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# **Weekly Newsletter**

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## **Special Issue: Plans to Eliminate Deceptive Financial Accounting Practices**

### **I. Introduction**

**I**n an effort to eliminate the deceptive financial accounting and reporting practices - often referred to as “window dressing” accounting - that deceive or harm investors, impair market mechanisms, or otherwise place a heavy burden on the overall economy, the Korean government and the FSC/FSS jointly announced plans aimed at eliminating such practices on April 3, 2001.

The plans include steps for strengthening the external audit system, conducting stricter inspections and reviews of auditors, enforcing auditors’ professional responsibilities, and restricting credit access to companies that engage in deceptive financial accounting and reporting. The plans also allow an adjustment period for full adoption of the new accounting standards that will be phased in during the first and second half of this year.

### **II. Plans to Be Implemented during First Half of 2001**

#### **Strengthening External Audits**

##### **□ Enhancing independence of auditors**

- Any accounting firm shall be barred from conducting external audits for a company in which it owns an equity interest (0.01% of outstanding shares or 30 million won, whichever is less) or owes or holds claims greater than 30 million won to or against the company. Currently, the thresholds for equity interest and liability claims are 1% and 100 million won, respectively.
- The largest institutional shareholder shall be appointed to the external auditor appointment committee of the audited company to participate in the selection of an external auditor to conduct an independent audit.



□ **Continuous financial reporting system**

- Quarterly reviews of financial statements by an independent auditor shall be phased in based on such criteria as size of the companies or a threshold of 2 trillion won in assets.
- Companies that are required to present annual financial statements pursuant to the Securities and Exchange Act shall notify its external auditor of all material financial information and consult the external auditor on accounting treatment of all significant business activities.

□ **Strengthening internal control systems**

- Companies listed on the Korea Stock Exchange or the KOSDAQ shall establish clearly defined internal accounting procedures pertaining to classification of their accounting records, entry methods, closing dates, adjustment entries, transaction entry methods, and other related activities. The companies shall be required to record all transaction activities as they occur and without exception.

**Stricter Inspections & Reviews, and Clarification of Professional Responsibilities**

□ **Increase of FSS enforcement personnel**

- The Financial Supervisory Service shall increase the number of enforcement personnel in charge of detecting deceptive financial accounting and reporting practices to a level that is appropriate to effectively cope with the new standards.

□ **Misconduct and professional responsibilities and liabilities**

- The scope of responsibilities and liabilities between an audited company and the auditor shall be clearly delineated, and penalties commensurate with the severity of misconduct shall be imposed, whenever appropriate.



- Greater use of monetary penalties shall be enforced against misconduct by accounting firms in conducting audits.

### **Improving Audit Quality**

#### **□ Introduction of peer review**

- A peer review committee shall be formed in the Korea Institute of Certified Public Accountants to conduct independent peer review of audit performance by accounting firms. The results of the peer review shall then be reported to the Securities and Futures Commission.

#### **□ Incentives to outstanding accounting firms**

- Accounting firms that are designated as “outstanding” by the Securities and Futures Commission based on an FSS inspection and audit reviews shall receive preferential status from the Commission when it selects an external auditor for companies subject to audit review.

#### **□ Rational compensation system for audit services**

- A rational audit service fee structure based on asset size and the audit hours needed for target companies shall be established under the guidance of the Korea Institute of Certified Public Accountants and associations representing listed companies in Korea.

### **Market Mechanisms to Counter Deceptive Accounting Practices**

#### **□ Listing exclusion of companies receiving “qualified opinion”**

- If a company receives a “qualified opinion” on its financial statement, it shall be excluded from consideration for listing on domestic stock markets, as it will be



deemed as not having received an external audit.

□ **Discriminating treatment by financial companies**

- Financial companies shall be encouraged to enforce penalties such as earlier loan repayment, higher interest rates, and other unfavorable treatment against companies that engage in deceptive financial accounting or reporting.
- Financial companies shall be encouraged to give preferential treatment on credit evaluations to companies that receive an external audit voluntarily, even though they are not required to receive one.

□ **Disclosure via the Internet**

- The items of accounting information subject to disclosure shall be significantly expanded through such means as the Internet in order to enable investors and other external users to gain greater access to the financial status of companies and to impose stricter market discipline.

