www.samil.com

PyeongChang 2018

Official Accounting Services Supplier

Korea Regulatory Reforms

Implications for Companies and Audit Firms in Korea

February, 2018

pwc

SAMIL | 삼일회계법인

Background

On September 28, 2017, the National Assembly passed far reaching reforms to Korea's financial reporting and external audit practices. The impact for companies and external audit firms in Korea is extremely significant, and represent the most significant reforms in over 30 years.

The reforms will result in fundamental changes covering a wide range of issues, including corporate accountability, external audit requirements and standards, and disciplinary measures, that will set higher standards for all stakeholders, including companies, auditors and financial regulators.

Alongside these regulatory reforms there are several other evolving trends that impact financial reporting and external audits, such as renewed focus by regulatory bodies on corporate governance, new proposed amendments to labor regulations (52 hour work week), and an increasingly hostile regulatory inspection and monitoring environment.

What is driving these reforms?

A number of combined factors are driving these reforms, including:

- Recent high profile accounting scandals in Korea (such as Daewoo Shipbuilding & Marine)
- Shifts in public sentiment towards Corporate Korea have led to changes in the political environment, and ultimately to an increased focus by the new administration on corporate accountability and transparency
- Changes within Korean society as the country continues its evolution to a more developed economy, with increased desire for work-life balance, less tolerance towards political and corporate misbehavior and social inequality leading to changes in labor laws and higher expected standards of working practice

What will these reforms mean for companies and audit firms in Korea?

Company management need to understand the new regulations and take appropriate action to ensure they appropriately plan for its implementation. Company management should plan in advance for the additional time and resource needed in their financial reporting processes in order to comply with the new requirements.

The main impact for audit firms will be the additional time and resource needed to perform audits due to increased regulator reviews, increased staffing needs as a result of the new 52 hour work week regulations, and increased difficulty associated with hiring and retaining qualified audit professionals due to increased demand for such professionals.

When will the reforms be effective?

The majority of the reforms will take effect from November 1, 2018 (i.e. for calendar year companies, first applicable for December 31, 2018 year-end reporting/audit periods), however, some will take effect on a deferred basis in 2019 or 2020.

Summary of Key Regulatory Reforms and Effective Dates

Key change	Applicable to	Effective from*
Enhanced criminal charges and disciplinary actions		
• Disciplinary actions strengthened for fraudulent financial reporting impacting companies, management, employees and auditors, including increased prison sentences (up to 10 years), increased financial penalties and increased statutes of limitation. • Penalty surcharges (with no dollar value limit) to be newly introduced under the Act, as follows: - Company: up to 20% of the total magnitude of fraudulent financial reporting - Employees: up to 10% of the penalties imposed against the company - Auditor: up to 5 times of audit fees	All companies Management Employees External auditors	2018
Enhanced responsibilities for the Company's preparation of financial statements		
• New obligations to disclose specific reasons if the company is not able to submit its unaudited financial statements to the regulatory authority and external auditor within a defined legal period (6 weeks before general shareholders' meeting) • Companies prohibited from asking or requesting accounting advice or preparation of financial statements from auditors, and auditors also prohibited from responding to such requests (subject to criminal penalties and/or mandatory auditor designation by regulatory authority if breached)	All companies	2018
"6+3 rule" – External auditor designation on a rotational basis		
• External auditor to be designated by regulatory authority for three consecutive years within every nine year period for all listed companies and certain private companies with poor corporate governance who have appointed its external auditor for six consecutive years (exemptions expected to be very rare)	Listed companies	2020
Expanded scope of auditor designation		
• Scope of mandatory auditor designation by regulatory authority to be heavily expanded for breaches or non-compliance with regulatory guidance (including prohibition of advising or supporting financial statements preparation and standard audit hour requirements)	All companies (only listed companies for certain financial metric related criteria)	2019

*For Dec 31 year-end companies

Key change	Applicable to	Effective from*
Standard audit hour requirements		
• The regulator perceives the current average level of audit hours as too low and is establishing standard audit hour requirements as a means of assessing audit quality. The standard audit hours are expected to be significantly higher than current average hours disclosed by audit firms. If actual hours are found to be lower than the standard then this would attract the attention of regulatory bodies, and could potentially lead to: - Tax investigations against the company - Regulatory inspection of audit files - Mandatory auditor designation by regulatory authority	All companies	2018
Audit of internal control over financial reporting		
• CEO required to report on management's assessment of internal controls at the annual shareholders' meeting	All companies	2019
• Auditor attestation strengthened to include audit of internal control over financial reporting (i.e., similar to US SOX), previously only a limited review of management assessment was required	Listed companies	Gradual adoption from 2019 to 2023, depending on asset size
Authority to appoint external auditors		
• Instead of appointment by management, the external auditor must be appointed by the Audit Committee (or individual internally appointed as 'statutory auditor') • Timing for auditor appointment accelerated.	All companies	2019
Enhanced responsibilities for fraudulent financial reporting identified		
• New requirements for audit committee (or individual internally appointed as 'statutory auditor') when informed of any fraudulent financial reporting by external auditor, including the need to investigate, take corrective actions and report to regulatory authority (similar to US Section 10A provisions)	All companies	2018

