External audit on internal accounting control system will be expanded from next year to include listed firms with less than KRW100 billion in assets. However, due to small volume of business transactions and simple business process, there is more cost than benefit for small listed firms to carry out external audit of internal accounting control system.⁶

(To be Improved) Listed firms that have less than KRW100 billion in assets will be exempted from external audit requirement of internal accounting control system (a financial “review” rather than a financial “audit” will be required as it is the case now for small-sized listed firms).

b) Scope of large unlisted firms

(As of Now) Currently, large unlisted firms⁷ (KRW100 billion or more in assets) are subject to the same level of accounting regulations that are applied to listed firms such as the duty to set up and operate an internal accounting control system and have an auditor appointment committee. This is for transparency to stakeholders.

(To be Improved) The scope of large unlisted firms will be adjusted to those with KRW500 billion or more in asset.⁸

c) Setting up and operating internal accounting control system⁹

(As of Now) Currently, all listed firms with any asset size and unlisted firms that had KRW100 billion or more in assets in the previous business year are required to set up an internal accounting control system and to have an external auditor review their accounting practices. In this regard, unlisted firms face heavy burdens as the total asset standard is applied uniformly regardless of company size or the number of investors¹⁰

(To be Improved) The scope of unlisted companies required to have internal accounting control system will be reduced¹¹ to include only “large unlisted firms” in line with expected changes.

⁵ Requires a revision of the Act on External Audit of Stock Companies.

⁶ U.S. allows an exemption of external audit on internal control over financial reporting (ICFR) for businesses with less than USD7.5 million in market capitalization and businesses that have less than USD700 million in market capitalization and KRW100 million in sales.

⁷ The concept of large-sized non-listed (nonpublic) firms was introduced when a major accounting reform took place in 2018 and the scope of the concept was set broadly from the beginning.

⁸ Total number of companies will be reduced from 3,841 to 807 entities (down 3,034) based on the Framework Act on Small and Medium Enterprises.

⁹ Requires a revision of the Enforcement Decree of the Act on External Audit of Stock Companies.

¹⁰ U.S. and Japan impose duty to set up internal control over financial reporting (ICFR) for listed companies only.

¹¹ (Basic rule) Companies with KRW500 billion or more in assets
(Exception) (a) Companies that submit business reports, (b) Companies affiliated with conglomerates (KRW5 trillion in assets) that are subject to the disclosure duty under the Monopoly Regulation and Fair Trade Act.

III. REDUCING THE BURDEN OF EXTERNAL AUDIT

a) Auditing standard for small companies

(As of Now) The International Standard on Accounting (ISA) is designed for large listed companies and thus not quite suitable for small firms.

(To BE IMPROVED) For small unlisted firms,¹² a much simplified auditing standard (vis-à-vis ISA)¹³ will be applied.

b) Auditing practices

(As of Now) Unlike large accounting firms, small- and medium-sized accounting firms face difficulties in carrying out auditing practices tailored to small companies due to limited manpower and financial resources.¹⁴

(To BE IMPROVED) The effectiveness of auditing on SMEs will be improved with strengthened support for auditing practices like a manual for auditing small firms and document format development for audit statements.

IV. SUPPLEMENTARY MEASURES

a) Improve disclosure on the internal accounting control system

(As of Now) Currently, disclosed contents for the internal accounting control system is being prepared largely in a perfunctory manner which results in a low level of effectiveness for disclosures. Penalties¹⁵ for having adverse opinion on internal accounting have discouraged companies from making efforts to find their own problems and improve them on a voluntary basis.

(To BE IMPROVED) Disclosure requirement will be broken down further to reveal more specific contents and stronger responsibility of company executives and auditors over the operation and oversight of their internal accounting control system will be demanded. To help encourage self-corrective efforts of companies on internal accounting, the current penalty of listing eligibility review will be eased and the level of their self-improvement efforts will be reflected in post-inspection measures.

b) Increase the monetary reward amount given to accounting fraud reporter

(As of Now) Currently, there is a monetary reward system for reporters of accounting frauds (in place since 2006) but reward amounts remain too low (KRW30 million or KRW40 million per case on average) to encourage reporting.

¹² Assets below KRW20 billion or sales below KRW10 billion → About 12,887 companies

¹³ Implement measures currently pursued by International Accounting Standards Board (IASB) first (a draft unveiled and expected to take effect in 2025).

¹⁴ Auditing for small-sized companies is usually carried out with a modified auditing program and software specifically tailored for small-sized companies and developed by accounting firms.

¹⁵ Designation of company stock for investor caution (for having adverse opinion once), subject to listing eligibility review (for having adverse opinion twice in a row)

(TO BE IMPROVED) The reward calculation method¹⁶ will be improved to increase the reward amount per case significantly (by three times). The maximum standard reward amount per case will be doubled from the current level of KRW500 million to KRW1 billion and the number of deduction components decreasing final reward amount will be minimized¹⁷ by eliminating many components except core components.

ANTICIPATED EFFECT

With these measures, the FSC expects that excessive accounting-related costs (for preparing financial statements, hiring an external auditor, etc.) will be significantly reduced while maintaining accounting transparency for SMEs.

FURTHER PLAN

The FSC will actively support the legislative process at the National Assembly to ensure the passage of the revision bill of the Act on External Audit of Stock Companies within this year. The FSC will work to finish revising the Enforcement Decree and subordinate regulations until the first half of next year. Implementation of the measures that require no revision bill will be completed until the first quarter of 2023.

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For press inquiry, please contact Foreign Media Relations at fsc_media@korea.kr.

¹⁶ Calculated reward amount = Maximum standard reward amount multiplied by the degree of contribution made after considering deduction criteria.

¹⁷ e.g. Deduction criteria that are deemed as too arbitrary or qualitative in nature such as “cooperative behavior” and “impact on market” will be removed.