**Mitigating the Impact of New Standards on Companies**

□ **Temporary easing of credit criteria for corporate borrowers**

- Financial companies shall be encouraged to ease loan criteria for a period of one year for corporate borrowers that voluntarily take remedial actions to correct past accounting discrepancies, in order to mitigate the negative impacts that their voluntary actions may have on balance sheets, credit rating and access to credit from lenders.
- Financial companies shall also be encouraged to refrain from taking punitive actions against the corporate borrowers whose debt-to-equity ratio increases to above 200% due to the correction of past accounting discrepancies.



- With respect to classification of loans to companies that correct past accounting discrepancies, financial companies shall use their discretion to determine appropriate asset classification in light of the newly recognized losses.

### III. Measures to be Implemented during Second Half of 2001

#### □ **Punitive actions against interference of external auditing and other measures**

- The willful submission of falsified or misleading data to external auditors shall be deemed equivalent to making falsified financial reports, and companies found guilty of engaging in such acts shall be subject to administrative punishments including but not limited to requests for the discharge of responsible executives and restrictions on the issuance of securities for a certain period.

#### □ **Unified supervisory approach to certified public accountants**

- A unified organization will replace existing organizations and be responsible for administering the examinations of certified public accountants (CPA) and taking administrative actions against any misconduct by CPAs.

#### □ **Protecting shareholders and strengthening market discipline**

- Starting next year, minority shareholders will be able to initiate class-action suits against companies and accounting firms that have engaged in deceptive financial accounting and reporting in order to gain re-compensation for losses or damages incurred due to the misconduct. This new legal right for minority shareholders is expected to greatly enhance market discipline and provide a strong incentive for companies not to engage in deceptive accounting and reporting practices.

### IV. Audit Reviews in 2001



□ **Audit review based on most recent financial statements**

- Audit reviews will no longer rely on past or outdated financial statements, but will examine the most recent financial statements of companies in order to determine whether or not they have engaged in deceptive financial accounting and reporting practices.

□ **Focusing audit reviews on suspicious firms**

- The current system of randomly selecting companies subject to audit review will be replaced by a new system introduced by the FSS under which companies that are highly suspected of engaging in deceptive accounting practices will be targeted and selected for audit reviews.

## **Major Financial Issues from Mar. 29 to Apr. 4**

### **Detailed Guidelines to Promote Credit-based Lending Practices at Banks**

**I**n order to promote lending practices at banks based primarily on borrowers' credit, the FSS has provided detailed guidelines that outline minimum criteria for making loan decisions. Banks are required to establish and submit a schedule for meeting the detailed guidelines to the FSS, which will then regularly monitor banks' compliance with the new guidelines. The detailed guidelines are as follows.

#### **A. Continuous updates and improvements to credit evaluation model**

To enhance the accuracy and reliability of credit evaluation models, banks will be required to compile loan information and data related to credit evaluation by industry sector and periodically verify and upgrade their models if necessary.



### **B. Increase loans based on borrowers' credit rating**

Under the new guidelines, the basic principle of extending loans to companies based on their credit history and rating will be gradually instituted. Moreover, domestic banks will be encouraged to differentiate loan conditions applied to borrowers based on their credit ratings.

### **C. Signing of covenants with borrowers regarding financial structure**

In order to prevent additional bad or non-performing loans, banks will sign covenants with borrowers regarding the soundness and stability of their financial structure prior to initiating loans and periodically monitor compliance with the covenants.

### **D. Operation of an appropriate "trigger" system**

Banks will also be strongly encouraged to establish and operate a system of appropriate "triggers," which would allow them to review loans to borrowers that suffer a sudden or unexpected fall in credit, and determine methods to recover the loans extended to such borrowers. The "trigger" system would essentially serve as a contingency plan to deal with situations in which borrowers' ability to repay its obligations is weakened or compromised.

### **E. Enhanced reliability of corporate accounting data**

As creditors, banks help to ensure the accuracy and reliability of corporate accounting data by participating in the external auditor appointment committee and imposing strict penalties against any companies or accounting firms found to be engaging in "window dressing" accounting practices. Any firm that intentionally or due to gross negligence deviates from accounting rules more than one time shall be registered on the corporate credit information list maintained at the Korea Federation of Banks.



## FSS Introduces Simplified Bankruptcy Procedures

**T**o help accelerate the resolution procedures of ailing financial companies, the FSS introduced simplified bankruptcy procedures on April 1, 2001.

The new measures facilitate the swifter implementation of bankruptcy procedures for ailing financial companies without undergoing the liquidation procedures, and allow submission of the recommendation for a receiver to the court to be made by the KDIC in lieu of the FSC.