*For Dec 31 year-end companies

Key change	Applicable to	Effective from*
Enhanced regulation for large private companies and financial institutions		
• New qualification requirements for audit firms auditing large private companies and financial institutions • Audit appointment for 3 consecutive years, not annual (same as current requirements applicable to listed entities) • New partner rotation requirements (every 3 years)	Large private companies & financial institutions 'Large' expected to be defined as total asset size over KRW 500 million (announcement pending)	2019
Statutory audit requirements for LLCs		
• Limited liability company's (LLC) meeting certain criteria (still to be announced) to become subject to statutory audit requirements and other requirements related to filing and regulatory monitoring	Limited liability companies	2020
Improved whistleblowing protection		
• Criminal penalties newly introduced and administrative proceedings enhanced for better protecting whistleblowers		November 1, 2018
Enhanced responsibilities for accounting firms		
• Accounting firm registration requirements, based on certain criteria, for auditing listed entities • Greater accountability for audit quality control • Strengthened supervision and monitoring on accounting firms by regulatory authority with increased reporting responsibilities	Accounting firms	November 1, 2018

*For Dec 31 year-end companies

Other Changes Impacting Financial Reporting and External Audits

Besides the recent regulatory reforms, there are also several other developing trends occuring in Korea that also contribute to significant changes in the financial reporting and external audit landscape, such as the following:

1. **Triggers for Tax Inspections**

   The new Framework Act on National Taxes specifically links the targeting of Companies for tax inspections with the quality of a company's financial reporting. This means that companies with modified or qualified audit opinions, or companies with audit hours reported as lower than standard hours, are significantly more likely to be targeted for tax inspection.

2. **Corporate Governance**

   There are several ongoing initiatives, driven by government regulatory bodies, focused on enhancing corporate governance in Korea. An example includes recent Corporate Governance guidance being developed by the Korea Corporare Governance Centre and sponsored by the financial regulator.

3. **Amendments to Labor Laws (52 hour work week)**

   The government is expected to pass proposed amendments to the Labor Standards Act in July 2018 that will restrict employees in Korea from working more than 52 hours per week. This will impact companies in all industries, including finance team organizations and audit firms, resulting in the need for additional staffing levels in many cases.

4. **Increasingly Hostile Regulatory Inspection and Monitoring Environment.**

   In recent years the financial regulator has increased the frequency and rigor of inspections at both Companies and audit firms. The financial regulator has been strengthening their inspection teams with increased and more highly qualified resource levels. In addition, there are also clear trends towards the regulator taking stricter interpretations in assessing issues and imposing much higher sanctions in the event of perceived wrong doing.

5. **Audit Personnel Restrictions**

   There are regulations in Korea that prohibit the use of non-KICPA (Korean Certified Public Accountants) from performing certain roles on statutory audits. In recent years the interpretation of these rules by the regulator has been applied more narrowly, limiting the ability for audit teams to drive efficiency from performing certain procedures by shared service center functions.

Implications of Regulatory Changes on Companies in Korea

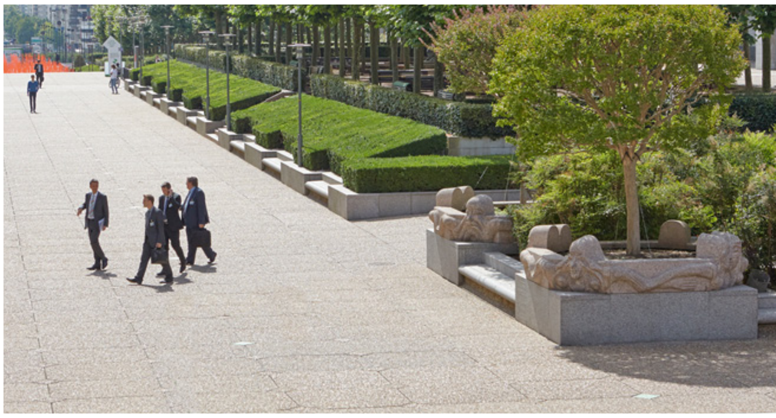
It is important for Company management to appropriately assess the risks and challanges created by the changes to financial reporting environment in Korea. We expect key considerations will include:

- The need for a paradigm shift within companies to recognize the increased importance of statutory reporting obligations and associated risks
- The need for greater number of, and more highly qualified, accounting resources in finance teams (or increase leverage of outsourced accounting service providers);
- The need to strengthen the role of the audit committee (or individual internally appointed as 'statutory auditor') to take on the additional required responsabilities
- The need for increased recognition of the role of the external audit, and the value that a robust external audit process can provide for all stakeholders in light of the new regulatory environment
- The need to assess corporate governance framework and identify areas for improvement

Implications of Regulatory and Other Changes on Audit Firms in Korea

The time and resources associated with performing an audit in Korea are expected to increase as a result of the new regulatory reforms and other changes impacting the financial reporting and external audit environment in Korea. A summary of the key drivers behind the expected input increases are as follows:

- Increased risk exposure by audit firms and audit professionals
- Increased standard audit hour requirements
- Increased frequency and rigor of audit inspections by regulator
- Increased regulatory responsibilities placed on audit firms
- Increased demand for audits due to increase in scope of companies requiring audits
- Increased difficulty associated with hiring and retaining qualified audit professionals
- Increased audit staffing levels needed due to new mandated 52 hour work week as additional audit staff will need to be recruited and trained for each job rather than having continuity from a smaller group of staff for longer durations
- Increased need for more senior audit professionals on audit teams to navigate the additional risks and complexities associated with the new regulatory reforms



Questions

We are very happy to help address any questions you may have on the changes taking place in Korea impacting your organization and your external audit. Please contact your local audit partner in the first instance with any questions you may have.

S/N: 1802A-BR-004