### **Bankruptcy Procedures for Ailing Financial Institutions**

Before (6 Steps)	After (4 Steps)
1) Revocation of authorization by the FSC	1) Suspension or revocation of business authorization by the FSC
2) Appointment of a liquidator and liquidation procedures by the FSC	
3) Application for bankruptcy to the court by the liquidator	2) Application for bankruptcy to the court by the FSC
4) FSC receives recommendation for receiver candidates by the KDIC	3) Recommendation for receiver candidates to the court by the KDIC
5) Recommendation for receiver candidates made to court by FSC	
6) Adjudication of bankruptcy and appointment of receiver by the court	4) Adjudication of bankruptcy and appointment of receiver by the court

However, in cases where assets exceed liabilities, or when the simplified bankruptcy procedures may negatively impact the financial consumers' interests, the previous rule that includes both liquidation and bankruptcy procedures will be applied.

Under the new bankruptcy system, early recovery of public funds will be made possible by shortening the time needed to liquidate a bankrupt firm by 4-6 months. In addition, required expenses to complete liquidation procedures are expected to be substantially reduced.



## Business Tie-ups at Financial Companies Increase in 2000

**F**ollowing the enactment of the “Regulation on Entrustment of Business between Financial Institutions” and the rapid growth of electronic finance, domestic financial companies dramatically increased their participation in cooperative business tie-ups, with the total number of such operational linkages in 2000 rising to 2,596 cases, up 1,609 cases from 1999.

By type of financial company, banks accounted for 29.7% of total business tie-ups, followed by insurance companies (29.5%), non-bank financial companies (21.3%), and securities companies (19.5%). Business linkages by banks and insurance companies were mainly related to electronic finance and agency business, respectively, while those by securities companies and non-banking financial companies were mainly related to payment settlement.

By type of business alliance, the highest rate of growth in business linkages was seen in electronic finance at 678%, followed by strategic alliances at 648%. The high growth rate in business tie-ups linked to electronic finance was attributable to the expansion of Internet banking, on-line securities trading, and insurance cybermalls. The growth in business tie-ups for strategic alliances was mainly due to increases in joint marketing and joint development of new products by financial companies.

Overall, electronic finance accounted for 23.7% of total business tie-ups, followed by payment settlement (22.1%) and agency business (19.7%) in 2000. By contrast, payment settlement accounted for 34.7% of all tie-ups in 1999, followed by agency business (29.4%), and asset management (11.2%).

## FSS Releases Analysis Results of Audit Opinions for Listed Companies

**T**he FSS released the results of an in-depth analysis of audit opinions for the financial statements of 1,081 companies that are listed on either the KSE or KOSDAQ and closed their books at the end of December 2000.

According to the results, the proportion of firms receiving an “unqualified” audit opinion - which indicates that an auditor reviewed the financial statements in accordance with auditing standards and without any limitation on audit scope, and that the auditor believes the financial statements were fairly presented in conformity with the Financial Accounting Standards - decreased to 93.4% in 2000, down 1.6 percentage points from 1999.

Among the 72 firms that failed to receive the “unqualified” audit opinion, a total of 39 firms received “qualified” opinions, which means that there are limitations on audit scope or identified departures from the Financial Accounting Standards that have material effects on the financial statements. Meanwhile, seven companies received “adverse” opinions, which indicates that identified departures from the Financial Accounting Standards have significant material effects on the financial statements, while 26 companies received a “disclaimer of opinions,” which indicates that there are limitations on audit scope that have significant material effects on the financial statements or a lack of independent data.

The total number of firms receiving “adverse” and “disclaimer” opinions in 2000 more than doubled from 1999. Moreover, the number of firms receiving audit opinions downgraded from “unqualified” increased to 41 firms in 2000, up from 18 firms in 1999.

### Distribution of Audit Opinions

(unit : %)

	Unqualified Opinion	Qualified Opinion	Adverse Opinion	Disclaimer of Opinion	Total
1999	1,026 (95.0)	40 (3.7)	1 (0.1)	13 (1.2)	1,080 (100)
2000	1,009 (93.4)	39 (3.6)	7 (0.6)	26 (2.4)	1,081 (100)



The rise in the number of firms that failed to receive an “unqualified” audit opinion was attributed to the following reasons.

First, the strengthening of standards for auditing and accounting procedures, including stricter asset classification criteria, since the financial crisis of 1997 contributed to the fall in “unqualified” audit opinion as it led to greater transparency of accounting information.

Secondly, the enhanced independence of external auditors laid the foundation for a more fair and strict audit process. External auditors benefited from introduction of an auditor appointment committee and mandatory three-year appointments, which allows them to audit the same company over the three-year period.

Thirdly, companies and accounting firms that previously engaged in “window dressing” accounting practices were subjected to stricter audit reviews and higher penalties. Accordingly, the market discipline to such companies has been strengthened by making them liable to damages than ever before and giving more rights to minority shareholders.



**(Appendix)**

**1. Major Financial Statistics**

(unit: point, percent, won)

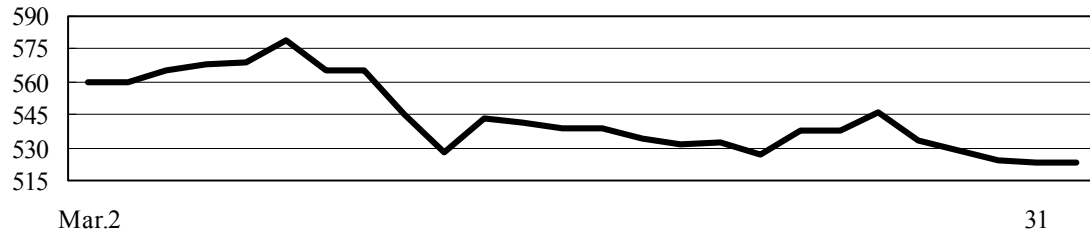
	Equity Indexes			Interest Rates				Exchange Rates	
	KOSPI Index	KOSPI 200 Index	KOSDAQ Index	Corp. Bond Yields (3 years)	Gov't Bond Yields (3 years)	Call Rate (1day)	CD Yields (91days)	Won/ USD	Won/ 100 JPY
Mar.2	559.44	69.84	71.99	6.82	5.55	4.99	5.67	1,262.5	1,071.28
3	-	-	-	6.81	5.55	5.04	5.67	1,271.0	1,066.99
5	565.38	70.76	74.32	6.82	5.58	5.06	5.66	1,275.5	1,067.81
6	568.15	71.13	73.52	6.94	5.83	5.05	5.67	1,264.0	1,064.87
7	568.64	71.12	75.35	7.13	6.04	4.97	5.68	1,274.0	1,065.22
8	579.28	72.47	78.00	7.37	6.30	5.01	5.69	1,275.0	1,061.62
9	565.76	70.55	76.56	7.17	5.99	4.87	5.68	1,269.5	1,060.86
10	-	-	-	7.17	5.99	5.05	5.68	1,271.0	1,062.71
12	545.05	67.89	72.33	7.24	6.09	5.00	5.68	1,278.5	1,060.12
13	527.97	65.82	68.57	7.23	6.09	4.97	5.68	1,277.0	1,061.95
14	543.28	67.69	72.04	7.02	5.74	4.97	5.68	1,276.0	1,062.01
15	541.83	67.57	71.24	6.96	5.57	4.99	5.67	1,286.0	1,065.45
16	538.67	67.1	71.38	7.02	5.61	4.98	5.67	1,291.0	1,053.28
17	-	-	-	7.02	5.6	5.02	5.67	1,294.0	1,051.18
19	534.33	66.51	71.33	7.06	5.64	4.98	5.67	1,299.0	1,051.40
20	531.59	66.12	71.35	7.07	5.63	5.00	5.67	1,294.0	1,053.57
21	532.59	66.26	71.27	7.17	5.71	4.97	5.68	1,302.0	1,058.54
22	527.05	65.47	70.64	7.29	5.85	5.06	5.69	1,316.0	1,063.00
23	537.97	67.01	70.61	7.21	5.76	4.96	5.69	1,309.0	1,064.66
24	-	-	-	7.21	5.76	4.88	5.69	1,305.0	1,062.18
26	545.98	68.04	72.77	7.14	5.68	5.04	5.69	1,311.0	1,062.83
27	532.90	66.25	71.86	7.17	5.72	5.01	5.69	1,308.0	1,066.45
28	528.79	65.77	70.58	7.31	5.88	4.97	5.70	1,304.0	1,067.10
29	523.80	65.18	69.14	7.51	6.12	4.96	5.70	1,318.0	1,070.24
30	523.22	65.16	68.43	7.69	6.31	4.89	5.70	1,328.0	1,065.38
31	-	-	-	7.69	6.31	4.94	5.70	1,335.0	1,056.17

Note : End of Period

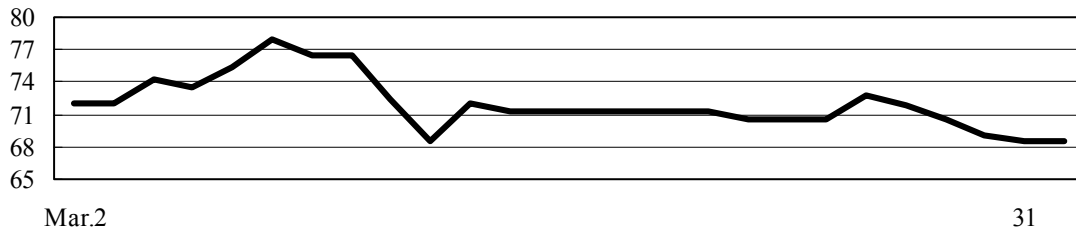


## 2. Daily Trends

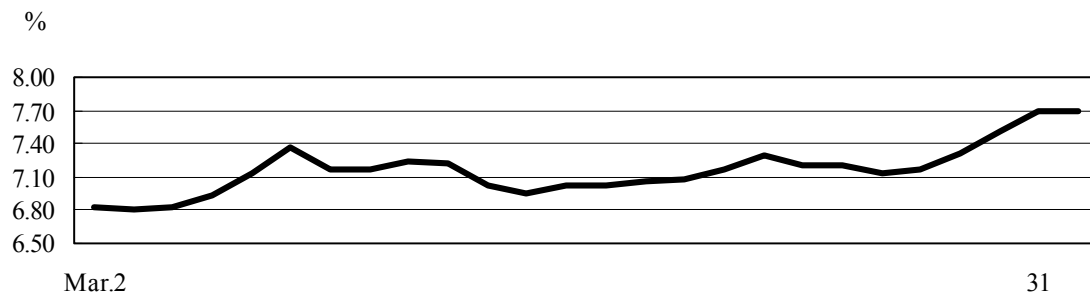
### 1) KOSPI



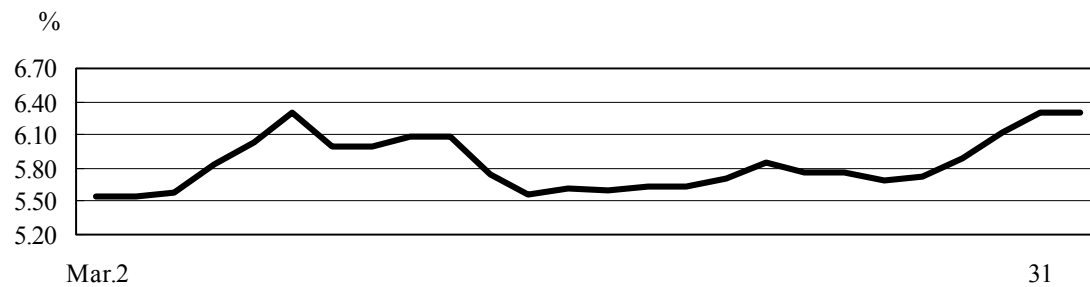
### 2) KOSDAQ Index



### 3) Yields on Corporate Bond (3 Years)

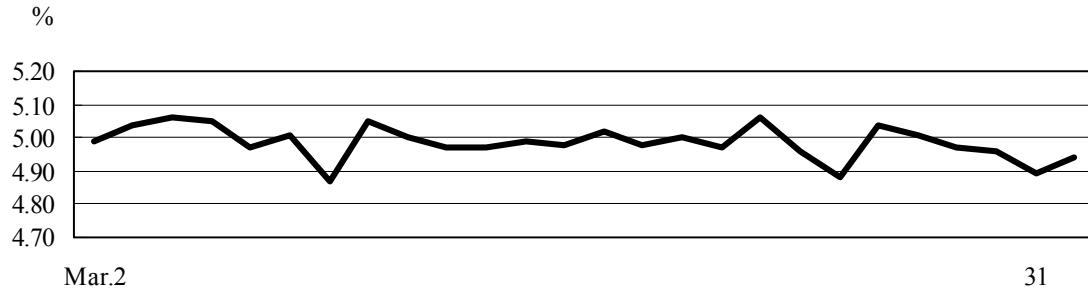


### 4) Yields on Government Bond (3 Years)

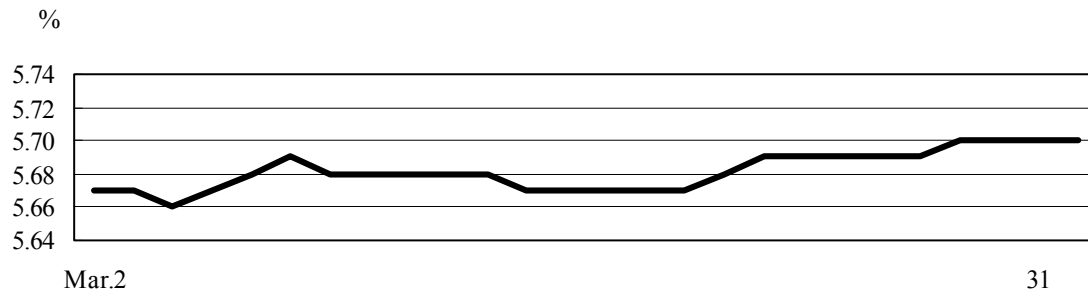




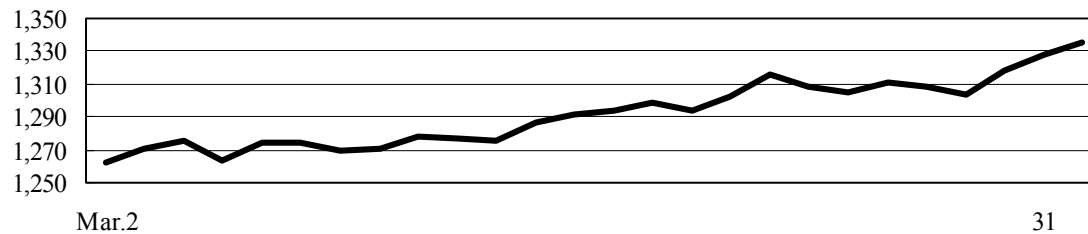
**5) Call Rate (1 Day)**



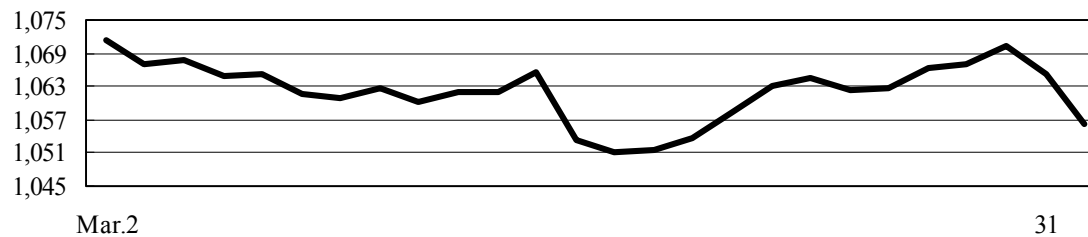
**6) Yields on CD (91 Days)**



**7) Won/US Dollar**



**8) Won/100 Japanese Yen**





Financial Supervisory Service

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**Main Office**

27, Yoido-dong, Youngdeungpo-gu, Seoul 150-743, Korea  
Tel: 82-2-3771-5114 Fax : 82-2-3771-5985  
Http://www.fss.or.kr

**Overseas Offices**

**New York**

14<sup>th</sup> floor, 780 Third Avenue New York, NY 10017 U.S.A  
Tel : 1-212-350-9388 Fax : 1-212-350-9392  
E-mail : newyork@fss.or.kr

**London**

3<sup>rd</sup>. Floor 1, Minster Court, Mincing Lane, London EC3R 7AA, U.K  
Tel : 44-207-621-8490 Fax: 44-207-929-1677  
E-mail : london@fss.or.kr

**\* Frankfurt Resident**

Messturm 28. OG. Friedrich-Ebert-Anlage 49, 60308 Frankfurt am Main, Germany  
Tel : 49-69-7434-8722 Fax: 49-69-7434-8729  
E-mail : frankfurt@fss.or.kr

**Tokyo**

Yurakucho Denki Bldg. South Kan 1051, 7-1, Yurakucho 1-Chome, Chiyoda-ku, Tokyo,  
Japan  
Tel : 81-3-5224-3737 Fax : 81-3-5224-3739  
E-mail : tokyo@fss.or.kr

**\* Hong Kong Resident**

Rm 1208-9, Alexandra House 20 Chater Road, Central, Hong Kong  
Tel : 852-2526-6508 Fax: 852-2868-5276  
E-mail : hongkong@fss.or.kr

**If you have any questions, suggestions, and/or comments, please feel free to contact the International Cooperation Office at (82-2) 3771-5975, fax (82-2) 3771-5985, or e-mail us at [soykim@fss.or.kr](mailto:soykim@fss.or.kr)**